

JOHNSON WINTER & SLATTERY

L A W Y E R S

20 June 2006

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Mr Scott Gregson
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Australian Competition & Consumer Commission
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BY EMAIL

Dear Mr Gregson

Qantas & Air New Zealand Authorisation Applications (A91001 – A91003)

We refer to your letter of 22 May 2006, which contained a request for further information in relation to the above applications, and our initial response of 13 June 2006.

We have set out our clients' second tranche of responses in the attached schedule and accompanying annexures. There is only one request (Q11) that remains outstanding and we have been in correspondence with the Commission in this regard. We intend providing the Commission with a response to Q11 in the very near future.

Confidentiality

We request, pursuant to section 89(5) of the *Trade Practices Act 1974* (Cth), that the Commission refrain from disclosing the attached schedule on the basis that it contains information that is confidential to Qantas and/or Air NZ.

We will provide you with a version of the schedule that masks the relevant confidential responses for inclusion on the public register shortly.

Given that Qantas and/or Air NZ confidential information was required to prepare the attached schedule, the Applicants took steps to ensure confidential information was not disclosed between them. In the attached schedule specific confidential information has been highlighted in yellow (for Qantas) and blue (for Air NZ). These highlighted responses (or partial responses) were not provided to any members of the other Applicant's internal legal or commercial teams, nor was their content disclosed to these teams.

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Please do not hesitate to contact us if you have any queries in relation to this letter or the attached schedule.

Yours sincerely

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cc: Ms Isabelle Arnaud, Australian Competition & Consumer Commission
Mr Carl Toohey, Australian Competition & Consumer Commission

**ACCC QUESTIONS FOR QANTAS & AIR NEW ZEALAND –
TASMAN NETWORKS AGREEMENT [TRANCHE 2]**

20 June 2006

CURRENT OPERATIONS***Other trans-Tasman routes***

1. **In Table 1 of the submission, the Applicants provide a table of capacity shares (by airline) on the 'nine main Tasman routes' which are stated to account for approximately 85 per cent of all Tasman non-stop capacity. Can the Applicants provide capacity shares, at an equivalent date, for all other trans-Tasman routes?**

See response provided on 13 June 2006.

Capacity

2. **The Applicants estimate that there are 5,200 empty seats per day on the main Tasman routes, and 6,300 overall. What is the basis for this estimate?**

See response provided on 13 June 2006.

Can the Applicants provide a breakdown of which routes this surplus capacity is occurring on? How many of these estimated empty seats are offered by (i) Qantas and (ii) Air NZ?

See response provided on 13 June 2006.

3. **The ACCC notes that Air NZ has substantially increased capacity on the main Auckland and Wellington routes since March 2004. Can Air NZ explain the reasons for this capacity increase?**

Introduction

By way of introduction to Q3 and Q4, it is important to note that the term "capacity" has two dimensions. It can refer to the frequencies or services (i.e. the number of flights per week) that a carrier offers on a particular route. It can also be used to describe the number of available seats a carrier offers on a route. This second type of "capacity" can alter without any change to the number of frequencies on a route where an airline elects or is compelled to alter the aircraft type (for example, a move from B737s to A320s) or to change the internal seat configuration of its existing aircraft.

The Applicants' submission to the Commission of 13 April 2006 makes the following point: "*the consequences of a network carrier unilaterally removing capacity from a market, such as the Tasman, would be to cede competitive advantage to the competing airline's network while effectively marginalizing its own network*" (see para. 3.8).

In this context, the term "capacity" should be read as referring to frequencies. That is, if an airline unilaterally reduces the number of frequencies it offers in a market like the

Tasman (for example, it withdraws a particular service) in many situations there are likely to be negative network consequences.¹ As a result, significant unilateral reductions in frequency generally only occur in exceptional marketplace circumstances or where necessary decisions taken elsewhere in the network have "flow on" implications for Tasman operations.

However, the Applicants' proposition should not be taken to suggest that Qantas or Air NZ cannot unilaterally make marginal adjustments to their total seat capacity. Indeed, minor changes in total seat capacity often occur for a range of reasons, some of which are outlined in the Applicants' responses to Q3 and Q4 below. There is however, a limit to the steps that a carrier can take in implementing capacity reductions without significantly reducing the value of its overall network through reductions in the frequency or route density of Tasman services. The capacity reductions proposed under the TNA can only be achieved by the carriers working together to maintain network connectivity and city presence by code-sharing on each others' services and extending the number of flights that are available to passengers across the Tasman routes.

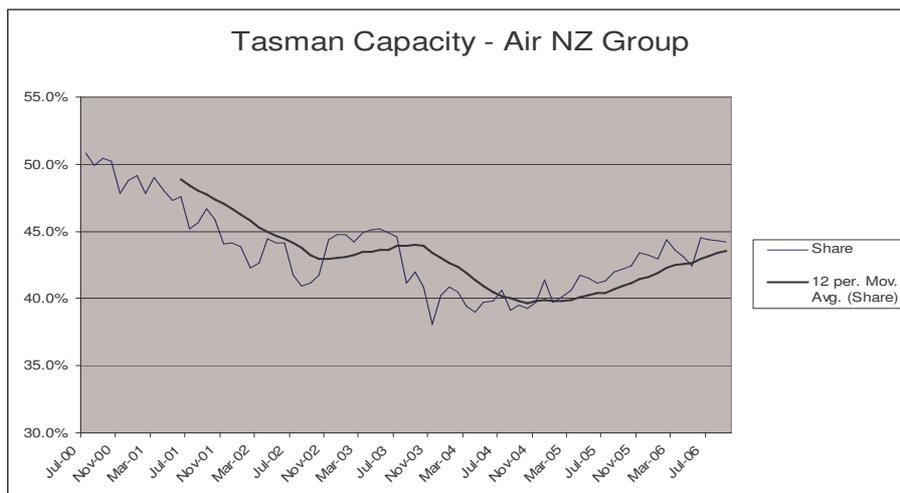
Response to Question 3

This response has been prepared by Air NZ.

