

respect to the application lodged under subsection 88(9) of the Act (A30222) until 30 September 2003.

### **The Strategic Alliance Proposal and the Cooperation Agreement**

- 9.8. Section 45 of the Act prohibits the making of or the giving effect to contracts arrangements or understandings that have the purpose or effect of substantially lessening competition in a market or which contain an exclusionary provision.
- 9.9. The Applicants lodged applications A30220 and A90862 pursuant to subsection 88(1) of the Act for authorisation under that subsection to make and give effect to arrangements (the Strategic Alliance and the Cooperation Agreement respectively) that contain provisions that might be an exclusionary provision within the meaning of section 45 of the Act.
- 9.10. The Applicants lodged applications A30221 and A90863 pursuant to subsection 88(1) of the Act for authorisation under that subsection to make and give effect to arrangements (the Strategic Alliance and the Cooperation Agreement respectively) that might have the purpose or effect of substantially lessening competition within the meaning of section 45 of the Act.
- 9.11. An authorisation granted pursuant to subsection 88(1) provides protection from action by the Commission or any other party for potential breaches of section 45 of the Act (either arrangements containing an exclusionary provision or arrangements that have the purpose or effect of substantially lessening competition as appropriate).
- 9.12. Subsection 90(6) of the Act provides that the Commission shall not make a determination granting authorisation under subsection 88(1) in respect of a provision (not being an exclusionary provision) of proposed arrangements unless it is satisfied that in all the circumstances that the provision would result in a benefit to the public and that that benefit would outweigh the detriment to the public constituted by any lessening of competition that would result, or would be likely to result, from the making and giving effect to the proposed arrangements.
- 9.13. Subsection 90(7) of the Act provides that the Commission shall not make a determination granting authorisation under subsection 88(1) of the Act in respect of a provision (not being an exclusionary provision) of arrangements unless it is satisfied in all the circumstances that the provision has resulted, or is likely to result, in a benefit to the public and that that benefit outweighs or would outweigh the detriment to the public caused by any lessening of competition that has resulted, or is likely to result, from giving effect to the arrangements.
- 9.14. Subsection 90(8) of the Act provides that the Commission shall not make a determination granting authorisation under subsection 88(1) in respect of a provision of proposed arrangements that is or may be an exclusionary provision unless it is satisfied that in all the circumstances that the provision

would result, or would be likely to result, in such a benefit to the public that the proposed arrangements should be allowed to be made.

- 9.15. In relation to the Cooperation Agreement, the Commission notes that subsection 88(6) provides that an authorisation granted by the Commission in respect of an application lodged pursuant to subsection 88(1) of the Act has the effect as if it were “an authorisation in the same terms to every other person named or referred to in the application for the authorisation”. This is relevant to applications A90862 and A90863 as they relate to Air Pacific.

#### **The relevant test**

- 9.16. Whilst there is some variation in the language of the tests for authorisation set out in subsections 90(6), 90(7), 90(8) and 90(9), the Commission adopts the view taken by the Trade Practices Tribunal (now the Australian Competition Tribunal) that in practical application the tests are essentially the same.<sup>38</sup>
- 9.17. The Commission, however, notes and has applied the additional requirements set out at subsection 90(9A) in relation to application A30222. Subsection 90(9A) of the Act requires the Commission, in relation to applications for authorisation under subsection 88(9) of the Act, to regard a significant increase in the real value of exports or a significant substitute of domestic products for imported goods as being public benefits for the purposes of the test set out in subsection 90(9) of the Act. The Commission must also take into account all other relevant matters that relate to the international competitiveness of any Australian industry. The Commission notes that it would, in any event, take such public benefits into consideration in the assessment of any authorisation application if they are relevant.

#### **Common assessment**

- 9.18. The Commission has applied a common assessment of the Applications and considered each of the Applications within the same draft determination. The Commission has also considered each of the Applications within its final determination. This is consistent with the provisions of the Act and with the positions expressed by the Applicants.
- 9.19. Subsection 90A(13) provides that where the Commission is of the opinion that two or more applications for authorisations that are made by the same person involve the same or substantially similar issues, the Commission may treat the applications as if they constitute a single application and may prepare one draft determination in relation to the applications and hold one conference in relation to that draft determination.
- 9.20. The Applicants have also confirmed that “*no aspect of this conduct will be implemented independently*” and that the Commission should “*use the entirety of the supporting submissions in respect of the applications and any*”

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<sup>38</sup> *Re Media Council of Australia* (No.2)(1987) ATPR 40-774 at 48,419.

*future submissions...for the purposes of applying the respective tests for authorisation to each of the five applications”<sup>39</sup>.*

- 9.21. Where the Commission accepts that various arrangements are integral parts of a wider arrangement, it follows that the public benefits and anti-competitive detriment flowing from each of the arrangements may be considered as benefits and detriment flowing from the wider arrangement.
- 9.22. Having regard to the foregoing, the Commission is of the view that the arrangements proposed in the Applications involve substantially similar issues. The Commission further accepts the submission of the Applicants that the arrangements in relation to each of the Applications are integral parts of a wider arrangement. For these reasons, the Commission has applied a common assessment of the Applications (including a common assessment of the public benefits and anti-competitive detriments flowing from the Proposed Arrangements) and proposes to issue one determination.

#### **Joint venture**

- 9.23. Subsection 90(15) of the Act provides that where a party to a joint venture makes at the one time two or more applications for authorisations, being applications each of which deals with a matter relating to a joint venture, the Commission must make its determination in relation to each application at the same time.
- 9.24. In the Applications, the parties stated that the arrangements are part of a joint venture. The Commission has not formed a view as to whether or not the arrangements the subject of the Applications constitute a joint venture for the purposes of the Act. Nevertheless, as discussed above, the Commission intends to make one Determination in relation to each of the Applications.

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<sup>39</sup> Letter to the Commission, 18 February 2003.

## 10. Market definition

- 10.1. The first step in assessing the competitive effects and the public benefit/detriment of the conduct for which authorisation is sought is to consider the relevant market(s) in which that conduct occurs.

### Markets generally

- 10.2. Section 4E of the Act states that a market for goods or services includes other goods or services that are substitutable for, or otherwise competitive with, the first goods or services.<sup>40</sup> The courts have established that both demand and supply side substitution must be taken into account in determining the relevant market. QCMA<sup>41</sup> is often cited when seeking to explain how markets are defined:

*“A market is the area of close competition between firms or, putting it a little differently, the field of rivalry between them... Within the bounds of a market there is substitution between one product and another and between one source of supply and another, in response to changing prices. So a market is the field of actual and potential transactions between buyers and sellers amongst whom there can be strong substitution, at least in the long run, if given a sufficient price incentive... Whether such substitution is feasible or likely depends ultimately on customer attitudes, technology, distance and cost and price incentives.*

*It is the possibilities of such substitution which set the limits upon a firm’s ability to ‘give less and charge more’. Accordingly, in determining the outer boundaries of the market we ask a quite simple but fundamental question: If the firm were to ‘give less and charge more’ would there be, to put the matter colloquially, much of a reaction?”*

- 10.3. In establishing the market boundaries, the Commission seeks to include all those sources of closely substitutable products, to which consumers would turn in the event that the firm attempted to exercise market power. The Commission looks at both the demand and supply side of the market and defines up to four different dimensions:

- geographic market - which may be local, state, national or international depending on where trade occurs;

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<sup>40</sup> The Commission identifies the relevant market by determining the smallest area over which a profit maximising monopolist would impose a “small but significant and non-transitory increase in price” (SSNIP), or equivalent exercise of market power. By including all substitution possibilities, the process of market definition identifies all the sources of competition that effectively constrain the price and output decisions of the relevant entities. Market definition is not an end in itself but rather a tool of analysis. The market must be defined only to the extent necessary to determine the effect of the Proposed Arrangements on competition.

<sup>41</sup> *Re Queensland Co-op Milling Association Ltd & Defiance Holdings Ltd* (1976) ATPR 40-012.

- product market - based on whether products are close substitutes for one another;
  - functional market - defines at what level the conduct in question occurs, for example, retail or wholesale; and
  - temporal market - the period of time over which substitution possibilities may arise.
- 10.4. If market boundaries are too narrow so that actual or potential sources of competition are excluded, then the proposed conduct will appear to have greater anti-competitive effect than is actually the case. On the other hand, the market may be defined too widely to include products or geographic areas that are not close substitutes. In such circumstances the anti-competitive effects of the proposed conduct will appear to be weaker than they actually are.

### **The Commission's general view of air transport sector markets**

#### *Previously stated views of the Commission*

- 10.5. The Commission has previously expressed views on markets relevant to air transport in its Determinations A90565 (Qantas and BA) of 12 May 1995, A90649 and A90655 (Ansett Australia, Ansett International, Air NZ and Singapore Airlines) of 22 July 1998, A30202 (Qantas and BA) of 10 May 2000 and A90408 (IATA Passenger Agency Program) of 13 November 2002.
- 10.6. In these determinations the Commission generally concluded that there were three broad product dimensions in markets of relevance to air transport:
- passenger transport;
  - freight; and
  - ticket sales.

