the domestic market increased from around 50 per cent to almost 90 per cent following the failure of Ansett. However, vigorous growth by Virgin Blue has subsequently seen Qantas' market share fall to an estimated 75 per cent.[13]

3.21. Table 3.5 below shows the top ten Australian domestic passenger routes between 2000/01 and 2001/02.

Table 3.5 Top ten domestic passenger routes: 2000/01 – 2001/02[14]

Route	Revenue passengers ('000)			Available seats ('000)		
	2000/01	2001/02	% change	2000/01	2001/02	% change
Melbourne – Sydney	6,184	5,421	-12.3	8,429	7,169	-15.0
Brisbane – Sydney	4,329	3,718	-14.1	5,830	4,864	-16.6
Brisbane – Melbourne	2,153	2,227	3.4	2,760	2,757	-0.1
Adelaide – Melbourne	1,422	1,403	-1.3	1,881	1,853	-1.5
Adelaide – Sydney	1,250	1,161	-7.1	1,789	1,552	-13.2
Coolangatta – Sydney	1,240	1,107	-10.8	1,448	1,261	-12.9
Brisbane – Cairns	1,019	968	-5.0	1,294	1,247	-3.6
Melbourne – Perth	1,000	935	-6.5	1,249	1,200	-4.0
Perth – Sydney	1,039	900	-13.4	1,323	1,133	-14.4
Canberra – Sydney	929	723	-22.2	1,390	1,099	-21.0
Total	*29,625*	*27,142*	*-8.4*	..	..	..

3.22. According to DTRS, total revenue passengers carried decreased 8.4 per cent from 29.63 million (2000/01) to 27.14 million (2001/02), as a result of a reduction in international traffic and the collapse of Ansett.

Virgin Blue[15]

3.23. The Virgin Group announced the establishment of a "low-fare" airline in Australia in November 1999 and Virgin Blue commenced domestic operations within Australia on 31 August 2000. According to Virgin Blue, the impact of its entry on Australian domestic aviation travel was an increase in traffic of 26 per cent on the Brisbane-Sydney route in the year it commenced operations and a 30 per cent increase on the Brisbane-Melbourne route in the same year.

3.24. At the time it commenced services in 2000, Virgin Blue operated services between Brisbane and Sydney and Brisbane and Melbourne. At the time of Ansett's collapse Virgin Blue operated nine 737s and flew five routes. Virgin Blue now operates 29 737s and has 1330 departures per week. Table 3.6 shows the services currently operated by Virgin Blue.

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[13] Virgin Blue Submission to the Commission, 12 February 2003.
[14] Department of Transport and Regional Services (2002), *Air Transport Statistics: Australian Domestic Airline Activity,* Issue 66.
[15] Virgin Blue Submission to the Commission, 12 February 2003.

Table 3.6 Direct routes flown by Virgin Blue*

Origin	Destination(s)
Adelaide	Brisbane, Broome, Canberra, Gold Coast, Melbourne, Perth, Sydney
Alice Springs	Sydney
Brisbane	Adelaide, Cairns, Canberra, Darwin, Hobart, Mackay, Melbourne, Perth, Proserpine, Rockhampton, Sydney, Townsville
Broome	Adelaide
Cairns	Brisbane, Melbourne, Sydney
Canberra	Adelaide, Brisbane, Gold Coast, Melbourne, Sydney
Coffs Harbour	Sydney
Darwin	Brisbane, Sydney
Gold Coast	Adelaide, Canberra, Melbourne, Sydney
Hobart	Brisbane, Melbourne
Launceston	Melbourne, Sydney
Mackay	Brisbane
Maroochydore	Melbourne, Sydney
Melbourne	Adelaide, Brisbane, Cairns, Canberra, Gold Coast, Hobart, Launceston, Perth, Maroochydore, Sydney
Perth	Adelaide, Brisbane, Melbourne, Sydney
Proserpine	Brisbane, Sydney
Rockhampton	Brisbane
Sydney	Adelaide, Alice Springs, Brisbane, Cairns, Canberra, Coffs Harbour, Darwin, Gold Coast, Maroochydore, Melbourne, Perth, Proserpine
Townsville	Brisbane

* Virgin Blue website, www.vriginblue.com.au, as at 2 September 2003

3.25. Virgin Blue utilises jets configured into a single seating class and does not bundle services such as meal services, frequent flyer programs or club lounges into its fares.

3.26. Virgin Blue has announced its intention to provide services to New Zealand and within New Zealand.

Regional Express[16]

3.27. Regional Express ("Rex") is a full service carrier operating in south eastern Australia. It has a fleet of 28 aircraft and services 31 towns and cities in New South Wales, Victoria, South Australia, Tasmania and the Australian Capital Territory. Rex operates services between regional centres and Sydney, Melbourne and Adelaide and also operates services on the Sydney-Canberra and Canberra-Taralgon routes.

3.28. Outside the Qantas Group and Virgin Blue, Rex is Australia's third largest domestic airline.

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[16] Regional Express submission to the Commission, February 2003.

3.29. Rex competes with Qantas on 12 routes and Qantas' partner airlines on four routes. Rex is also the sole operator to a number of centres.

3.30. Rex has interline agreements with international carriers including one with Air NZ, which was signed in September 2002.[17]

Airline industry performance

Global performance

3.31. *Airline Business* magazine conducts an annual assessment of the financial performance of the world airline industry. An assessment of the years 1992 to 2001 appeared in its September 2002 edition.

Table 3.7 Top 150 airline groups: 1997 to 2001[18]

Year	**1997**	**1998**	**1999**	**2000**	**2001**
Revenue*	293.2	299.1	320.0	346.4	320.7
Operating result*	20.5	19.3	1.6	13.7	-5.7
Operating margin (%)	7.2	6.7	5.3	4.2	-2.0
Net result*	9.3	9.0	8.7	3.5	-12.6
Net margin (%)	3.2	3.1	3.0	1.1	-5.2

* All figures are US$ billion.

3.32. *Airline Business* noted that most of the $12.6 billion net loss and almost $6 billion operating loss can be attributed to the events of September 2001, but noted that predictions in early 2001 were for a "modest annual profit" and these predictions had been revised to "fairly large losses" by mid 2001. These losses were predicted due to slow economic growth, tightening corporate travel budgets and rising labour demands.

3.33. *Airline Business* noted that in the Asia Pacific region the fallout from the United States' terror attacks was weaker than in the rest of the world.

3.34. The following table highlights growth in revenues for a range of Asian regional airlines.

[17] Rex noted that this agreement has not progressed to a "functional" stage by Air NZ since the announcement of the Strategic Alliance Proposal.
[18] Baker, Colin (2002), "A year to forget", *Airline Business,* September 2002.

Table 3.8 Revenue growth for Asian regional airlines: 1998 to 2002[19]

Airline	Revenue (A$million)		Annual growth (%)
	1998	2002	
Air NZ	2,587	3,166	4.2
Qantas	8,131	11,322	8.6
Singapore	7,228	9,604	5.2
Cathay Pacific	5,627	7,530	6.4
Malaysia	3,075	4,061	4.8

3.35. The airlines in Table 3.8 above together carry around 65 per cent of total passenger traffic to and from Australia and around 60 per cent of freight to and from Australia and up until the end of 2002 had been performing well in a challenging international environment.

3.36. The Commission notes that the figures above do not capture the impact on air travel of more recent events such as severe acute respiratory syndrome ("SARS") and the war in Iraq.

3.37. The Commission notes that the aviation industry experienced a downturn in passenger numbers as a result of these factors and, in this regard, the Commission acknowledges recent figures which suggest that traffic on Asian routes in March, April and May fell significantly. It has been suggested[20] that the impact of SARS on purely international carriers Cathay Pacific and Singapore Airlines has improved Qantas' position relative to those carriers.

3.38. However, the war in Iraq is over and a large number of commentators have declared that the worst of SARS is also over.[21] Analysts were stating[22] in July this year that Qantas could fully recover from the impact of the Iraq war and SARS far more quickly than the three to six months that was initially predicted.

3.39. The Commission notes that freight services and domestic air travel services have not been significantly impacted by instability in the international aviation industry.

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[19] Air NZ, Qantas, Singapore Airlines, Cathay Pacific and Malaysia Airlines, Annual Reports and company websites.

[20] "How SARS could lift Qantas fortunes", The Australian, 24 April 2003.

[21] Bisignani, Giovanni (2003), "International Air Traffic Drops 21 per cent in May, Optimism for June Start to Traffic Recovery", *IATA Press Release,* 2 July 2003; Thomas, Geoffrey (2003), "Qantas Gets Bounce on SARS News", *The West Australian,* 30 April 2003; TravelBiz (2003), "WTO forecasts tourism recovery by year end", http://www.travelbiz.com.au/articles/53/0c017753.asp, 17 June 2003; TravelBiz (2003), "WHO predicts end to SARS threat 'within months'", http://www.travelbiz.com.au/articles/50/0C017750.asp, 17 June 2003;

[22] Scott Rochfort, "Fall in May passenger tally fails to faze Qantas", the Sydney Morning Herald, 23 July 2003.

Qantas' performance[23]

3.40. Table 3.9 below outlines Qantas' financial performance for the last five years.

Table 3.9 Qantas financial performance: 1997/98 to 2001/02

Year ended 30 June	1998	1999	2000	2001	2002
Sales & operating rev ($m)	8,131.5	8,448.7	9,106.8	10,188.2	11,322.6
EBIT ($m)	581.7	762.6	847.0	695.8	679.3
Profit before tax ($m)	478.0	662.0	762.8	597.1	631.0
Net profit ($m)	304.8	421.6	517.3	415.4	428.0
Revenue seat factor (%)	71.9	73.2	75.4	75.9	78.3
Operating margin (%)	7.1	9.0	9.3	6.8	6.0
Net margin (%)	3.7	5.0	5.7	4.1	3.8

3.41. In its 2002 annual report, Qantas stated that:

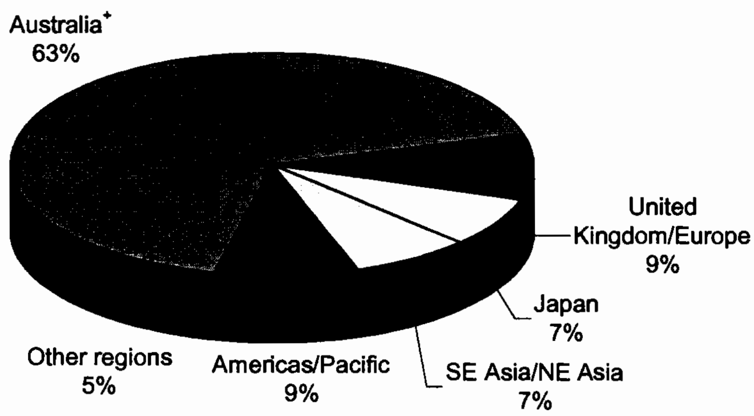
> *"The impact of September 11 on [the airline] industry was enormous. According to the International Air Transport Association, 2001 was only the second year in the history of civil aviation in which international traffic declined. The IATA membership of airlines collectively lost more than US$12 billion. At the same time, in the domestic market, Ansett collapsed...Qantas was able to add the equivalent of about seven years' growth, virtually overnight."*

3.42. In 2001/02 Qantas delivered a profit (before tax) of $631 million, and a net profit of $428 million. With regard to international and domestic volatility, Qantas' performance in 2001/02 was strong.

3.43. Figure 3.1 below shows international route profitability by geographic region.

[23] All data in this part sourced from Qantas (2002), *Annual Report* and Qantas (2002), *Qantas and Controlled Entities Consolidated Financial Report: Half year ended 31 December 2002,* unless otherwise noted.

Figure 3.1 Analysis of Qantas revenue* by region: 2001/02



* Derived from the country from which revenue was sourced.
\+ Australia includes revenue from domestic and international operations.

3.44. The United States and United Kingdom routes were the highest sources of revenue, internationally, for Qantas in 2001/02. Australia and "Other regions" were the only regions which experienced growth over the past 12 months.

3.45. During 2001/02, Qantas added nine return services per week between Australia and New Zealand and began domestic New Zealand services.

3.46. Table 3.10 below shows a breakdown of earnings (before interest and tax) ("EBIT"). Qantas' strong domestic operations means that it is not as susceptible to international aviation developments as airlines such as Cathay Pacific and Singapore Airlines.

Table 3.10 Earnings before interest and tax: 2000/01 and 2001/02

Segment	2000/01		2001/02	
	EBIT ($m)	(%)	EBIT ($m)	(%)
International operations	458.7	65.9	202.8	29.9
Domestic operations	127.4	18.3	298.2	43.9
Qantas Holidays Group	33.5	4.8	42.4	6.2
QantasLink Group	6.4	0.9	42.5	6.3
Qantas Flight Catering	54.3	7.8	69.6	10.2
Other subsidiaries	15.5	2.2	23.8	3.5
Total	*695.8*	*100.0*	*679.3*	*100.0*

3.47. The fall in international operations may to a large extent be attributed to a downturn in international travel following the events of 11 September 2001. This fall, however, was offset by a large improvement in domestic performance which can be attributed to a substantial increase in Qantas' domestic operations following Ansett being placed into voluntary administration in September 2001 and ceasing operations completely in March 2002.

3.48. Qantas' load factors have consistently been in the range of 70 to 80 per cent over the past five years.

3.49. Qantas' half-yearly results for 2002/3, released on 20 February 2003, show that its financial performance continues to improve. The company reported an increase in net profit of 129 per cent compared to the previous financial year. International operations earnings before interest and tax ("EBIT") increased from a loss of $15.5 million in the last six months of 2001 to a profit of $263.9 million in the last months of 2002. Load factors on international operations improved by 0.46 per cent and yield increased by 4.3 per cent. Domestic EBIT was $197.9 million which was down 1.7 per cent on 2001 performance. Domestic yield deteriorated by 5.1 per cent but was offset by a 22 per cent increase in load factors.

3.50. The Commission notes that the above figures do not capture any effects on Qantas' operations of the war in Iraq or SARS. In May this year, Qantas reported that international traffic had dropped by 11 per cent in March, with load factors sitting at around 74 per cent. Qantas also reported that, domestically, traffic fell 3.6 per cent while capacity rose by five per cent. Domestic traffic also experienced a fall in load factors on the same time last year to 74 per cent. In May, Qantas downgraded its profit forecast of $707 million[24] by between 20 per cent and 30 per cent.

3.51. On 21 August 2003 Qantas released its financial results for the year ended 30 June 2003. Over that period Qantas achieved a profit before tax of $502.3 million and a profit after tax of $343.5 million from a revenue base of $11.4 billion.

Air NZ[25]

3.52. The following table sets out Air NZ's financial performance over the last five years.

Table 3.11 Air NZ financial performance: 1997/98 to 2001/02

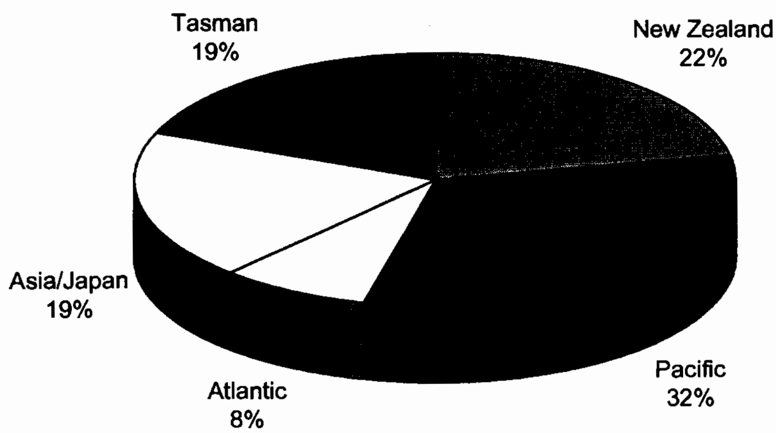
Year ended 30 June	**1998**	**1999**	**2000**	**2001**	**2002**
Operating revenue (NZ$m)	3,089	3,332	3,656	4,025	3,642
EBIT (NZ$m)	170.0	201.0	236.0	141.5	89.1
Profit before tax (NZ$m)	129.7	123.1	143.3	24.6	32.9
Net profit (NZ$m)	145.0	214.0	-600.0	82.5	-318.5

[24] TravelBiz (2003), "Qantas March traffic figures show SARS impact", http://www.travelbiz.com.au/articles/ff/0c016eff.asp, 30 May 2003.
[25] All data in this part sourced from Air NZ, *Annual Reports*, various years.