#### Passenger transport

- 10.7. The Commission has consistently stated that the most important dimensions of the passenger transport market are the geographic and product dimensions.
- Geographic market
- 10.8. The Commission has previously distinguished between the domestic and international markets mainly on the basis of the different regulatory environments.
- Domestic
- 10.9. An important element of the regulatory distinction is cabotage policy which restricts the carriage of passengers between points in Australia to domestic airlines. Government specified ownership restrictions effectively prevent

foreign international carriers from operating on Australian domestic routes. Foreign persons, including foreign airlines, are allowed to have up to 100 per cent equity in an Australian domestic airline, unless this is contrary to the public interest. While a foreign airline is prevented under cabotage from carrying domestic passengers in Australia, it can operate a wholly owned subsidiary in the domestic market.

- 10.10. The Commission has previously noted that, while foreign carriers were prevented from operating in the Australian domestic market, they could have a presence through code sharing, with the Government allowing foreign carriers to code share to all points in Australia on Australian domestic airlines. This policy only relates to international passengers continuing their international voyages beyond their point of entry into Australia. However it does result in domestic flights carrying a mixture of international travelling passengers and domestic passengers. It also encourages linkages between international carriers and domestic carriers. This means that alliances between Australian and foreign carriers on international routes can have an impact on the performance of the Australian domestic market.
- 10.11. Following the failure of Ansett in September 2001 the Commonwealth Government temporarily relaxed cabotage policy as a means of achieving greater balance between supply and demand on trunk routes. United, for example, was allowed to utilise surplus capacity to carry domestic passengers between Sydney and Melbourne.

- International

- 10.12. When examining international air transport passenger markets, the Commission has consistently stated that, after taking into account opportunities for indirect travel, a regional approach to market definition is generally the most appropriate. However, this does not preclude the Commission from adopting a different market definition including a point-to-point market, depending on the circumstances of the conduct at issue.

- Product market

- 10.13. In Determination A30202, the Commission stated that it cannot be assumed that a single air transport market exists for both economy and premium class passengers. In stating this view the Commission referred to the differences in demand characteristics and service requirements of premium class and economy class passengers and the extent to which substitute services that are acceptable to premium class passengers can be provided by airlines in competitive markets. The Commission also stated that it considered that, in the premium class cabin, the high proportion of passengers travelling under corporate contracts and within loyalty programs would effectively lock those passengers into specific airlines and make it difficult for other airlines to enter that market.

### Freight

- 10.14. In A30202 the Commission reaffirmed its previously stated views on air freight.
- Geographic market
- 10.15. The Commission considered that the regional market approach used for passengers was also appropriate for freight. In forming this view, the Commission noted that the primary concerns of shippers in relation to cargo are that it arrives on time and in good condition. This gave greater flexibility to cargo carriers and made indirect routings a very viable alternative.
- Product market
- 10.16. The Commission revisited whether there should be separate markets for time critical and non-time critical freight. This issue was seen as related to geographic market definition because forwarders of time critical freight may prefer direct routes.
- 10.17. The Commission acknowledged that poorly developed or inefficient transport points could make indirect routings unviable, especially for perishable goods. However, it was considered that sufficient adequate transit points were available within each region to provide indirect route alternatives.
- 10.18. Different types of freight were therefore regarded as representing different market segments rather than different types of markets.

### Sale of air travel

- 10.19. While the Commission has generally identified the ticket sales market as one of the markets relevant to the air transport of passengers, in A90408 it recognised that this market should embrace not only those organisations able to sell tickets directly to the public (airlines and IATA accredited agents), but also licensed agents which are not IATA accredited.
- Geographic market
- 10.20. The Commission believes that the geographic market for the sale of air travel (in both international and domestic trades to consumers located in Australia) has traditionally tended to be the whole of Australia, but not outside of Australia.
- 10.21. However, in A90408 the Commission recognised that, with the development of internet web sales sites by both agents and airlines, the geographic dimension of the air travel market boundary is becoming increasingly blurred. Visitors to Australia, for example, can book internal travel in Australia in advance over the internet to access heavily discounted domestic fares. Similarly, industry portals being developed (such as Zuji) are accessible by consumers from any country and provide an ability to purchase travel across a wide range of airlines and international and domestic routes.

- Product market

- 10.22. In A90408 the Commission reaffirmed its belief that the product market in ticket sales includes tickets sold directly by airlines to travellers as well as those sold through indirect channels (for example, travel agents).
- 10.23. The Commission considered that airlines are active retailers in both the domestic and international travel markets and are increasingly promoting sales of their own products both through internet sales and through aggressive press advertising. The Commission expressed the view that tickets sold by airlines are an important part of the airline travel product market.
- 10.24. As indicated above the Commission has previously suggested that it cannot be assumed that a single market exists for both economy and premium class passenger transport. A corollary of this view is that there could similarly be separate markets for the sale of air travel to economy class and business class passengers. Certainly there are agencies which specialise in corporate travel and comments have been made to the Commission that airlines actively pursue such customers and corporate accounts because of the higher revenue they generate and the repeat business they bring.

- Functional market

- 10.25. The Commission is not aware of any changes in the distribution chain for airline tickets. In the absence of comments from the Applicant and submitters, the Commission will therefore assess the application on the basis that consumers can purchase tickets from any segment of the distribution system, including retail travel agents, airlines and package tour operators (wholesalers). The Commission continues to see consolidators as an integral part of this distribution system.
- 10.26. It is noted that airlines fill the role of wholesalers to the travel agent industry for air travel as well as retailing air travel in their own right.

- Market shares

- 10.27. In A90408 the Commission indicated that, as at 2002, airlines had around 20 per cent of the retail market for international fares in Australia and travel agents had market share of around 80 per cent. The domestic air travel distribution market was noted to be structured differently to the international travel market, with more emphasis on direct sales by airlines through call centres and web sites. Industry estimates suggested that in Australia about 50 per cent of domestic air travel sales are made directly through airlines and 50 per cent through agents.

*Market definition comments made by the Applicants*

Geographic

- 10.28. The Applicants have stated in their supporting submission that Australia and New Zealand should be considered as a single Australasian market for the



purposes of the Applications for both passenger air services and freight services.

- 10.29. The Applicants stated that the primary markets in which the competitive impact of the Proposed Arrangements needs to be assessed are those within the JAO Network, being the separate markets for passenger services and freight in Australasia (within each of and between Australia and New Zealand) and between Australia and North America, as well as the market for travel distribution services.
- 10.30. The Applicants considered that the primary area of Australian competition law significance occurs in respect of the trans-Tasman segment of Australasian passenger air services and freight markets.
- 10.31. To the extent that coordination between the Applicants may also occur outside the JAO Network, the Applicants also nominated as relevant the following markets where they might offer services:
- between Australia and North Asia;
  - between Australia and South-East Asia;
  - between Australia and Asia-Pacific destinations;
  - between Australia and Europe;
  - between Australia and India /Middle East;
  - between Australia and South America; and
  - between Australia and Africa.
- 10.32. In advocating an Australasian market the Applicants cited a view stated by the Commission in A30202 (Qantas and BA) that, as long as foreign owned international carriers are precluded by cabotage policy from operating in domestic Australia, it would be difficult for the Commission to form any conclusion other than that the domestic market is distinct from the international market.
- 10.33. The Applicants' logic was that, because under the Single Aviation Market ("SAM") arrangement agreed between the Governments of Australia and New Zealand, New Zealand based carriers have the right to fly domestically in Australia and Australian majority owned carriers have the right to fly domestically in New Zealand, and the grounds for the distinction made by the Commission in A30202 does not apply here.
- 10.34. The Applicants also argued that the cost of expanding from one of the Australasian market sectors to the others is marginal and that there will be a natural propensity on commercial grounds to seek to enter, over time, the main trunk routes within each country and the principal trans-Tasman routes.

- 10.35. The Applicants also pointed to statements made by the Commission in A30202 to the effect that the distinction between international markets was not as clear cut as it was five years earlier because of code sharing by international carriers on domestic sectors in Australia and because of the way that alliances between Australian carriers and foreign carriers can impact on Australian domestic segments and on the ability of a wholly owned subsidiary of a foreign carrier to operate within Australia.
- 10.36. NECG also submitted, on commercial reality grounds, that there is a single market for New Zealand domestic, Australian domestic and trans-Tasman services, but says alternatively there are three separate markets.

#### Product

- 10.37. The Applicants considered that there is a single product market for airline passengers. This product market embraces passengers with different reasons for travel. It was suggested that travellers demonstrate a range of demand characteristics relating to time sensitivity, flexibility in regard to conditions, complexity of itinerary and product quality. The Applicants submitted that customers select the fare type that is most appropriate to their needs at the time.
- 10.38. The Applicants stated that airlines offer an array of fare types to maximize yield and this is done in a flexible and variable way, responding to demand and competition. The Applicants submitted that tickets with special fare conditions are generally discounted because they help an airline manage inventory and are not targeted at any one reason for travel.
- 10.39. The Applicants pointed to analysis done by NECG which it argued demonstrated that even if there are some customers who are not willing to substitute fare types, the cross-section of customers who are willing to substitute is significant enough to prevent a price increase by a hypothetical monopolist. Reference was made to a paper prepared for the United Kingdom Office of Fair Trading and a case in the United States in support of the thesis that any captive group of customers must be substantial before being treated as a separate market.
- 10.40. It was further claimed that large numbers of business travellers in Australia fly in economy class particularly on short haul services and that Virgin Blue is strongly contesting corporate accounts.

#### *Market definition suggested in submissions*

##### Virgin Blue

- 10.41. Virgin Blue considered that the relevant markets for analysing the Proposed Arrangements are domestic New Zealand air services, domestic Australian air services, Tasman air services, Asia Pacific air services and potentially South Pacific air services. Virgin Blue endorsed the Frontier Economics view that passenger and freight services are most usefully incorporated into one market definition.

- 10.42. Frontier Economics, in rejecting a single Australasian market for disaggregated domestic markets and a trans-Tasman market, commented that interlining across national boundaries is not a factor which should require the definition of an Australasian market. It noted that airlines such as Qantas, Air NZ and Virgin Blue have survived for a long time by specializing in parts of the region.
- 10.43. In suggesting an airline services market which incorporates the carriage of both freight and passengers Frontier Economics noted that most cargo is carried in the “belly holds” of passenger aircraft (as against in dedicated freighters) and that there is a synergy between freight and passenger carriage. It suggested further that when an airline decides to increase capacity, it does so on the basis of total revenue expectations regardless of whether it is sourced from passengers or freight.

### **Submissions on market definition provided since the Commission’s Draft Determination**

#### *The Applicants*

- 10.44. The Applicants submitted that evidence provided does not support the conclusions in the Draft Determination that:
- there is not a single Australasian market;
  - Australia-Fiji constitutes a separate market in and of itself; and
  - there may be separate product markets based on whether travellers are travelling for the purpose of leisure or business.
- 10.45. The Applicants submitted that, even if historically it was possible to consider leisure and business travellers separately, this has become impossible with the entry of Virgin Blue and the commoditisation of the market.
- 10.46. The Applicants submitted that, in some instances, the Commission’s conclusions appear inconsistent.

#### *Gullivers Pacific Group*

- 10.47. GPG submitted that it supports the Commission’s view of market definition as expressed in its Draft Determination, particularly in relation to the sale of air travel.
- 10.48. GPG submitted that it does not agree with the Applicants’ view that fifth freedom carriers will act as a competitive constraint on the Applicants under the Proposed Arrangements. GPG submitted that the Proposed Arrangements will therefore lead to the provision of less efficient airline services, fewer services, higher cost operations and higher consumer prices.
- 10.49. GPG submitted that SAM agreements are limiting competition on the trans-Tasman and are concentrating market power to the two incumbents.

- 10.50. GPG submitted that trans-Tasman routes are not natural monopolies exhibiting powerful scale monopolies.

**The Commission's view on market definition**

- 10.51. The Commission has considered submissions put to it in relation to market definition. The Commission's view on market definition remains the same as that expressed in its Draft Determination. This view is outlined below.

*Passenger transport*

Geographic

- 10.52. While the characteristics of the SAM arrangements between the Governments of Australia and New Zealand do allow a level of reciprocity of access to the domestic markets of each country by the carriers of the other, this does not seem to the Commission to provide a compelling reason to conclude that domestic markets should be subsumed under a larger regional market.
- 10.53. The regulatory features of the Australian domestic market which distinguish it from international markets would seem the same (including the influence of the SAM between Australia and New Zealand) regardless of the alliance being considered.
- 10.54. That aside, the nature of the SAM is such that reciprocity is not automatic. In terms of access to the trans-Tasman and the New Zealand domestic markets an important issue is that access is restricted to majority Australian owned airlines, even though the wholly owned subsidiaries of foreign airlines are allowed to participate in the Australian domestic market. Virgin Blue was effectively prevented from operating on trans-Tasman routes, or any other international services, or New Zealand domestic services until the acquisition of equity in the airline by Patrick Corporation.
- 10.55. The Applicants' claim that there is a natural commercial tendency for airlines to operate across the whole of the Australasian region does not seem borne out by history. Qantas has taken a long time to enter the New Zealand domestic market. Air NZ has never entered the Australian domestic market and Ansett entered neither the trans-Tasman nor New Zealand domestic markets in any substantial form.
- 10.56. There are also regional airlines in both countries, such as Origin Pacific and Rex, which provide important feeder services and are specialists within the domestic market. These airlines appear unlikely to enter other sectors under the SAM.
- 10.57. In their joint submission of 14 September 1999, made in support of their application for authorisation of the RJSA between Qantas and BA, Qantas stated at paragraph 8.16 on page 53:

*"Accordingly, this submission does not consider issues associated with the competitiveness of the domestic air services market. Nevertheless, the applicants agree with the*

*Commission's conclusion in the SQ/AN/NZ Determination [A90649 and A90655] that domestic air services are a separate market from international air services, and that the market for domestic air services comprises the whole of Australia."*

- 10.58. Both the Applicants and NECG have stated that the choice of market definition is not critical to assessment of the authorisation applications. The Applicants stated that, despite their view that the broader Australasian geographic market is correct, the Proposed Arrangements qualify for authorisation even if narrower markets are adopted. NECG stated that overall, their views as to the relevant markets do not significantly impact on their evaluation of net benefits of the Proposed Arrangements.
- 10.59. While the Commission has consistently stated that a regional approach to market definition is the most appropriate approach for many international air services, it is not universally applicable. Market definition will be conducted on a case by case basis. Under these circumstances, the Commission intends to assess the Qantas and Air NZ Applications on the basis that Australia-New Zealand is a relevant separate international market. For similar reasons the Commission also regards Australia-Fiji as a relevant separate international market.
- 10.60. Given the availability of indirect services through Canada, the Commission will examine the Proposed Arrangements as they relate to services offered between Australia and the United States as part of the North America region.

#### Product

- 10.61. The Commission notes the views of the Applicants that there is a single product market and that airlines offer a range of fares with different characteristics which passengers are free to choose from depending on their needs. The Applicants suggested that the reason for travel should not be a basis for recognizing separate markets.
- 10.62. In A30202 the Commission explored the possibility that there could be separate markets for economy and premium class passengers. After further consideration, the Commission has formed that view that, if there are different product markets for passengers, it is more likely to be based on whether travellers are travelling for the purpose of leisure or business, than on the class of ticket purchased.
- 10.63. The Applicants submitted that there is a single product market and argued against the Commission's previously stated view of a fare-class based distinction between travellers on the basis that many business travellers fly economy class on Virgin Blue. The fact that business travellers fly economy on Virgin Blue is not inconsistent with the Commission's latest position that there can be different demand elasticities for different types of travellers. Demand by a business traveller is relatively price inelastic compared, for example, with demand by leisure travellers.

- 10.64. It may be argued that airlines have already recognised the distinction between leisure travellers and business travellers in the way that fares and conditions of travel are structured. The typical business traveller requires flexibility, short stay, and short lead booking times. Premium class satisfies all these requirements, but at a relatively fixed price. At the economy class level, low fares are associated with conditions such as advance purchase, no flexibility and no refunds. These conditions make those fares unattractive to the business traveller. Even if the business traveller can plan a trip in advance to meet these requirements, minimum stopover conditions, in many cases, will rule out that fare.
- 10.65. Table 30 in the NECG Report shows that Qantas discount return economy class fares on the Sydney-Auckland route range from \$509 to \$999 depending on when the ticket is purchased and the length of stopover. However all these fares include a compulsory Sunday stopover. If the business traveller wants to go to a Wednesday meeting in Auckland, the only option is to pay \$1,379 for a fully flexible ticket. This same type of fare structure operates across most international and domestic routes and on Virgin Blue services (albeit at possibly lower prices).
- 10.66. The distinction between business travellers and leisure travellers is also becoming evident in the way that airlines structure their operations. Qantas has recognised routes where leisure travellers predominate and has tailored its product to meet those markets. Australian Airlines is a single class product designed to meet the needs of inbound international leisure travellers. On domestic routes where leisure travellers predominate, such as the Gold Coast, Qantas also offers a single class product.
- 10.67. Air NZ has similarly adjusted its operations to recognise the business traveller with the introduction of Express Class. A press release of 15 October 2002 announcing the launch of Express Class stated:
- “Specifically the new system of one-way pricing allows more pricing flexibility than ever before as New Zealand’s business travellers can now mix and match fare types and get a ‘combo’ return fare to best match their needs at the start or end of a work trip as the demands of business can be unpredictable.”*
- 10.68. The studies cited by the Applicants<sup>42</sup> that illustrate that captive customers need to be substantial in size before being treated as separate markets actually seem to suggest that, if the percentage of business travellers was large enough, there could be justification for treating them as a separate market. In this respect the Commission notes that Table 37 of the NECG Report showed that business travellers comprise 37 per cent of all travellers on the major Auckland-Sydney route and 35 per cent on the Auckland-Melbourne route.