3.53. Table 3.11 shows that Air NZ has experienced volatility in sales, EBIT and net profit over the past five years. This volatility can be attributed to a number of exogenous events, including the Asian economic crisis, the September 2001 terrorist events, expenditure associated with the failure of Ansett and weak global economies impacting business travel and tourism.

3.54. Air NZ's relatively high reliance on international operations (see Figure 3.2 below) means that any weakness or volatility in international tourism is likely to impact upon Air NZ quite significantly.

Figure 3.2 Analysis of Air NZ revenue by region: 2001/02



3.55. Air NZ's load factors have improved significantly over the past five years and in 2002 were just above 72 per cent.

3.56. On 20 December 2002, Air NZ announced that it expected to *"report a profit before unusuals and tax of around NZ$230 million...this is a significant improvement on results in recent years..."* and Air NZ's half-yearly results (27 February 2003) showed profit before tax and unusual items of NZ$138.3 million and profit after tax and unusual items of NZ$93.9 million. Air NZ's EBIT results for the six months ending December 2002 had improved to NZ$149.9 million (an increase of NZ$200.7 million on the six months ending December 2001).

3.57. Further evidence of Air NZ's improved performance was the announcement in December last year that it would lease ten new Airbus A320 aircraft, with another five to be purchased directly from Airbus.

3.58. In April, Air NZ reported a 5.7 per cent fall in its load factor as a result of SARS on international routes. At the same time, Air NZ also reported continuing strong domestic demand, with a five per cent increase on traffic overall and, for the 2002/03 financial year (to April), Air NZ reported that traffic increased 6.1 per cent over the same period in the previous year.

While Air NZ in mid May warned[26] that the airline industry environment remained volatile it did not change its latest forecast of profit before abnormals and tax of NZ$200 million.

3.59. On 28 August 2003, Air NZ announced a profit of NZ$220.3 million before unusuals and tax, exceeding its forecast by over NZ$20 million. This result represented an increase of NZ$187.3 million (567 per cent) on the pervious year.

3.60. One factor which has had a positive impact on Air NZ's performance is the introduction of "Air NZ Express Class" in November 2002. Air NZ introduced Express Class as part of cost reducing measures. Key elements of Express Class include flexible airfare structuring and cheaper fare structures. Express Class Air removes business class from its services. The single-class services allow an extra 14 seats on 737s and increases Air NZ's domestic capacity by 12 per cent. New Zealand domestic traffic increased by 14 per cent following the introduction of Express Class.

3.61. Air NZ indicated early in 2003 that it intended to introduce a modified version of the Express Class domestic product on trans-Tasman flights.[27] On 12 August 2003 Air NZ announced[28] details of a new Tasman Express service. The service which is to apply to flights from 20 October 2003 sees a restructuring of fares and service with fares between Auckland and Sydney reduced by 45 per cent and between Auckland and Melbourne by 32 per cent. Air NZ expected the new fare structure to boost air travel between Australia and New Zealand by ten per cent.

Airline alliances

3.62. The proliferation of airline alliances has been a feature of the development of the international aviation industry over the last decade. The alliance was an industry response to strong competition, low yields and low profitability and enabled airlines to expand networks and services while controlling costs and increasing productivity.

3.63. There are effectively two styles of alliance: marketing alliances and integrated alliances.

3.64. Integrated alliances, such as the Strategic Alliance Proposal, typically involve a high degree of integration of the airlines concerned, including coordination of fares, schedules, service levels and yield and capacity management.

3.65. Marketing alliances offer the consumer the benefits of broader networks, more seamless travel and expanded loyalty programs. However the alliance airlines generally continue to offer their fares, schedules and services independently, and airlines within the same marketing alliance may compete

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[26] Creedy,. Steve "Air NZ clips wings again as SARS hits", The Australian, 16 May 2003.
[27] Creedy, Steve (2003), "Kiwi grab at no-frills class", *The Australian,* 28 February 2003.
[28] "Air NZ slashes trans-Tasman fares", The Age, 12 August 2003

with each other if on the same route. Examples of marketing alliances include **one**world and the Star Alliance.

3.66. Another form of alliance behaviour which can occur within both integrated alliances and marketing alliances, as well as outside of such alliances, is code sharing. Code sharing involves one airline purchasing and marketing under its own brand name seats on another airline's flights.

3.67. The impact of code sharing on a market will depend on the nature of both the code share payment arrangements and the market in which it occurs. It is fair to say that competition benefits generally will only arise where the code share involves a blocked seat arrangement whereby the purchasing airline effectively commits to purchase a fixed number of seats and therefore has an incentive to market them. When code shares involve "free sale" arrangements, where the marketing carrier effectively only pays for the seats it sells, there is normally no increase in competitive pressure.

3.68. Code sharing may add competition, albeit at the margin, on routes where multiple airline operation is not economically feasible. The Productivity Commission has noted that where carriers are already operating on the same route, and have relatively high market shares, code sharing is likely to reduce competition.[29]

3.69. Generally, where code sharing is used to extend routes by offering seats on other carriers' flights there is little competitive impact. In such circumstances there is little apparent difference for the passenger over interlining. Against this is the possibility that the consumer may not be aware of the actual carrier operating the flight.

3.70. Code sharing may give rise to competitive benefits if it allows an airline to develop a market to a stage where own aircraft operation is feasible. It may also allow an airline to maintain a presence following withdrawal from an unsustainable market pending possible later re-entry. There may also be other circumstances where code sharing is competition neutral.

3.71. Both Applicants are involved in integrated alliances, in a marketing alliance and in separate code shares.

3.72. Qantas is involved in the **one**world alliance. **one**world alliance partners include Aer Lingus, American Airlines, British Airways, Cathay Pacific, Finnair, Iberia and LanChile in addition to 23 regional affiliates. Qantas has bilateral alliances with British Airways, American Airlines, Japan Airlines and Air Pacific and has code share arrangements with airlines including Air Calin, Air Nuigini, Air Tahiti Nui, Air Vanuatu, Alaska Airlines, Alitalia, Asiana, China Eastern, Eva Air, Gulf Air, Origin Pacific, Polynesian Airlines, South African Airways and Vietnam Airlines.

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[29] Productivity Commission (1998), *International Air Services: Inquiry Report,* Commonwealth of Australia: Canberra.

3.73. Air NZ is involved in the Star Alliance. Air NZ's Star Alliance partners include Air Canada, All Nippon Airways, Asiana Airlines, Austrian Airlines, British Midland, Lauda Air, Lufthansa, Mexicana, Scandinavian Airlines, Singapore Airlines, Thai Airways International, Tyrolean Airways, United Airlines and Varig. Air NZ code shares with airlines which include United, Lufthansa, Mexicana, British Midland, Thai Airways and Singapore Airlines. Air NZ has an established alliance agreement with Singapore Airlines with network wide application. Air NZ also has an Alliance Expansion agreement with United Airlines, enabling network wide collaboration.

3.74. There are two other global alliances, namely, the SkyTeam alliance and Wings. SkyTeam alliance members include Aeromexico, Air France, Alitalia, CSA Czech Airlines, Delta and Korean Air. While Wings is not a "formal" alliance, two of its members, KLM and Northwest Airlines, show strong cooperation. Other Wings members include Japan Air Systems, Kenya Airways, Malaysia Airlines, Martinair and Surinam Airways.[30]

3.75. According to Credit Suisse First Boston, aligned airlines had a 45.4 per cent share of the total number of seats offered worldwide in 2001.

Table 3.12 Estimated alliance share of worldwide number of seats (capacity) and growth: 2000, 2001[31]

Alliance	Share (%)		Growth (%)
	2000	2001	2000-01
Star	17.3	17.3	0.9
oneworld	13.0	12.9	-0.5
SkyTeam	11.6	11.1	-3.6
Wings	4.2	4.1	-1.9
Total	*46.0*	*45.4*	*-0.6*

3.76. Table 3.12 above shows each alliance's share of the total international number of passenger seats.

Previous Commission decisions

3.77. The Commission has previously considered a number of authorisations relating to alliance or equity proposals between airlines. An outline of some of the more recent Commission decisions follows.

Qantas/BA Joint Services Agreement

3.78. On 12 May 1995 the Commission granted authorisation for Qantas and BA to operate a Joint Services Agreement ("JSA") which provided for the coordination of various key aspects of their Australia/Europe, Australia/South East Asia, and South East Asia/Europe services.

[30] See Credit Suisse First Boston (2002), *Global Alliances.*

[31] Credit Suisse First Boston (2002), *Global Alliances,* Figure 3.

3.79. The agreement involved:

- fixing prices (that is, jointly determining air fares and freight rates) on all routes between Australia and Europe (including through the US) and Australia and South East Asia;
- jointly managing capacity and yields on selected routes between Australia and Europe and Australia and South East Asia;
- coordinating scheduling of flights and relevant sales and marketing operations on selected routes between Australia and Europe, and Australia and South East Asia; and
- amending the routes which will be subject to all aspects of the agreement at any time in the future.

3.80. In making its determination, the Commission concluded that the agreement would result, or be likely to result, in a lessening of competition. However it acknowledged that a number of public benefits would result from the agreement.

3.81. Overall, the Commission considered that the weighing of anti-competitive detriment against public benefit was finely balanced. The Commission decided to grant authorisation for five years from May 1995, subject to certain conditions including:

- average net revenue per passenger on a representative fare class will not increase in real terms over the three years to March 1998;
- until 31 March 2000, the average weekly available capacity for freight from Australia to the UK on eastern hemisphere routes will not be less than 100 tonnes; and
- reporting requirements on the above conditions.

3.82. In May 2000, the Commission considered a Restated Joint Services Agreement ("RJSA") lodged by Qantas and BA. The RJSA provided for the coordination of airline services between Qantas and BA on nominated routes. The coordination arrangements included coordination on freight, scheduling, marketing, sales, pricing and customer service activities. The RJSA extended to the full networks of both airlines.

3.83. The Commission granted authorisation of the RJSA for a period of three years. Authorisation expired on 21 July 2003. On 6 May 2003, Qantas and BA lodged an application for re-authorisation of the RJSA with the Commission. Pending assessment of this application, the Commission has granted interim authorisation for the arrangement.

Air NZ acquisition of Ansett Holdings Limited

3.84. In May 1996, the Commission was advised that Air NZ proposed to acquire TNT Limited's 50 per cent interest in Ansett Holdings Limited.

3.85. The Commission concluded that the acquisition would not substantially lessen competition in an Australian market. It was also satisfied that there would not be a substantial lessening of competition in relation to international travel into and out of Australia or travel distribution in Australia.

3.86. The Commission noted the move toward the creation of a single aviation market for Australia and New Zealand and took account of this when reaching its decision.

Alliance agreement between Ansett Australia, Ansett International, Air NZ and Singapore Airlines

3.87. On 22 July 1998 the Commission granted authorisation for Ansett Australia, Ansett International, Air NZ and Singapore Airlines to enter into an alliance agreement which provided for the coordination of various aspects of their airline services including capacity, frequency and prices. The agreement applied to services operated between Singapore and New Zealand, between Australia and South East Asia, on trans-Tasman, on Australian domestic routes and on routes beyond Australia, New Zealand and Singapore.

3.88. The Commission concluded that while the alliance agreement would lessen competition, the agreement would be likely to result in benefits to the public which would outweigh that detriment. The Commission formed the view that the alliance agreement was likely to have public benefits in the areas of:

- increasing competition, particularly with the Qantas/British Airways group;
- more efficient use of resources and elimination of duplication;
- assisting in the development of Ansett International and the consequent benefits of a strong, second Australian international airline; and
- improved customer service through the integration of computer systems, seamless service, wider lounge access and the ability to earn frequent flyer points on economy class travel with Singapore Airlines.

3.89. This authorisation expired on 21 July 2003.

Applications for authorisation currently under consideration

3.90. On 4 September 2003 the Commission issued a final determination responding to an application for authorisation lodged by Air NZ on behalf of other members of the Star Alliance. The determination authorised the:

- Star Joint Corporate Agreement Program which would enable Star Alliance members to offer fares and incentives jointly to corporate customers for their air travel business; and
- Star Alliance Conventions Plus Program which would enable Star Alliance members to offer fares and incentives jointly to convention organisers and convention delegates.

3.91. The authorisation is subject to an Air NZ undertaking not to participate in the Corporate Agreement and Conventions Programs at the same time as participating in an alliance with Qantas.

4. The Applicants' submissions

Supporting submission

4.1. The Applicants lodged a supporting submission with the Commission in respect of their Applications. The Applicants also lodged a report prepared by NECG detailing the likely competitive effects and public benefits arising out of the Proposed Arrangements. The Applicants later submitted a revised NECG Model and a revised summary of net public benefit.

4.2. In the supporting submission, the Applicants foreshadowed that they would be advising on proposed undertakings and these were submitted to the Commission on 24 January 2003. The Applicants submitted a paper describing the undertakings in greater detail on 12 March 2003. The Proposed Undertakings are discussed in further detail in Part 14 below.

4.3. The Applicants also submitted reports by Tourism Futures International ("TFI") and PricewaterhouseCoopers ("PwC"). These reports were commissioned by the Applicants to assess the "reasonableness" of the Applicants' claims to tourism benefits and the appropriateness of the data and assumptions used in the NECG Report.

4.4. The Applicants also submitted a substantial amount of additional information at the request of the Commission in relation to the characteristics, operation and assumptions used in the NECG Model and the performance projections under a range of operating scenarios.

4.5. The Applicants submitted that the Proposed Arrangements result in net public benefits taking into account the proposed undertakings and the competitive constraints imposed by existing and future competitors.

4.6. The Applicants submitted that full service airlines ("FSAs") face a threat from VBAs in the current aviation environment.[32]

4.7. In particular, FSA operators face a threat from VBA entry on "Australasian" routes for two reasons:

- Australia and New Zealand are "end of route" destinations and the market does not have a large enough base to support two sustainable FSAs with independent global networks; and

- Australasian short haul routes are ideally suited for VBA entry because there are a limited number of city pairs which comprise a high percentage of overall traffic and consumers (both leisure and business) give preference to price and frequency. The Applicants submitted that

[32] According to the Applicants, VBAs are characterised by low fares (courtesy of a very low cost base) rapid turn around, point to point service, avoidance of low demand city pairs, a single class offering and utilising a "greenfield" cost base.

this limits the effectiveness of FSA product differentiation through loyalty programs and lounges, for example.

4.8. The Applicants submitted that, from Air NZ's perspective, the Proposed Arrangements will:

- remove a threat to its medium to long term viability;
- remove the likelihood of a material contraction of its international networks;
- offer a means to maintain a New Zealand owned and controlled flag carrier;
- support New Zealand's export industries;
- provide an opportunity for Air NZ to regain feed from Australia which is important to its domestic New Zealand, trans-Tasman and international networks; and
- enable Air NZ to invest in fleet upgrades and improved information technology.

4.9. Qantas submitted that the Proposed Arrangements represent a "unique opportunity" to establish a significant airline grouping within Australasia and are an important step toward securing Qantas' long term position as an Australasian based global network carrier.

4.10. The Applicants also submitted that the Proposed Arrangements provide an opportunity for the airlines to combine two strongly branded, locally based international airlines into a sustainable regional airline group and that this opportunity is unlikely to remain in the future. The Applicants submitted that damage from the ongoing battle to develop sustainable networks will erode the benefits of an alliance.

Market definition

4.11. In relation to market definition, the Applicants submitted that the appropriate markets for the Commission to consider are:

- a single product market for Passenger Air Services in the Australasian geographical market and between Australia and North America;
- a single product market for freight air services with different types of freight representing market segments of the overall market in the Australasian geographical market and between Australia and North America; and
- a national geographical market for travel distribution services which includes all segments of the distribution system include retail travel agents, airlines and package tour operators.

4.12. In relation to other ancillary markets including CRS/GDS, engineering services and terminal and ground handling services, the Applicants submitted that the Proposed Arrangements will have a minimal impact on these markets.