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<sup>42</sup> Paragraph 5.19 of Qantas and Air NZ submission of 9 December 2002

- 10.69. In terms of their contribution to airlines' revenue, business travellers could certainly be regarded as substantial in size. The general manager of United Airlines in Australia, in emphasising the importance of business travellers to the airline, estimated<sup>43</sup> that about ten per cent of its passengers account for 50 per cent of its revenue. New low cost services being introduced across the Tasman by Qantas and Air NZ both feature a two class product.
- 10.70. As a result of the above consideration, and taking into account factors raised in A30202 such as the effect of loyalty programs, corporate travel contracts and the existence of a highly specialised business travel agency industry, the Commission is increasingly of the view that there are separate markets for business and leisure travellers.

#### *Freight*

- 10.71. The Commission is not persuaded by the argument of Virgin Blue that there should be a single market for freight and passengers. While it is true that the majority of air cargo is carried in the holds of passenger aircraft, the aircraft selection practices of airlines and differing characteristics of the carried product (freight versus passenger) are indicative of separate markets.
- 10.72. It is the Commission's understanding that airlines make decisions on where to operate services and the type of aircraft to be operated based on passenger traffic considerations. While cargo revenue is welcomed, it is supplementary. This is most evident in the stated intention of Air NZ<sup>44</sup> to replace wide-body B767 capacity on the Tasman with narrow body A320 capacity with or without the Proposed Arrangements. Given the severe limitations of narrow-body aircraft as movers of freight (relative to wide-body aircraft) Air NZ's decision is obviously a decision made from the perspective of passenger traffic.
- 10.73. A corollary of this is that the decision to move to narrow-bodied aircraft is unlikely to have an air transport supply side impact on passengers but it certainly will have one for freight, especially in the trans-Tasman market. In other markets, depending on the circumstances, there may be economies of joint production in respect of the provision of passenger and freight services.

#### *Sale of air travel*

- 10.74. No information has been provided which suggests the Commission should depart from its view of the sale of air travel market as expressed in A90408.

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<sup>43</sup> Stuart Washington, "Defying gravity", Business Review Weekly, 25 July 2003.

<sup>44</sup> Page 161 of the NECG Report

## **11. The future without the Proposed Arrangements – the Counterfactual**

### **The “future with-and-without test”**

- 11.1. The Commission’s evaluation of the Proposed Arrangements is made in accordance with the statutory tests outlined in Part 9 of this Determination. As required by the tests, it is necessary for the Commission to assess and weigh the likely public benefits and detriment flowing from the Proposed Arrangements.
- 11.2. In doing so, the Commission uses the “future with-and-without test” established by the Australian Competition Tribunal to identify and measure the public benefit and anti-competitive detriment generated by the arrangements proposed to be authorised.<sup>45</sup>
- 11.3. Under this test, the Commission compares the public benefit and anti-competitive detriment generated by the arrangements in the future if the authorisation is granted with those generated if the authorisation is not granted.
- 11.4. An important element of this comparison is the determination of the “future with” the Proposed Arrangements and the “future without” the Proposed Arrangements. The future without the Proposed Arrangements is also referred to as the “counterfactual”.
- 11.5. The counterfactual provides the benchmark against which anti-competitive detriment and public benefits are assessed. For example, in examining prices to consumers associated with specific conduct, the Commission would expect to compare estimates of prices under the Proposed Arrangements with prices under the counterfactual.
- 11.6. It can be seen that the state of the market selected as the counterfactual can be important in terms of determining net public benefit. In the majority of authorisation applications coming before the Commission, the counterfactual is determined to be the status quo. However, this need not necessarily be the case and depends on likely or imminent developments in the markets concerned.

### **The counterfactual claimed by the Applicants**

#### *Qantas and Air NZ*

- 11.7. The Applicants have proposed a counterfactual described as involving a more aggressive level of competition and increases in capacity across their relevant Australasian networks.

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<sup>45</sup> See, for example, *Re Australasian Performing Rights Association* (1999) ATPR ¶41-701.



- 11.8. This initiative has its origins in Qantas' stated intention to participate in the New Zealand domestic market (which it sees as part of its home base of operations) and to increase capacity on routes where it currently competes with Air NZ, that is, on domestic New Zealand trunk routes, the trans-Tasman route and the Auckland-Los Angeles route.
- 11.9. The rationale put forward for increasing capacity is that each of the domestic New Zealand and Australian markets can only sustain one FSA and FSAs compete by increasing capacity. This claim appears to be based on assertion rather than the product of analysis or research. It is stated that sectors operated by network carriers are interdependent with changes in capacity or load factors on one sector necessarily affecting the profitability of other network sectors.
- 11.10. Consistent with this thesis, it is postulated that Air NZ would respond to Qantas' increases in capacity under the counterfactual by making corresponding increases in capacity. It is claimed that a failure by Air NZ to respond to the Qantas capacity increases would have a detrimental effect on the viability and profitability of Air NZ's entire network.
- 11.11. It is suggested by the Applicants that a war of capacity would lead to a contraction of the Air NZ route network and under certain circumstances could lead to its demise.
- 11.12. NECG has assumed a position of strong competition on capacity between Qantas and Air NZ for the purposes of the counterfactual used in its modelling analysis. The specific capacities and schedules on city pairs used in the Model were supplied separately and confidentially to NECG by each of the Applicants.

**Table 11.1. Postulated changes in trans-Tasman air passenger services (per week/each way)\***

	<b>Air NZ seats</b>	<b>Qantas seats</b>	<b>Total seats</b>
<i>Currently</i>	41,592	46,266	87,858
<i>The future without the Proposed Arrangements</i>			
Year 1	#	#	#
Year 2	#	#	#
Year 3	#	#	#
<i>The future with the Proposed Arrangements</i>			
Year 1	40,516	48,976	89,492
Year 2	41,896	50,168	92,064
Year 3	41,180	52,214	93,394

\*As advised by Qantas and Air NZ

# This information was provided to the Commission by the Applicants on a confidential basis

- 11.13. The Applicants claimed that in the counterfactual scenario one airline will be forced to accept a role secondary to the other. NECG has expressed the view that Air NZ is more likely to contract than Qantas given the relative strength of the two parties. NECG sought a further counterfactual of schedules that Air NZ would be most likely to implement if it could no longer sustain its full

service operations. This information was again provided on a confidential basis.

- 11.14. While the Commission is not able to reveal confidential information on schedules the Applicants claim they would operate in the future without the Proposed Arrangements, it is able to show how the trans-Tasman market would appear in summary under the Proposed Arrangements relative to current operations by the two airlines – see Table 11.1 above.

*Other airlines*

- 11.15. Table 11.2 below shows assumptions made by the Applicants about VBA behaviour with and without the Proposed Arrangements. NECG has assumed that a VBA would be entering the trans-Tasman market under both scenarios. The VBA would enter the Tasman route with five aircraft with the Proposed Arrangements and four aircraft without them. A lower level of entry has been assumed in the absence of the Proposed Arrangements on the basis that total market capacity is higher leaving less space for a new entrant.

**Table 11.2 VBA presence in Trans Tasman air passenger services (per week, each way)\***

<b>VBA presence (trans-Tasman)</b>		
	Seats	Flights
<i>Currently</i>	-	-
<i>The future without the Proposed Arrangements</i>		
Year 1	-	-
Year 2	6,120	31
Year 3	6,120	31
<i>The future with the Proposed Arrangements</i>		
Year 1	7,380	41
Year 2	11,340	63
Year 3	11,340	63

\* As assumed by the Applicants

*Other scenarios*

- 11.16. The Applicants examined and discarded four alternative scenarios that might occur if the Proposed Arrangements do not proceed. These were described as the status quo, the cosy duopoly, an alternative alliance and equity injections.
- 11.17. The *status quo* would see current aircraft, schedules and frequencies maintained. The Applicants rejected the status quo on the grounds that it is not plausible to argue that Qantas would continue to operate on New Zealand domestic trunk routes without increasing capacity. Qantas has stated an intention to remain in the market and expand.
- 11.18. The *cosy duopoly* would see Qantas and Air NZ cease competing aggressively with price and output trending towards the duopoly level. This scenario is rejected on the grounds that liberalised aviation markets do not evidence cosy duopoly characteristics given that they involve high fixed costs, low marginal costs and perishable products. These are features that

result in strong competition. The Applicants argued that, given their view of low barriers to entry and no barriers to expansion for an Australasian airline, tacit agreement to raise prices would drive down demand and encourage entry or expansion by a VBA.

- 11.19. Regarding suggestions of an *alternative alliance*, the Applicants submitted that there are no other airlines that have indicated a willingness to enter into an alliance which can resolve the strategic imperatives for Air NZ which include avoiding a wasteful war of attrition with Qantas and a contraction of Air NZ's international route network.
- 11.20. The Applicants submitted that *equity injections* would merely prolong the war of attrition, do not cure the underlying problem and would be implausible and irrational.