4.13. The Applicants' submission in relation to the relevant markets, interested parties' submissions and the Commission's view on these markets is discussed in further detail in Part 10 below.

The Counterfactual

4.14. The Applicants submitted that the appropriate "counterfactual" (that is, the future without the Proposed Arrangements) against which to compare the net public benefits of the Proposed Arrangements is one where there is a more aggressive level of competition between Qantas and Air NZ which will result in additional capacity being applied to material parts of their Australasian networks.

4.15. The Applicants further submitted that the Australasian market cannot support two FSAs and that ultimately one airline will be forced to accept a secondary role to the other which will lead to the contraction of other aspects of its network. NECG submitted that the airline which will be forced to contract is likely to be Air NZ given the relative strengths of Qantas and Air NZ.

4.16. The Applicants' submission in relation to the counterfactual, its views on alternative scenarios, interested parties' submissions and the Commission's view on the counterfactual is discussed in further detail in Part 11 below.

Anti-competitive effects

4.17. The Applicants submitted that, in assessing the extent to which competition will be lessened in any market, the following factors should be considered:

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

4.18. The Applicants submitted that the market for Passenger Air Services is highly contestable and that the Proposed Arrangements are likely to enhance the quality of competition to the benefit of consumers.

4.19. The Applicants submitted that there is no material anti-competitive detriment and that any anti-competitive detriment is ameliorated by the existence of low barriers to entry and no barriers to expansion, the existence of a committed entrant (that is, Virgin Blue), the presence of significant and expanding fifth freedom carriers and the undertakings offered by the Applicants to the Commission.

4.20. In relation to competitiveness in the Australia-North America passenger market, the Applicants submitted that there will be no impact on competition in this market unless and until all the relevant parts of an agreement between United and Air NZ come to an end. The Applicants submitted that, in any event, the anti-competitive effect in this market as a result of the Proposed Arrangements is likely to be minimal because barriers to entry on routes between Australia and North America are low and United is the main competitor to the Applicants in the market.

4.21. In relation to freight markets, the Applicants submitted that there are low or no barriers to expansion in these markets and that many carriers have fifth, sixth or seventh freedom rights. The Applicants submitted that specialised freight carriers are therefore able to enter or expand and defeat any attempt to increase prices in the market.

4.22. In relation to the Travel Distribution Services market, the Applicants submitted that under the Proposed Arrangements the competitive constraints from existing competitors will not be reduced. The Applicants submitted that their retail operations will not be able to raise the prices charged for selling tickets above competitive levels because:

- consumers can access different functional levels within the market;

- there are significant existing competitors within the market; and

- market concentration is low.

4.23. The Applicants submitted that there is, therefore, unlikely to be a material impact on competition in the Travel Distribution Services market.

4.24. The Applicants' submission in relation to the potential anti-competitive detriment is discussed in further detail in Part 12 below.

Public benefits

4.25. The Applicants submitted that the primary sources of public benefit as a result of the Proposed Arrangements are:

- cost efficiencies;

- scheduling efficiencies;

- increased tourism in Australasia;

- improved freight operations;

- increased international competitiveness of Australia's aviation industry;

- preservation of a commercially viable full service Australasian airline and network; and

- furtherance of the national interest.

4.26. The Applicants submitted that these benefits flow from, and are dependent on, the Proposed Arrangements. The Applicants submitted that these benefits are net gains to society.

4.27. In relation to the cost efficiencies claimed, the Applicants submitted that these will result from economies of scale and more cost efficient aircraft usage and maintenance. According to the Applicants, scheduling efficiencies are the result of improved flight frequency, enhanced connectivity and the provision of additional direct services.

4.28. The Applicants submitted that, in relation to tourism, benefits are the result of:

- cooperative advertising, primarily in retail sales promotion of home markets;
- opportunities for savings and leveraging through joint media purchasing;
- a new product in the form of streamlined Australasian itineraries to offshore markets, increasing the number of dual destination travellers to the region;
- stimulating tourism through new flights, new fares and an enhanced network;
- incentives for Qantas Holidays to market Air NZ as a carrier and New Zealand as a destination; and
- additional tourists to Australia.

4.29. In relation to public benefits arising from improved freight operations, the Applicants submitted that the Proposed Arrangements will, in some cases, improve freight access to major markets to the benefit of Australian importers and exporters. The Applicants submitted that cooperation in respect of freight will create opportunities for both Qantas and Air NZ to expand freight services and that the Proposed Arrangements will increase freight capacity by over five per cent by Year 3 (with a benefit of $4 million per annum). The Applicants also submitted that the Proposed Arrangements will result in unquantifiable benefits in terms of freight, including through improved scheduling, realisation of cost savings and possible joint freighter services.

4.30. The Applicants submitted that the estimation of public benefits (see Table 4.1 below) excludes public benefits which cannot be readily quantified. The Applicants submitted that these benefits include enhanced connectivity, increased global competitiveness, preservation of a first tier full service Australasian airline with a comprehensive domestic and international network and furtherance of the national interest.

Net public benefits

4.31. Initially, the Applicants submitted that the net public benefits (in net present value terms) of the Proposed Arrangements amounted to almost $900 million. On 5 March 2003, NECG made a further submission to the Commission which included a revised version of the NECG Model. This model corrected a number of errors identified by the Commission and included NECG's own revisions. The Commission also considered the impact of United Airline's withdrawal from the Auckland-Los Angeles route. NECG submitted the following as a revised summary of the net annual public benefits to Australia.

Table 4.1 Summary of net annual public benefits to Australia (A$'000)

Year	Benefits					Detriment		Trade-off
	Cost savings	Scheduling	New direct	Tourism	Freight	Deadweight	Net transfer	Total welfare
1	44,000	9,000	0	32,000	-3,000	27,000	-25,000	80,000
2	74,000	3,000	6,000	57,000	-1,000	14,000	-9,000	134,000
3	78,000	1,000	7,000	86,000	2,000	27,000	-18,000	165,000
4	73,000	1,000	7,000	81,000	2,000	26,000	-16,000	146,000
5	69,000	1,000	6,000	76,000	2,000	25,000	-16,000	146,000
Total	***337,000***	***16,000***	***26,000***	***332,000***	***3,000***	***119,000***	***-85,000***	***679,000***

4.32. Table 4.1 shows that the Applicants are of the view that the benefits to Australia from the Proposed Arrangements are estimated at almost $680 million over five years.

4.33. The public benefits claimed by the Applicants and the NECG Report are discussed in further detail in Part 13 below.

4.34. The Applicants concluded that the Proposed Arrangements should be authorised by the Commission.

PricewaterhouseCoopers

4.35. The Applicants provided a copy of a report by PwC to the Commission. PwC was commissioned by the Applicants to review the economic analysis conducted by NECG. PwC examined the methodology employed by NECG, the material input assumptions to the models, the reasonableness of the models' outputs and the accuracy of the models' operation.

4.36. PwC did not consider factors such as the impact of any undertakings which may be provided by the Applicants or the NECG's sensitivity analysis, and it assumed that the Proposed Arrangements would provide the necessary economic and commercial incentives for Qantas to place its engineering and maintenance work with Air NZ.

4.37. PwC concluded that it had no reason to consider that the calculations supporting NECG's conclusions were not reliable.

Tourism Futures International

4.38. The Applicants provided a copy of a report produced by TFI that examined the Applicants' claims as to the effect on tourism of the Proposed Arrangements. This report was commissioned to assess the reasonableness of the estimates provided by the Applicants to NECG.

4.39. TFI contended that the following benefits to tourism will flow from the Proposed Arrangements:

- the potential expansion to, or maintenance of, existing operations in emerging overseas markets;
- the opportunity for the operation of new flights and improvement of network quality (particularly as Qantas will increase its network coverage between New Zealand and Asian destinations);
- the combination of greater product variety and volume (for example through joint Australian and New Zealand air and land product), and an increase in the number of distribution outlets available for both New Zealand and joint tourism product, will increase the prospect of attracting new long haul tourists and repeat visitors;
- consolidation of the promotion budgets of both Applicants, providing a larger budget for the promotion of Australia and New Zealand; and
- opportunities for the joint marketing of the Australian and New Zealand tourism products, which will assist to streamline and minimise the gaps in the travel decision-making process, and will further provide the Qantas distribution network with the incentive to sell the New Zealand product.