**Interested party views on the counterfactual (prior to the Draft Determination)**

*Gullivers Pacific Group*

- 11.21. GPG, which is involved in travel distribution, submitted that claims made by the Applicants and NECG that Air NZ cannot win a war of attrition under the counterfactual cannot be accepted at face value. In forming this view, GPG cited the strength and form of Air NZ's domestic operations, brand loyalty, its role in providing aviation support services in New Zealand, its recent re-equipment of its fleet and the introduction of Express Class with reduced costs.
- 11.22. GPG also made reference to the strength of Air NZ's direct services to Japan where it is the only direct carrier and the withdrawal of United from the New Zealand-North America route. It is suggested that Qantas has had numerous opportunities over the previous thirty years to enter the New Zealand market but has failed to do so because of the strength of Air NZ in its local market.

*Professor Tim Hazledine*

- 11.23. Professor Hazledine noted that an innocuous "future with" the Proposed Arrangements (as submitted by the Applicants) can be made to look very good if it is compared to an unattractive counterfactual. He stated that the NECG results relied heavily on a deeply unattractive counterfactual that has Air NZ and Qantas engaging in ruinously vicious competition (through large and probably predatory expansion of capacity by Qantas) if they are not permitted to form a "cartel".

*Importers Institute of New Zealand*

- 11.24. IINZ claimed that the Applicants have used a device of comparing current capacity against a worst-case scenario (the counterfactual) based on confidential data. The IINZ stated that the airlines have, in fact, put up a "straw man" against which their preferred scenario looks that much better. An alternative scenario is raised in the form of the New Zealand Government selling Air NZ.

*Department of Industry, Tourism and Resources*

- 11.25. DITR noted that the Applicants' submission is based on the premise that without the Proposed Arrangements Air NZ would be likely to exit the market under intense competition from Qantas and possibly low cost carriers. While it regarded this as a worst case scenario, DITR described it as a possibility in the current international aviation environment.

*Origin Pacific Airways Ltd*

- 11.26. Origin Pacific, a competitor of Air NZ on regional routes in New Zealand, expressed doubt about the counterfactual put forward by the Applicants saying a more likely outcome is the airlines co-existing in "tacit live and let live environment" rather than a "cosy duopoly". Origin Pacific suggested that Qantas would not have an easy path given the statement in the NECG Report at page 11 that Air NZ "*now has a strong and committed shareholder in the New Zealand Government. It also has the advantage of a loyal customer base, a deep knowledge of and presence in domestic New Zealand, and greater connectivity, particularly at Auckland, than could be readily obtained by a competitor*". Origin Pacific also noted that Qantas has shown little interest in the New Zealand market until a time when Air NZ is perceived to be vulnerable.

*Queensland Government*

- 11.27. The Qld Govt claimed that the Proposed Arrangements are crucial to the future viability and operation of Air NZ.

*Sydney Airport Corporation Ltd*

- 11.28. SACL commented that while the collapse of Air NZ may not be the only feasible outcome absent the Proposed Arrangements, it is possible in the current uncertain world aviation environment.

*Virgin Blue*

- 11.29. Virgin Blue considered that the counterfactual scenario advanced by Qantas and Air NZ is implausible and unlikely. The likely strategies of the three relevant airlines absent the Proposed Arrangements, as submitted by Virgin Blue, are described below.
- 11.30. Air NZ would consolidate its presence on domestic and trans-Tasman routes and continue to operate other important and profitable international routes. The New Zealand Government has demonstrated its strong political/nationalistic interest in seeing the continuation of the brand by its decision to invest in the carrier in 2002. Virgin Blue submitted that, absent the Proposed Arrangements, the Air NZ brand would be used to maximise returns to shareholders. Air NZ may have to vigorously challenge attempts by Qantas to capture sales on domestic routes. Air NZ has strong brand loyalty with residents and first mover advantages. Although Qantas and Virgin Blue may make route gains at the expense of Air NZ, it is highly unlikely that Air NZ would withdraw from domestic routes within the foreseeable future.

- 11.31. Qantas is likely to maintain something like its current presence on trans-Tasman routes. Because it is likely to suffer cash losses in the New Zealand domestic market for some time, it is likely to gradually expand its activities in this market rather than engage in an extreme and inefficient war of attrition. The advent of Virgin Blue on domestic New Zealand routes is likely to reinforce Qantas' determination to stay on those routes.
- 11.32. Virgin Blue submitted that it is planning to enter both key trans-Tasman and domestic New Zealand routes where it believes there is substantial scope for a low fare airline.
- 11.33. Virgin Blue suggested that the Commission should have some scepticism over the counterfactual claimed by the Applicants which is entirely within their control and perfectly suits their argument on the merits of the Proposed Arrangements. Virgin Blue submitted that all cost savings are attributed to the avoidance of an inefficient capacity war as opposed to any stand-alone cost savings.
- 11.34. Virgin Blue submitted that the postulated five year war of attrition is not plausible as it would require the parties to incur probable large losses with highly speculative uncertain outcomes. Virgin Blue said that it would be irrational for Air NZ to engage in such conduct given that the Applicants have stated that Air NZ *"is not well placed to win the battle nor does it have the financial resources to credibly signal to Qantas that it can successfully engage in a long term fight for market share."*
- 11.35. Virgin Blue suggested the counterfactual proposed by the Applicants overstates the likely success of Qantas in any war of attrition. The New Zealand public and Government would provide considerable support and brand loyalty to Air NZ ahead of the interests of Qantas. Air NZ could also be expected to adopt many of the features of a VBA to decrease its costs.
- 11.36. It is also suggested that the claim that New Zealand is critically important for Qantas looks to be overstated and is not substantiated. A claim by Qantas that *"abandoning New Zealand would be tantamount to abandoning Victoria"* should be considered against the small number of Qantas aircraft (five) operating in New Zealand and its recent entry into the market (May 2001).
- 11.37. Frontier Economics prepared a critique of the NECG Report for Gilbert and Tobin (counsel for Virgin Blue) on the Proposed Arrangements. The critique claimed that the counterfactual scenario detailed in the NECG Model, involving a Qantas initiated capacity war, is problematic because:
- FSA airlines have provided the majority of services on the trans-Tasman and New Zealand domestic routes for some decades now (implying there is room for more than one FSA);
  - Qantas' behaviour in the counterfactual could be regarded as inconsistent with a rational, profit maximising response unless it is designed to cause competitors to exit the market or to deter entry;

- it would be rational for Qantas to adopt such a strategy and to incur losses only if there were to be some pay-off in terms of “fancy” profits in the future, that is, an outcome which would require significant barriers to entry in the markets concerned; and
- Air NZ would be unlikely to adopt a strategy incurring substantial losses over an extended period and incur those losses before winding down operations. The strategy presupposes that the New Zealand Government would be prepared to fund a war to the death with Qantas that Air NZ cannot win.

11.38. Frontier Economics considered it surprising that VBA entry is regarded as viable during the capacity war that is predicted by NECG in the absence of the Proposed Arrangements.

11.39. Frontier Economics was also critical of the assumption that the strategies of an FSA are quite distinct from the strategies of a VBA. This assumption is seen as the key to the NECG proposition that Air NZ may cease to operate because of competition from Qantas, while at the same time a VBA viably enters the trans-Tasman market.

11.40. The critique suggested there is no obvious gap in the chain of substitutes between an FSA and a VBA which represent extremes in the continuum of strategies from which a carrier may choose. Some operators adopt intermediate positions, such as Air NZ Express Class, while others elect to operate in both modes at the same time.

11.41. It is claimed that NECG is inconsistent in applying the FSA/VBA distinction that it asserts exists. The distinction is sharply made in the counterfactual, with Qantas competing more closely with Air NZ than with the VBA. However in the future with the Proposed Arrangements the differentiation between the products of Qantas and the VBA is less marked, with the VBA offering strong competition for the aligned Qantas/Air NZ.

#### **Views expressed by the Commission on the counterfactual in the Draft Determination**

11.42. The Commission considered the counterfactual proposed by the Applicants to be unrealistic and unlikely to reflect the behaviour exhibited by the Applicants in the absence of the Proposed Arrangements.

11.43. The Commission considered that, absent the Proposed Arrangements, the Applicants are more likely to exhibit a measured approach to growing capacity on the route rather than incurring irredeemable losses in a capacity war. The Commission believed the status quo, subject to natural growth, to be a more realistic counterfactual scenario.

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

### *The Applicants*

- 11.44. The Applicants submitted to the Commission that they have provided the Commission with the reasons as to why the most likely economically rational counterfactual is the one in which the Applicants compete on the basis of increased capacity. The Applicants submitted that this counterfactual is consistent with evidence previously provided to the Commission and with the Applicants' view of the future and the nature of competition between FSAs.
- 11.45. The Applicants submitted that the Commission's conclusion that Qantas is unlikely to compete in this manner in the counterfactual is not supported by any evidence.
- 11.46. In relation to Air NZ's long term financial position, the Applicants submitted that the Commission has erred in its conclusion. The Applicants submitted that the Commission has focused inappropriately on Air NZ's half year profit result and that this result provides little indication of long term performance. The Applicants refer to Air NZ board papers presented to the Commission which it says conclude that a long term improvement in its underlying business will not occur simply through strong financial management and a focus on cost reductions and fare initiatives.
- 11.47. In relation to Virgin Blue's presence in the counterfactual scenario, the Applicants submitted that if the Commission does not accept that Virgin Blue can expand successfully into the trans-Tasman routes under the Proposed Arrangements, it must adopt a counterfactual in which Virgin Blue has no presence on the trans-Tasman.
- 11.48. The Applicants submitted that *"there are no plausible counterfactuals before the Commission other than those provided by the Applicants"*.
- 11.49. The Applicants submitted that the adoption of an inappropriate counterfactual has *"seriously skewed the weighing process...[and]...has caused the results of the weighing process to be inappropriately skewed to the disadvantage of the Applicants, particularly in the quantification of the cost efficiencies that will flow from the Alliance"*.