4.40. TFI contended that these benefits arise from the profit-sharing arrangements and improvement in Qantas' network reach under the Proposed Arrangements, and that they therefore could not be realised absent the Proposed Arrangements. TFI concluded that the Applicants' estimates of increased tourists to Australia and New Zealand as a result of the Proposed Arrangements were reasonable.

"Updated" TFI Report

4.41. The Updated TFI Report was submitted by the Applicants in response to issues raised by a number of tourism-related submissions lodged by third parties. An outline of the issues raised in TFI's updated report is at **Appendix B** to this Determination.

Response to submissions

4.42. In its response to submissions ("the Response"), the Applicants considered submissions lodged by third parties which were received by the Commission as of 7 March 2003. (Submissions lodged by third parties are outlined in Part 5 and **Appendix A** to this Determination.)

4.43. The Applicants considered matters including third party views on the counterfactual, VBA entry/expansion, freight capacity, travel distribution, tourism, undertakings and conditions, price and capacity changes, the impact on Origin Pacific Airways Limited ("Origin Pacific"), the impact on employment in Australia, the relevance of traffic rights and the impact on frequent flyer points.

4.44. The Applicants also submitted a "further description" of the Applicants' counterfactual.

4.45. As part of the Response, the Applicants also submitted a report prepared by NECG responding to the economic arguments raised in the third party submissions.

4.46. A more detailed outline of the main issues raised in the Response is set out in **Appendix B** to this Determination.

5. Submissions lodged by third parties on the applications

5.1. The Commission sought submissions from a wide range of interested parties in respect of the applications and received a number of unsolicited submissions in relation to the matter. Submissions received include two anonymous submissions (where confidentiality was granted by the Commission to the name of the submitter) and one confidential submission.

5.2. The Commission received submissions from the following parties:

- Air Freight Council of Queensland ("AFCQ");
- Australasia Pacific Airports (Melbourne) Pty Ltd ("Melbourne Airport");
- Australasian Business Travel Association ("ABTA");
- Australian Airports Association Limited ("AAA");
- Australian Consumers Association ("ACA");
- Australian Council of Trade Unions ("ACTU");
- Australian Federation of International Forwarders Ltd ("AFIF");
- Australian and International Pilots Association ("AIPA");
- Australian Manufacturing Workers' Union ("AMWU");
- Australian Services Union;
- Australian Tourism Export Council ("ATEC");
- Australian Tourist Commission ("ATC");
- Bon Voyage Marketing Ltd ("BVM");
- Brisbane Airport Corporation Ltd ("BAC");
- Consolidated Travel Pty Ltd ("Consolidated Travel");
- Danzas AEI Pty Limited ("Danzas");
- Department of Industry, Tourism and Resources ("DITR");
- Department of Transport and Regional Services ("DTRS");
- DHL International (Aust) Pty/Ltd ("DHL");
- Flight Attendants' Association of Australia;
- Gullivers Pacific Group ("GPG");

- Professor Tim Hazledine (University of Auckland);
- Importers Institute of New Zealand ("IINZ");
- International Air Services Commission ("IASC");
- International Federation of Freight Forwarders Associations;
- Jumpjet Airlines Limited ("Jumpjet");
- Mr Hugh Melton;
- New South Wales Government ("NSW Govt");
- Ms Jan Norrish;
- Northern Territory Airports Pty Ltd ("NT Airports");
- Northern Territory Tourist Commission ("NTTC");
- Origin Pacific Airways Ltd ("Origin Pacific");
- Queensland Government ("Qld Govt");
- Regional Express ("Rex");
- South Australian Government ("SA Govt");
- Sydney Airports Corporation Limited ("SACL");
- Tasmanian Government;
- Tourism Industry Association of New Zealand ("TIANZ");
- Tourism Task Force ("TTF");
- Transport Workers' Union of Australia;
- United Airlines ("United");
- The Hon Mark Vaile MP (Minister for Trade);
- Victorian State Government ("Vic Govt");
- Virgin Atlantic;
- Virgin Blue;
- Mr Peter Wakeman;
- Western Australian Government ("WA Govt");
- Westralia Airports Corporation Pty Ltd ("WAC"); and

- a submission on behalf of six separate interested parties ("Combined Submission").

5.3. An outline of these submissions is at **Appendix A.**

5.4. The Commission also considered a submission to the NZCC in relation to this matter by Tourism New Zealand.

5.5. Specific issues raised in other submissions are also discussed throughout the remainder of this Determination.

6. Draft Determination

6.1. Subsection 90(4) of the Act provides that the Commission shall state in writing its reasons for a determination made by it.

6.2. Subsection 90(5) of the Act provides that before making a determination (the final determination) in respect of an application for an authorisation the Commission shall comply with the requirements of section 90A.

6.3. Subsection 90A(1) of the Act provides that before determining an application for an authorisation (other than an application for an authorisation under subsection 88(9) of the Act), the Commission shall prepare a draft determination in relation to the application.

6.4. The Commission is not required to make a draft determination in relation to applications made under section 88(9) of the Act for authorisation under subsection 90(9) of the Act. Given the Commission's common assessment of the Applications, however, the Commission provided a draft assessment of application A30222 in its Draft Determination.

6.5. The Commission made a Draft Determination in respect of Applications A30220, A30221, A30222, A90862 and A90863) on 10 April 2003.

6.6. An outline of the Commission's Draft Determination is below.

Anti-competitive detriment

6.7. Following its assessment of the anti-competitive detriment flowing from the Proposed Arrangements, the Commission concluded that the Proposed Arrangements were highly anti-competitive and resulted in a high level of anti-competitive detriment. In forming this view, the Commission concluded that the Proposed Arrangements would result in:

- a substantial lessening of competition and a substantial increase in market power of the Applicants in relation to trans-Tasman passenger air services. The Commission is of the view that the arrangements, in relation to trans-Tasman routes, would be highly anti-competitive;

- significant anti-competitive detriment in relation to passenger air services between Australia and North America;

- little anti-competitive detriment in relation to passenger air services between Australia and the Pacific Islands albeit with the potential for the Proposed Arrangements to be anti-competitive;

- high anti-competitive detriment in relevant air freight markets leading to increased prices and reduced capacity;

- substantial anti-competitive detriment in the Australian domestic air passenger market; and

- some anti-competitive detriment in the relevant markets for the sale of air travel.

6.8. In considering the anti-competitive effects of the Proposed Arrangements, the Commission formed the view that the markets most likely affected by the Proposed Arrangements (from an Australian perspective) were the trans-Tasman passenger air services and trans-Tasman freight services markets. It followed therefore that the anti-competitive effect in those markets should be given greater weight.

6.9. Having regard to the foregoing, the Commission was of the view that the anti-competitive nature of the Proposed Arrangements would lead to increased fares and decreases in capacity and quality of service on routes which involve Australia.

Public Benefits

6.10. The Commission's overall assessment was that the Proposed Arrangements did not give rise to public benefits of significance to which a reasonable degree of certainty of realisation could be attached. The Commission's assessment was that:

- there existed substantial doubt as to whether the claimed significant cost efficiencies would flow from the Proposed Arrangements;
- any benefits that might accrue from scheduling efficiencies were not significant in the context of the overall Proposed Arrangements and there is a risk of capacity reduction associated with scheduling efficiencies;
- new direct services were not necessarily sustainable and any benefits for passengers were not significant;
- the Commission was not convinced that claimed tourism increases or associated public benefits would occur;
- the Commission was not satisfied that claimed freight capacity initiatives were sustainable and that associated public benefits would occur; and
- the Proposed Arrangements add only marginally to the global competitiveness of Qantas and are not necessarily in the national interest.

Balance of anti-competitive detriments and public benefits

6.11. Having regard to the foregoing and having applied the "with-and-without test", the Commission formed the view that the highly anti-competitive effects of the Proposed Arrangements identified by the Commission would, for the foreseeable future, significantly outweigh the low public benefits flowing from the Proposed Arrangements that were accepted by the Commission.

6.12. The Commission formed the view that the gap between the anti-competitive detriment and public benefits likely to flow from the Proposed Arrangements, in comparison with the situation likely to arise without the Proposed Arrangements, is large.