### *Qantas*

- 11.50. In response to the Commission's view of the counterfactual as outlined in its Draft Determination, Qantas submitted that a counterfactual with more intense competition and greater capacity is the most plausible counterfactual because:
- Qantas' New Zealand operations are important to the Qantas network as a way of achieving efficiencies that come from interconnecting New Zealand with a wider network;
  - Qantas lost its source of feed from domestic New Zealand with the demise of Qantas New Zealand; and

- Qantas views New Zealand as an integral part of its home market and securing a strong base is essential.
- 11.51. Qantas also submitted that the commercial rationale for the counterfactual was tested by NECG which found the predicted behaviour to be economically rational.
- 11.52. In relation to the Commission's concern, as expressed in its Draft Determination, that the counterfactual presented by the Applicants does not incorporate the iterative competitive responses of competitors, Qantas submitted that *"any estimate of future states of the world...will naturally suffer the same predicament. That is, any exercise in prediction will only ever be able to include best estimates of competitor behaviour made at a particular point in time."*
- 11.53. Qantas submitted that the Commission's apparent discounting of the submission that its New Zealand operations are an important part of the overall network and the observation that its submission is inconsistent with its long term behaviour is incorrect. Qantas submitted that it has maintained a presence in New Zealand through arrangements with Ansett New Zealand and Qantas New Zealand.
- 11.54. Qantas rejected that its proposed counterfactual involves possible illegal conduct by way of "capacity dumping" and submitted that it has outlined the commercial basis for its likely conduct should the Proposed Arrangements not be authorised. Qantas submitted that Air NZ has independently accepted the economic rationality and legality of Qantas' planned expansion in domestic New Zealand.
- 11.55. Qantas submitted that the network benefits accruing to it under its proposed counterfactual mean that it does not require recoupment in the form of future profits for the conduct under the counterfactual to be rational.
- 11.56. Qantas submitted that there is no basis for the Commission's view, as expressed in its Draft Determination, that the most likely counterfactual is the status quo with natural growth.

*Gullivers Pacific Group*

- 11.57. GPG submitted that it would be illogical for Air NZ to engage in a "fight to the death" with Qantas. GPG submitted that such behaviour would be unlikely given the history of Qantas' behaviour in the marketplace, the strength of Air NZ and the low levels of profitability likely to be achieved by Qantas even if they were successful in becoming a dominant player in the New Zealand domestic market.
- 11.58. GPG submitted that Air NZ has a significant amount of brand loyalty which is culturally based and deeply rooted.



### **The Commission's view on the counterfactual**

- 11.59. The Commission has considered all submissions put to it in relation to the most likely situation without the Proposed Arrangements. The Commission's view in relation to the counterfactual is set out below.
- 11.60. While the Commission does not intend to examine the New Zealand domestic aviation market as part of its assessment of anti-competitive detriment, it is relevant to examine that market in the context of determining the appropriateness of the Applicants' view of the future without the Proposed Arrangements. Developments in the New Zealand domestic market have implications, for example, for claims both in relation to the future of Air NZ and in terms of public benefits in the form of cost savings claimed to arise from the Proposed Arrangements including those arising in New Zealand.
- 11.61. Qantas has stated that if the Proposed Arrangements were not to proceed, it would increase capacity on routes where it competes with Air NZ, including the domestic New Zealand market which is a primary revenue source for Air NZ. The New Zealand domestic market is therefore very relevant to understanding the ability of Air NZ to respond to such initiatives. In this sense, the New Zealand domestic market is an important parameter to consider when examining the Air NZ view of the future without the Proposed Arrangements.
- 11.62. To the extent that developments in the New Zealand domestic market are pivotal to the Proposed Arrangements as a whole, they will also reflect on the credibility of the Applicants' view of the future without the Proposed Arrangements.
- 11.63. As discussed above, the Commission's consideration of the counterfactual takes into account the current state of the aviation industry and the impact that this may or may not have on Qantas, Air NZ and other players in the relevant markets.

#### *Development of the counterfactual*

- 11.64. It is stated by the Applicants in the submission supporting their application that they "*have independently concluded that the only counterfactual to test against the world with the Transactions is a more aggressive level of competition between them resulting in increased capacity being applied to material parts of their Australian networks*".
- 11.65. This counterfactual is described in the same submission as being consistent with Qantas' stated intention to increase capacity on domestic New Zealand main trunk routes, the trans-Tasman route and the Auckland-Los Angeles route. The counterfactual is also described as being consistent with information and assessments provided by each party to NECG on a confidential basis.
- 11.66. The Applicants state that Air NZ will respond to capacity increases by Qantas because to do otherwise will be a step towards surrendering control of its important domestic networks to its competitor. It is asserted that a failure by

a network carrier such as Air NZ to react to Qantas' capacity increases on Air NZ's core domestic and trans-Tasman routes would have a detrimental effect on the viability and profitability of Air NZ's entire network, including its international routes.

- 11.67. It is further claimed that Australasia cannot support more than one FSA and ultimately under the counterfactual scenario one of Qantas or Air NZ will be forced to accept a secondary role. NECG expresses the view that, given the relative strength of the two airlines, the airline likely to contract is Air NZ.
- 11.68. Qantas has now advised in response to the Draft Determination that it would not engage in a "capacity war" on the trans-Tasman route and that proposed Qantas growth on that route in the absence of the alliance would be in line with historic market growth. Qantas has also advised subsequent to the Draft Determination that its main capacity growth would be in domestic New Zealand and the Pacific.
- 11.69. The Commission is of the view that, unlike the development of a counterfactual that is based on the status quo, the acceptance of a counterfactual involving competition through increased capacity, as submitted by the Applicants, involves a high degree of uncertainty of outcome. A capacity war, by its very nature, must incorporate strategic competitive responses – the idea that a capacity war is planned and would take place without any knowledge of "attacks" and "counter attacks" is unrealistic. Because each airline has confidentially provided its counterfactual schedules to NECG, the counterfactual does not incorporate the iterative competitive responses of players in an evolving market.
- 11.70. It may be, for example, that Air NZ framed its postulated counterfactual passenger services on the trans-Tasman route on the basis of a "capacity war" rather than the historic growth now publicly acknowledged by Qantas.
- 11.71. In the "real" world, competition is a continuing process with rivals in a market making regular adjustments to their behaviour in response to the behaviour of their competitors. Under the counterfactual schedules put forward, each airline has been forced to make assumptions as to how the other will behave over the next three years. In the real world, the airlines would obtain continual feedback on their competitors' behaviour.
- 11.72. The reality of the counterfactual assumptions aside the Commission also has to consider whether increasing capacity is the only option available for responding to capacity increases from a rival network carrier, whether such capacity increases are likely given developments in the markets concerned and whether Air NZ is the party more likely to cede in the New Zealand domestic market. All of these issues are seen as relevant to assessing the credibility of the counterfactual put forward by the Applicants.

*VBA entry*

- 11.73. The Applicants have assumed for the purposes of their analysis that a VBA (such as Virgin Blue) would enter the trans-Tasman and New Zealand domestic markets if the alliance goes ahead. It is assumed that under such

circumstances VBA entry would involve five B737 aircraft over the Tasman and four in New Zealand in Year 1. Absent the Proposed Arrangements, entry by a VBA would be delayed a year on the trans-Tasman but not occur at all in the first five years in the New Zealand domestic market.<sup>46</sup> Entry is portrayed as being facilitated under the Proposed Arrangements because of capacity holes resulting from a rationalisation of capacity and schedules by the alliance partners.

- 11.74. Subsequent to the Commission's Draft Determination, Virgin Blue has obtained approval from the International Air Services Commission ("IASC") to operate on the trans-Tasman route. In seeking approval, Virgin Blue indicated that it would commence services from October 2003. Virgin Blue has indicated to the IASC and the Commission that its rate of expansion on that route will be dependent on outcomes associated with the Commission's final decision on the Proposed Arrangements between Qantas and Air NZ. Virgin Blue has indicated that its rate of expansion on the route would be higher if Freedom Air was divested to it from Air NZ as a condition of approval of the Proposed Arrangements. Virgin Blue has not indicated the rate at which it would expand otherwise.
- 11.75. In committing to enter the trans-Tasman route prior to the end of 2003, Virgin Blue has acted contrary to the counterfactual proposed by the Applicants, illustrating the uncertainty associated with that counterfactual.
- 11.76. Virgin Blue has also stated that it would enter the New Zealand domestic market. Such a development is not included under the counterfactual proposed by the Applicants in their submission supporting their application nor is it included under the preferred assumptions of modelling by NECG.
- 11.77. Virgin Blue's proposed entry into the New Zealand and trans-Tasman markets raises further doubts about the credibility of the counterfactual advanced by the Applicants. In a submission to the NZCC the Applicants cited a range of studies to conclude<sup>47</sup> that:

*"On average, VBA entry stimulates a relatively low level of initial growth in capacity by incumbents which over a period (certainly no longer than three years) is reduced to well below pre-entry levels."*

- 11.78. The Applicants' counterfactual claimed to apply in both the trans-Tasman and domestic New Zealand markets appears contrary to this conclusion. A counterfactual which involves historic growth in capacity in the trans-Tasman market and aggressive competition in capacity in the New Zealand domestic market would not seem consistent with the conclusion expressed by the Applicants that VBA entry sees a decline in capacity by incumbent airlines. A domestic capacity war in New Zealand, for example, would only seem

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<sup>46</sup> Table 5, Page 89, NECG submission of 8 December 2002.

<sup>47</sup> Page 27, Chapter 3, Qantas and Air New Zealand response to the Draft Determination of the New Zealand Commerce Commission.

tenable in the counterfactual under this conclusion if Virgin Blue does not enter the market.

*Qantas and the counterfactual*

- 11.79. The Commission has been provided with a range of confidential data in relation to Qantas' behaviour absent the Proposed Arrangements. This confidential information includes details of schedules and aircraft to be operated on city pair routes under the first three years without the Proposed Arrangements in the New Zealand domestic, trans-Tasman, and Sydney-Los Angeles sectors and projections of financial outcomes in relevant markets for the first five years under the counterfactual.
- 11.80. The supporting submission from the Applicants indicates that Qantas will increase its capacity in the New Zealand domestic market from five B737 aircraft to eight, an increase of 60 per cent on current capacity. This increase in capacity is consistent with confidential information provided to the Commission and represents a substantial increase in capacity over a three year period.
- 11.81. Qantas has submitted<sup>48</sup> that while its postulated growth in capacity on the trans-Tasman route exceeds the estimated natural rate of demand growth for the route, it is consistent with historic trends. This submission is consistent with data provided to the Commission.
- 11.82. Qantas has stated that:<sup>49</sup>
- “Qantas New Zealand operations are very important to the Qantas network as a way of achieving the efficiencies that come from interconnecting the routes within, to and from New Zealand into its wider network. They make a positive contribution to its network, although they are currently losing money on a stand alone basis. Consistent with the Single Aviation Market, Qantas views New Zealand as part of its home market. For Qantas, abandoning New Zealand would be tantamount to abandoning Victoria.”*
- 11.83. The Commission notes the submission made by Qantas in relation to its likely behaviour under the counterfactual, particularly in relation to its entry and capacity decisions in the domestic New Zealand market. However, the Commission remains of the view that, given that Qantas has been able to enter the New Zealand market in a substantial manner for some time but has failed to do so, Qantas' motivation to participate in the New Zealand market would seem pertinent to understanding not only the path it claims it would follow absent the Proposed Arrangements but also its apparent willingness to substantially increase capacity in a market where it publicly acknowledges it is already making losses.

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<sup>48</sup> Para. 5.22 of submission in response to Draft Determination of NZCC.

<sup>49</sup> Paragraph 6.7 at page 44 of the Qantas and Air NZ submission of 9 December 2002.

- 11.84. Frontier Economics has commented that Qantas' behaviour in the counterfactual could be regarded as inconsistent with a rational profit maximising response unless it is designed to either cause competitors to exit the market or deter entry. Such a strategy would only make sense if it were to be rewarded by substantial profits in the future, an outcome which Frontier Economics views as requiring significant barriers to entry in the markets concerned. The Commission considers this to be a reasonable proposition and, on the basis of confidential information provided by Qantas on its recent, current and projected financial performances on the routes concerned, a relevant proposition.
- 11.85. The Commission remains of the view that, based on the evidence currently before it, Qantas' proposed behaviour under the counterfactual in the New Zealand domestic market is unlikely given that it is not a rational response unless Qantas believed it would cause competitors to exit or unless Qantas was able to recoup losses in the future.
- 11.86. The Commission is of the view that contrary to claims made by the airline, Qantas' operations in the domestic New Zealand market are unlikely to confer "network benefits" on it to such an extent that such operations would be considered commercially viable or rational. To accept the network benefit arguments put forward by Qantas would be to accept that there is a considerable flow on, to mainly the trans-Tasman route (but possibly also to other areas of the Qantas route network), from Qantas operations in New Zealand sufficient to offset losses in the New Zealand domestic market incurred by Qantas under the counterfactual. The structure of Qantas operations does not suggest that this is the case. In forming this view the Commission took into account that the New Zealand airports served by Qantas operations in New Zealand are also served as part of its trans-Tasman operations. Most New Zealand travellers, for example, would not have to position themselves via Qantas domestic New Zealand services in order to access services to Australia. The Qantas argument that its performance in domestic New Zealand cannot be considered in isolation and that losses in one sector can be offset by network benefits would also appear inconsistent with Qantas' long term behaviour in relation to the New Zealand domestic market.
- 11.87. The creation and expansion of Jet Connect, the Qantas subsidiary operating in domestic New Zealand, may well have been motivated as much by the creation of a low cost operation for deployment on other parts of Qantas network as an intention to provide local services in New Zealand. The Commission notes that Jet Connect is to commence trans-Tasman operations in September 2003.
- 11.88. Continued loss making by Qantas in the New Zealand domestic market would, under normal circumstances, be expected to lead to Qantas reviewing its position in the market and the options of exiting the market or reducing its presence if, for example, Air NZ did not depart the market (the Applicants assert there is not room for two FSAs in the market). Confidential financial information supplied to the Commission by Air NZ does not suggest that Air NZ would necessarily be the airline likely to depart the market under the

counterfactual proposed by the Applicants. This view is not inconsistent with both Air NZ's recent financial performance and its strong domestic market presence and customer base.

- 11.89. To accept the Qantas counterfactual is therefore to accept that Qantas would be prepared to continue to incur losses on the New Zealand domestic market without offsetting benefits or strong chance of recoupment. The extent of those losses could be expected to be even higher than estimated if the presence of Virgin Blue in that market is taken into account.
- 11.90. The Applicants argued strongly in their supporting submission that barriers to entry are low in all the relevant markets, across all potential barriers including 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. The Applicants referred to previous decisions of the Commission and the NZCC which cited low barriers to entry in trans-Tasman and domestic markets and pointed to the success of Virgin Blue in entering the Australian domestic market and its stated intention to enter the trans-Tasman and New Zealand domestic markets. The Applicants state in their supporting submission in relation to barriers to entry in the trans-Tasman market:<sup>50</sup>

*"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. 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."*

- 11.91. The Commission does not believe that barriers to entry in the markets against which this application is being considered are low now or likely to be low for some time. The issue of barriers to entry and expansion is discussed in Part 12 when the Commission considers the anti-competitive detriment associated with the Proposed Arrangements. The Commission concludes that while some regulatory barriers are not high, there are other substantial barriers to market entry, especially for start-up airlines, in the areas of access to feeder traffic, access to capital and the ability to respond to the strategic decisions of incumbents. The comments made by the Commission in relation to low barriers to which the Applicants refer were in the context of A90649 and A90655 when authorising the alliance between Ansett, Air NZ and Singapore Airlines and the Commission was referring to the NZCC *Bodas* decision of April 1996.<sup>51</sup> The Commission conducts its analysis on a case by case basis. Issues associated with the aviation industry operational and investment environment that prevailed at the time in other cases and in other

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<sup>50</sup> Paragraph 6.39 at page 52 of the submission of 9 December 2002.

<sup>51</sup> 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.

circumstances are not necessarily applicable to the application being considered here.

*Air NZ and the counterfactual*

- 11.92. The Commission has also been provided with a range of confidential data in relation to Air NZ's behaviour absent the Proposed Arrangements. Again, this confidential information includes details of schedules and aircraft to be operated on city pair routes under the first three years of the counterfactual in the New Zealand domestic, trans-Tasman, and Auckland-Los Angeles sectors and projections of financial outcomes in relevant markets for the first five years under the counterfactual.
- 11.93. The Applicants claimed that a failure by Air NZ to respond to the capacity increases of Qantas would be a step towards surrendering control of this important domestic market and have a detrimental effect on the viability and profitability of Air NZ's entire network. The submission reported that Air NZ would increase its domestic and trans-Tasman capacity by a total of five per cent over a three year period in responding to the Qantas threat.
- 11.94. Working on the premise that Australasia cannot support more than one FSA network, the Applicants concluded that one of the two airlines will contract. NECG expressed the view that given the relative financial strength of the two parties it is likely to be Air NZ which contracts and possibly exits the market entirely in the long term.
- 11.95. The assumptions about Air NZ's condition and likely response under the counterfactual require closer examination. Virgin Blue suggested that it would be irrational for Air NZ to engage in a capacity war that will inevitably be lost. The Applicants seem to concede this outcome, stating in their supporting submission:<sup>52</sup>

*“Air NZ is not well placed to win that battle nor does it have the financial resources to credibly signal to Qantas that it can successfully engage in a long term fight for market share.”*

- 11.96. Frontier Economics considered that Air NZ would be unlikely to commit to a strategy which involved a commitment to incurring ongoing losses before winding down operations. Frontier Economics also commented that the strategy presupposes that the New Zealand Government would be prepared to fund a war to the death with Qantas that Air NZ cannot win.
- 11.97. The Commission considers that the ability of Air NZ to compete against Qantas should not be underestimated. Air NZ has an established domestic market presence, strong brand loyalty and an important role as the provider of aviation support services in New Zealand. It is engaging in successful innovative behaviour and is benefiting from changes to United's services.