Potential for undertakings to redress the imbalance

6.13. The Commission had indicated that it considered the ability of undertakings to control behaviour such as that proposed by the Applicants is severely limited.

6.14. In the context of the Applicants' Applications, the Commission did not believe that undertakings had the potential to significantly reduce the high level of anti-competitive detriment arising from the Proposed Arrangements.

6.15. The Commission also recognised that undertakings can be used to ensure that public benefits are realised. In this matter, any uncertainty with public benefit is mainly associated with the size of the benefit rather than realisation, for example, as with claimed tourism benefits. Accordingly, the Commission considered there to be limited scope for undertakings to be utilised to increase the level of public benefit arising from the Proposed Arrangements.

6.16. In summary, the Commission considered there to be limited potential in the foreseeable future for the giving of undertakings by the Applicants to change the balance of detriment and benefit to the extent that a position of net public benefit would be achieved.

Responses to the Draft Determination

6.17. The Commission received a small number of submissions from interested parties in relation to the Draft Determination, including a submission from the Applicants. These submissions are described in more detail at Appendix D and are addressed at relevant areas of the Commission's assessment.

6.18. Pursuant to section 90A of the Act the Applicants and other interested persons are entitled to request the Commission to hold a conference in relation to the Draft Determination. No party sought such a conference.

6.19. The Applicants advised the Commission in a letter dated 24 April 2003 that they did not wish to request a conference. They indicated they would make a further submission by 9 May 2003 and asked the Commission to finalise its Determination as soon as possible so that the Applicants could, if necessary, lodge their application for review. A 40 page submission was lodged with the Commission on 9 May 2003.

6.20. On 6 June 2003 the Applicants agreed to a request to extend the Commission's consideration of their application until 30 September 2003 to enable the Commission to adequately consider the material put to it by the Applicants since the Draft Determination.

6.21. While not calling for a conference in Australia the Applicants did attend and contribute to, by substantial submission and testimony, a conference called by the NZCC in relation to its Draft Determination proposing to deny approval to the Proposed Arrangements under New Zealand competition law.

6.22. In late July the Applicants formally lodged with the Commission their submission (of 570 pages) to the NZCC in relation to its Draft Determination.

6.23. On 1 September 2003 the Applicants lodged with the Commission a final submission (41 pages) and the full proceedings of the New Zealand Commerce Commission conference (estimated at around 1,300 pages). This submission contained a summary of matters raised with the NZCC and directed the Commission to particular issues that the Applicants considered pertinent to the Commission's assessment.

6.24. In reaching its final decision, the Commission has taken the above material into account as far as possible and to the extent it adds to information available to the Commission at the time of its Draft Determination. There are limitations on the extent to which the material can be used by the Commission in an Australian context. The material was submitted to the NZCC pursuant to New Zealand law, in response to questions and a Draft Determination issued by the NZCC, with different markets, benefits, detriments and modelling involved.

7. Submissions since the Commission's Draft Determination

Pre-decision conference

7.1. The Act requires that the Commission give interested parties an opportunity to request a pre-decision conference in relation to any draft determination it makes (section 90A). A pre-decision conference provides an opportunity for interested parties to make oral submissions to the Commission in respect of its Draft Determination.

7.2. Interested parties were required to advise the Commission by 24 April 2003 if they wished such a conference to be convened in relation to this matter.

7.3. No party requested that the Commission convene a pre-decision conference in relation to its Draft Determination (A30220, A30221, A30222, A90862 and A90863).

Written submissions

7.4. A small number of parties made written submissions to the Commission in relation to its Draft Determination. An outline of these submissions is at **Appendix D** to this Determination, however, specific comments made in further submissions are addressed in the relevant parts of this Determination.

8. Applicants' submissions in relation to the state of the aviation industry

8.1. In an "Updated Executive Summary" submitted to the Commission on 16 March 2003 and in their response to the Commission's Draft Determination the Applicants referred to the difficulties facing the aviation industry. The Applicants also submitted that the Commission had erred in a number of its conclusions on the background to the Applications and the "current crisis" in the aviation industry.

8.2. The Applicants submitted that the Commission had concluded that the pressure being experienced by airlines was a result of only temporary changes in the market. The Applicants submitted that this view was not consistent with evidence provided to the Commission that there has been a significant structural change in the airline industry as a result of:

- the development and rapid expansion of VBAs;
- globalisation and the rise of airline alliances;
- changes in the regulatory environment in which airlines operate;
- a write down in the value of aviation as a whole; and
- changes in consumer demand.

8.3. The Applicants submitted that the Commission's conclusion that the Applicants are experiencing only temporary pressures is not supported by evidence of extensive structural changes in the airline industry.

8.4. The Commission notes the Applicants' comments in relation to the difficulties currently facing Qantas and the aviation industry as a whole. The Commission is of the view that the Applicants have misinterpreted the Commission's position. Statements made by the Commission in relation to temporary pressures were directed towards the impact being felt by the industry at the time from the war in Iraq and from SARS. The Commission was effectively saying that it would be incorrect to give significant weight to such short term factors when considering long term structural proposals such as those put forward by the Applicants.

8.5. The Commission certainly did consider the "structural changes" claimed above by the Applicants when forming its views as to the counterfactual, anti-competitive detriment and public benefit. The Commission may not, however, have attached the same weight to such "changes" as attributed by the Applicants.

The development and rapid expansion of VBAs

8.6. The Commission is aware of the features and operating characteristics of VBAs as being introduced around the world and as operating in Australia in the form of Virgin Blue. The Commission notes that with their emphasis on narrow bodied aircraft and short haul route targeting such airline operations would seem suited to the trans-Tasman route.

8.7. The Commission also notes however that the advent of the VBAs has not yet impacted the international operations of Qantas and Air NZ. Moreover around 80 per cent of Qantas international passenger traffic, and an even higher proportion of international passenger revenue, relates to long haul routes not subject to or suited to competition from VBAs. It has been similarly observed[33] that full service European airlines face only limited competition from low cost carriers because those carriers do not fly the longer haul international routes that account for more than half of the big European carriers' business.

8.8. The Commission notes that both Qantas and Air NZ operate low cost airline models in their own right in the form of Australian Airlines, Impulse, Jet Connect and Freedom Air which would facilitate competition with a VBA such as Virgin Blue on short haul routes.

Globalisation and the rise of alliances

8.9. The Applicants point to a movement worldwide to closer links between airlines based on equity participation and fuller integration with recent turmoil in the industry adding impetus to this trend. It is pointed out that in 2002 alone seven international alliances have been granted regulatory approval or re-approval.

8.10. While it is true that such alliances are increasingly common they are still invariably subject to regulatory approval. The Commission has examined the seven alliances cited by the Applicants. Most of the alliances are not comparable with the alliance proposed between Qantas and Air NZ.

8.11. One of the alliances cited was between Delta and Korean Air ("KAL"), which was granted approval and anti-trust immunity for alliance agreements in June 2002. The US Department of Transportation ("the US DOT") found that, unlike Qantas and Air NZ in the trans-Tasman market:

> *"[Delta and Korean Air] do not compete head-to-head in any city-pair market, and several other US and foreign airlines provide competitive service in the transpacific markets and between the United States and the Republic of Korea."*[34]

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[33] "How Europe's airlines kept flying as US carriers sank", Carol Matlack, Joseph Weber and Wendy Zellner, Australian Financial Review, May 2003.

[34] United States Department of Transportation (2002), *Order granting approval and antitrust immunity for alliance agreements: Order 2002-6-18, served 27 June 2002*, page 7.

8.12. In relation to the level of competition on the routes affected by the proposed Delta-KAL alliance, the US DOT found that, in relation to the United States-Far East market, Delta's non-stop passenger market share was 2.4 per cent and the proposed Delta-KAL alliance had a passenger market share of 8.2 per cent. The US DOT also found that Delta and KAL faced competition in the US-Far East market from Star Alliance partners (with a market share of about 24 per cent), the Northwest Airlines-Malaysian Airline alliance (17 per cent), Japan Airlines (15 per cent), **one**world alliance partners (5.7 per cent) and Continental Airlines/Continental Micronesia (6.9 per cent).

8.13. In relation to the United States-Republic of Korea market and city-pair markets, the US DOT found that the Delta and KAL do not compete in these markets and, as such, the alliance would not substantially lessen competition.