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<sup>52</sup> Paragraph 3 on page 4 of the submission of 9 December 2002.

- 11.98. It is apparent that the financial position of Air NZ has improved significantly over the past financial year. Initiatives taken in the form of cost cutting, the introduction of Air NZ Express Class across the domestic sector and a more effective use of capacity has seen the airline lift pre-tax profit from NZ\$33million in 2001/02 to an estimated NZ\$230 million in 2002/03.<sup>53</sup> Developments in the first half of 2003 have seen that estimate adjusted to NZ\$200 million.
- 11.99. Following the withdrawal of United from the Auckland-Los Angeles route Air NZ has re-allocated capacity to the route from its Sydney-Los Angeles service. Given the comment<sup>54</sup> of the airline's Chief Executive Officer that the latter route is one of the airlines' least profitable and on the basis of confidential financial data provided to the Commission, it would be expected this outcome combined with reduced competition on the Auckland-Los Angeles route would be financially positive for Air NZ. The Commission notes recent reports that United is likely to emerge from Chapter 11 bankruptcy protection in the United States earlier than expected. However there has been no indication that United is likely to re-enter the Auckland-Los Angeles route in the foreseeable future.
- 11.100. The Commission is aware that the aviation industry is a volatile industry and globally under considerable pressure at the moment. However against that background and in the face of strong competition from Qantas on a significant portion of its routes, Air NZ is performing strongly in 2002/03 compared to most other airlines in the world. Symptomatic of that performance is the airline's commitment to a fleet re-equipment program with 15 Airbus A320s to replace four B767-200s and nine B737-300 aircraft.
- 11.101. The rejuvenation of Air NZ's financial position is also indicative of a willingness to explore new operating options and approaches which combined with other features of the company, could see it well placed to adopt an active role in competing with Qantas.
- 11.102. Alternative counterfactuals could see Air NZ continuing to improve its underlying business with strong financial management and a focus on cost reductions while further exploiting fare initiatives. The Commission stated in its Draft Determination that it considered there might be opportunities for Air NZ to reposition the company through the development and expansion of the Express Class brand in other markets. On 12 August 2003 the Chief Executive of Air NZ announced<sup>55</sup> a new Tasman Express fare structure based around the introduction of new lower operating cost A320 aircraft. The initiative was described as achieving an average 20 per cent reduction in fares and was expected to boost air travel between Australia and New Zealand by ten per cent.

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<sup>53</sup> Air NZ media release 20 December 2002.

<sup>54</sup> Air NZ media release 10 February 2003.

<sup>55</sup> "Air NZ slashes trans-Tasman fares", the Age, 12 August 2003.



11.103. The company also had options utilising Freedom Air, (which is already profitable) as a significant stand alone carrier directed towards leisure routes which could provide an established low cost operation to meet the competitive challenges of Qantas and any other entrant into the relevant markets.

11.104. The Commission does not believe that it has been established that the trans-Tasman route will not support two full services airlines, even after the entry of a VBA such as Virgin Blue. With around two million passengers per year travelling the route it is one of the most dense traffic routes in the world and comparable with routes such as London-Frankfurt, Seoul-Tokyo and London-Dublin without the surface transport competition evident on some of those routes. ICAO statistics show that three full service airlines operate the London-Dublin route in addition to a low cost carrier in the form of Ryan Air. The London-Frankfurt route is served by a number of full service carriers including British Airways, British Midlands and Lufthansa.

*The appropriateness of the Applicants' counterfactual*

11.105. For reasons described above the Commission does not consider that the counterfactual proposed by the Applicants constitutes a reliable guide to their likely behaviour in the absence of the Proposed Arrangements.

11.106. Factors which contributed to the Commission forming this view are as follows:

- on the basis of material provided by the Applicants showing the impact of VBA entry in a market on the capacity supply of incumbent airlines, a substantial increase in capacity from the Applicants in the trans-Tasman and New Zealand domestic markets (as postulated under their counterfactual) seems unlikely to occur given the imminent entry of Virgin Blue into those markets;
- the Commission does not believe that there are offsetting benefits or a strong chance of recoupment which would justify the substantial losses which would accrue to either or both of the Applicants under the proposed counterfactual;
- the individual counterfactual proposals of long term behaviour proposed by Qantas and Air NZ do not reflect the real world where competition involves continual and evolving strategic responses to competitors conduct; and
- there would appear to be options available to Air NZ other than simple capacity increases in responding to Qantas capacity increases.

11.107. The Commission considers that, absent the Proposed Arrangements, the Applicants are likely to exhibit a measured approach to growing capacity on the trans-Tasman reflecting natural growth in the market and developments in the market. The Commission believes that under these circumstances the status quo, subject to natural growth, is a more realistic and more likely

scenario of future behaviour in this market than the counterfactual offered by the Applicants.

## **12. Commission Assessment – Anti-Competitive Effects of the Proposed Arrangements**

### *The Proposed Arrangements*

- 12.1. Under the Proposed Arrangements Qantas will subscribe for up to 22.5 per cent of Air NZ's voting equity and the two airlines will enter into a Strategic Alliance across a JAO Network which comprises all Air NZ flights, and all Qantas flights into, within and departing from New Zealand. There will also be extensive reciprocal code sharing on each other's services.
- 12.2. In respect of the JAO Network the two airlines will coordinate pricing, capacity and all other aspects of the normal business operations of an airline. The airlines also agree, where it is effective and efficient for them to do so, to coordinate on their non-JAO Networks.
- 12.3. The conduct also involves an agreement between Qantas, Air NZ and Air Pacific to cooperate with respect to aspects of passenger and freight services, including with respect to pricing and scheduling.

### **The Commission's approach to detriment assessment**

- 12.4. It is the task of the Commission, for the purposes of assessing the Applications, to assess the extent to which the Proposed Arrangements result or would be likely to result in a lessening of competition in relevant markets and the detriment that would be likely to result.
- 12.5. The Commission conducts its assessment on a market by market basis and then forms a view of the impact of the conduct overall for the purposes of the Equity Proposal, the Strategic Alliance Proposal and the Cooperation Agreement.
- 12.6. The Applicants have advised that the conduct covered by the Applications should be treated as a "package", that is, no aspect of the conduct will be implemented independently. Further, the Commission is advised to use the entirety of the submission filed on 9 December 2002 and subsequent submissions lodged by the Applicants in respect of this matter for the purposes of applying the respective tests for each of the Applications.
- 12.7. The Applicants acknowledged that the Proposed Arrangements will give rise to some detriment in a number of markets where the Applicants are the primary providers of air passenger and air freight services, being the trans-Tasman market and the Australia-North America market.

- 12.8. The Applicants suggested that any assessment of how competition is lessened in any market should consider that market with the Proposed Arrangements as against without the Proposed Arrangements, taking into account:
- market concentration;
  - the existence and height of any barriers to entry and expansion and the likelihood of any such barriers being overcome;
  - competitive constraints imposed on the Applicants; and
  - other indicators of market structure and conduct.
- 12.9. Given that these are the factors the Commission would normally consider and given that the Applicants' Submission is structured in this way, it is convenient for the Commission to undertake its analysis utilising this approach.
- 12.10. The Applicants have also provided details of outcomes of econometric modelling by NECG of the Proposed Arrangements in relevant markets in support of their claims that the Proposed Arrangements result in minimal anti-competitive detriment. When assessing the Proposed Arrangements, the Commission will initially consider them in terms of their effect on competition in the terms identified above and then examine the outcomes and results of the NECG modelling before forming a final view on the extent, if any, of anti-competitive detriment.
- 12.11. It is not the intention of the Commission to consider the possible impact of undertakings when initially assessing anti-competitive detriment. The Commission will examine undertakings when weighing detriment against public benefit to ascertain whether undertakings have the potential to lead the Proposed Arrangements to a position of net benefit if the Commission concludes that without undertakings there would not be a net public benefit. Undertakings are discussed in further detail in Part 14 of this Determination.

### **International passenger transport markets: trans-Tasman**

#### *Anti-competitive detriment comments made by the Applicants*

- 12.12. The Applicants claimed that the trans-Tasman market for passenger air services is highly contestable with the Proposed Arrangements likely to enhance the quality of competition to the benefit of consumers, especially when regard is had to the effect of undertakings in facilitating and protecting new entry.
- 12.13. It is asserted that the NECG economic analysis concluded that there is no material anti-competitive detriment.

#### *Interested party views on anti-competitive detriment*

- 12.14. ABTA stated that its members feel that the Proposed Arrangements will make business activity across the Tasman more difficult as companies seek