8.14. Another alliance cited was between American Airlines and Finnair approved in 2002. The US DOT found in relation to this alliance that:

> *"[American Airlines and Finnair] do not compete head-to-head in any city-pair market, and several other US and foreign owned airlines provide competitive services in the relevant transatlantic markets."*[35]

8.15. In relation to the US-Europe market, the proposed American Airlines-Finnair partnership would have had a passenger market share of about 8.4 per cent, with competition from other **one**world alliance carriers (24.74 per cent), Star Alliance partners (21.64 per cent), SkyTeam alliance partners (17.92 per cent) and Northwest-KLM (8.87 per cent).

8.16. Similarly, in the US-Finland market, the US DOT found that the alliance between American Airlines and Finnair would not substantially reduce competition as American does not operate any flights to Finland and other alliances between a US airline and one or more foreign carriers operate competitive connecting services between the US and Finland. In the relevant city-pair markets, the airlines did not compete on a non-stop basis in any city-pair market.

8.17. The only alliance of those cited which is comparable to the Proposed Arrangements between Qantas and Air NZ was between Lufthansa and Austrian Airlines. The European Commission was concerned that the alliance would have created a near monopoly on the 33 routes between Germany and Austria. The alliance was only approved on the basis that there were four other airlines interested in providing services between the two countries and that Lufthansa and Austrian agreed to release up to 40 per cent of slots to enable rivals to enter the market. Lufthansa and Austria were also required to reduce fares on routes where they do not face competition every time they cut fares on routes where a new rival emerged.

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[35] US DOT (2002), *Order granting approval and ant-trust immunity for an alliance agreement: Order 2002-7-39, served 30 July 2002.*

8.18. There is little reference by the Applicants to proposed alliances where regulatory approval has either been denied, or given in a form unacceptable to the alliance partners, such as with proposed alliances between American Airlines and British Airways, or between Air France and Alitalia.

Changes in the regulatory environment

8.19. The Commission has clearly acknowledged the developments referred to by the Applicants in this area which predominantly relate to the deregulation and liberalisation of aviation markets. The Commission would observe that an intention of such deregulatory initiatives would appear to be to achieve an increase in competition rather than to provide justification for effective mergers between incumbent airlines.

A write down in the value of aviation as a whole

8.20. It is suggested that the world's major airlines have recently incurred major losses and stock markets have written down the value of aviation as a whole making it difficult for airlines to finance investment which, in turn, leads to ongoing structural weaknesses.

8.21. While this claim may be relevant to many airlines, particularly in the United States, it does not appear to apply to Qantas and Air NZ both of which are operating profitably and have recently been able to commit to aircraft procurement. It is possible that such developments strengthen the positions of Qantas and Air NZ relative to their competitors. Qantas, for example, has had little difficulty raising funds in recent years. Qantas executive general manager John Borghetti is quoted[36] recently as saying that despite estimates that world airlines would lose $US30 billion (A$46 billion) in the two years since the World Trade Centre attacks, Qantas had invested $7 billion in new aircraft and other infrastructure.

Changes in consumer demand

8.22. The Applicants have stated that FSAs must continue to maximise revenue by offering network breadth and competition on service quality while also dealing with a customer preference for price and frequency.

8.23. The Commission is aware of this dilemma faced by airlines in determining the nature of their product. Both Qantas and Air NZ are seen to have made attempts to tailor product to route and customer wants - Qantas with its "all leisure" traffic services and Air NZ with its "Express" services. Virgin Blue has taken steps in the other direction with its introduction of lounges, a loyalty program and valet parking.

8.24. From the Commission's perspective, on routes where there is VBA competition, VBA and FSA airlines tend to be heading towards common middle ground products with the consumer benefiting from improved service and price.

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[36] Matt Price & Steve Creedy, "Qantas admits planes too late", The Australian, 12 August 2003.

8.25. Turning then to the Commission's view of the current operating environment, the Commission accepts, and has accepted throughout this process, that the airline industry is dynamic and has, in recent years, undergone significant changes – some structural, some not.

8.26. The Commission is of the view, however, that the current issues impacting most on the profitability of the airlines are not necessarily long term issues. Terrorism, SARS and a downturn in the economic conditions are not necessarily long term phenomena. Indeed, as discussed above, many commentators have declared that the worst of SARS is over, and the war in Iraq is over. Many airlines in the Asian region are announcing a return to normal services. Economic downturns have impacted the industry before (as in 1991) and the industry recovered.

8.27. While the Commission also accepts that there have been structural changes such as the relaxation of regulations and the emergence of low cost carriers, the relevance of such developments and the extent to which they should be taken into account would appear to be a product of the measure to which they impact on the specific markets concerned and the state of the players involved. The developments will not apply universally and equally to all airlines and all markets.

8.28. Just because a market has become deregulated, for example, does not necessarily mean that new players will flock to it. The impact of VBA entry on individual airlines will similarly depend on the structure of the airlines' route networks. A short haul FSA airline within Europe or the United States is more likely to be impacted than long haul airlines such as Qantas.

8.29. The Applicants have suggested that the Commission should not draw conclusions as to the long term performance of both Qantas and Air NZ from their recent results. Qantas is critical of the Commission for taking a "snapshot view" as a guide to the airline's performance.

8.30. However from the Commission's perspective the industry has been under the same pressures described by the Applicants for some time and it does not appear unreasonable for the Commission to take the Applicants' performance under these circumstances as a guide to their future performance. The Commission is also mindful that the Asia Pacific area is commonly acknowledged as being less impacted by recent developments than, say, Europe or North America.

8.31. The Commission notes that the international ratings agency Standard and Poor's maintained Qantas BBB-plus rating in April this year. The agency said[37] that Qantas was in a better position than most of its peers to withstand the severe conditions facing the industry in the near term and thus its rating was not under threat. The rating was described as reflecting Qantas' strong fundamentals, good fleet flexibility, strong liquidity with $2 billion in cash and its robust performance in the first half of fiscal 2003.

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[37] Geoffrey Thomas, *"Qantas wins tick from rating body,"* The West Australian, 2 April 2003.

9. Statutory Basis for Assessment

9.1. The Commission's assessment of the Applications is in accordance with the various statutory provisions set out in the Act. The relevant provisions and the context for the Commission's assessment are detailed below.

The Equity Proposal

9.2. Subsection 50(1) of the Act provides:

> *"A corporation must not directly or indirectly:*
>
> *(a) acquire shares in the capital of a body corporate; or*
>
> *(b) acquire any assets of a person;*
>
> *if the acquisition would have the effect, or be likely to have the effect, of substantially lessening competition in a market."*

9.3. The Applicants lodged application A30222 pursuant to subsection 88(9) of the Act for authorisation under that subsection for Qantas to acquire shares in the capital of Air NZ (the Equity Proposal). An authorisation granted pursuant to subsection 88(9) provides protection from action by the Commission or any other party for potential breaches of section 50 of the Act.

9.4. Subsections 50(4) and (5) of the Act provide a mechanism for authorisation of existing contracts for the acquisition of shares or assets provided the contract is conditional on authorisation being granted. Qantas and Air NZ entered into such a contract (the Subscription Agreement) on 25 November 2002.

9.5. Subsection 90(9) of the Act provides that the Commission shall not make a determination granting authorisation under subsection 88(9) unless it is satisfied that in all the circumstances that the proposed acquisition would result, or be likely to result, in such a benefit to the public that the acquisition should be allowed to take place.

9.6. Paragraph 90(11)(a) of the Act provides that the Commission has a period of 30 days to consider an application for authorisation under subsection 88(9) of the Act. Subsection 90(11A) of the Act provides that this period may be extended to 45 days for complex matters. The period may also be extended by Commission requests for information from the applicants (under paragraph 90(11)(b) of the Act) or with the agreement of the applicant (subsection 90(12) of the Act). If the Commission has not made a determination in the relevant period the authorisation is deemed to have been granted.

9.7. In their covering letter to the Applications, dated 9 December 2002, the Applicants advised that for the purposes of subsection 90(12) of the Act, Qantas and Air NZ agreed to the Commission taking a longer period for the determination of the application under subsection 88(9) of the Act being the period ending on 5 July 2003. The Applicants have since agreed to extend the period within which the Commission may make a final determination with