Generally

The addition of capacity since March 2004 must be viewed in the context of the substantial reduction in market share that Air NZ experienced between 2000 and 2004 and in particular in the period following Emirates' entrance in late 2003 (see Figure 1 below).

Figure 1



¹ The significance of these negative network consequences is often related to the density of the route (i.e. how many frequencies already exist on a particular route and what frequencies would remain after the withdrawals are implemented)

[RESTRICTION OF PUBLICATION CLAIMED]

When viewed in this context, much of the capacity added to the Tasman since 2004 is consistent with an attempt by Air NZ to 'recover lost ground' in order to achieve a level of connectivity, frequency and overall network presence on the Tasman that had been lost relative to its competitors in the period leading up to March 2004.

Against this backdrop, more specific comments are provided for Auckland and Wellington below.

Auckland Routes

The Air NZ Group's ASKs² on the main Auckland routes (i.e. Sydney/Melbourne/Brisbane – Auckland) increased by approximately 33% over the period from the 12 months ending March 2004 to the 12 months ending April 2006.

This addition of capacity was a move toward historical capacity shares in these markets that had been lost in the period since Air NZ pulled down capacity after the collapse of Ansett. This increase was achieved primarily through the increased utilisation of wide-bodied aircraft and consequently is primarily an increase in total seat capacity, rather than a substantial increase in the frequency of Auckland services offered by Air NZ. In addition to strengthening Air NZ's capacity share, this shift towards wide-bodied capacity occurred for a number of reasons³, including:

- (a) Wide-bodied aircraft are needed to create through flights to the USA (such as Melbourne-Auckland-Los Angeles).
- (b) Wide-bodied aircraft increase Air NZ's cargo capacity, particularly on Auckland-Melbourne.
- (c) Wide-bodied aircraft increase Air NZ's business class capacity on Auckland-Sydney. In addition, customer feedback emphasised that passengers generally preferred wide-bodied aircraft. As a result, a B767 was dedicated to the Auckland-Sydney route.
- (d) To train pilots on B777 flying as this new fleet type was progressively introduced.

A flow-on opportunity from the increased utilisation of wide-bodied aircraft was the introduction of three additional A320 frequencies, which were reallocated from Auckland-Melbourne to Auckland-Brisbane in the Northern Summer 04 scheduling season.

² In simple terms, ASKs (or airline seat kilometres) is a measure of total seat capacity that is calculated by multiplying the number of seats on a particular route by the number of kilometres travelled

³ A more detailed explanation for Air NZ's shift towards wide-bodied capacity on the Tasman is provided in response to Q13 below

Wellington Routes

The Air NZ Group's ASKs on the main Wellington routes (i.e. Sydney/Melbourne/Brisbane – Wellington) increased by approximately 23% over the period from the 12 months ending March 2004 to the 12 months ending April 2006.

The main reason for this increase in total seat capacity is Air NZ's gradual replacement of its B737 aircraft (with 114 seats) on the Tasman with A320 aircraft (with 146 seats). This transition process commenced in or around February 2004.

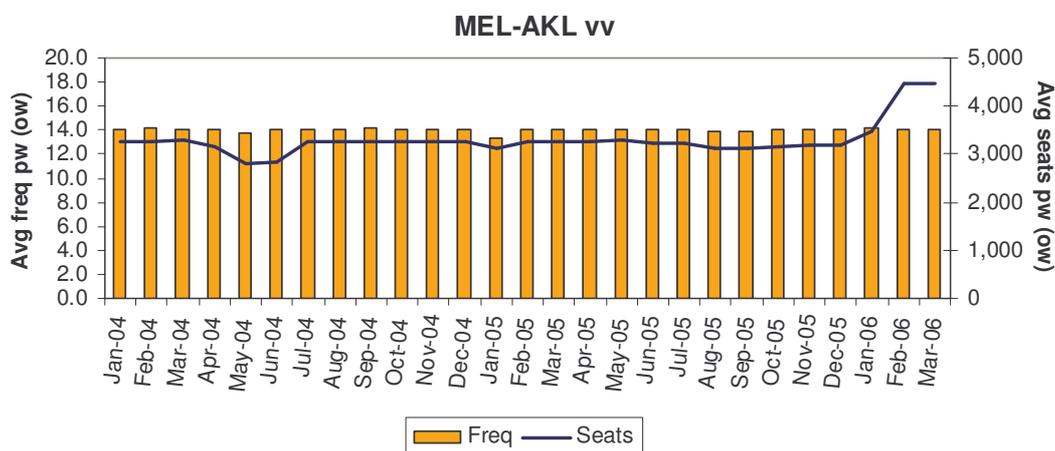
4. The ACCC notes that Qantas' capacity on the main Auckland routes has declined since March 2004. How does Qantas reconcile this reduction in capacity with the Applicants' rationale for the proposed TNA that they cannot reduce capacity unilaterally?

This response has been prepared by Qantas.

As the introduction to Q3 highlights, the capacity adjustments undertaken by Qantas over the period from March 2004 should not be examined independently of associated changes to frequencies. Each of the main Auckland routes is examined separately below, but overall the shifts in capacity on these routes have been infrequent and illustrate that for the core of Qantas' Tasman schedule Qantas normally takes steps to avoid implementing significant unilateral reductions in frequency.

Melbourne – Auckland

Below is a graph illustrating Qantas' average weekly frequencies (or numbers of flights per week) and available seats for the period from January 2004 to March 2006.



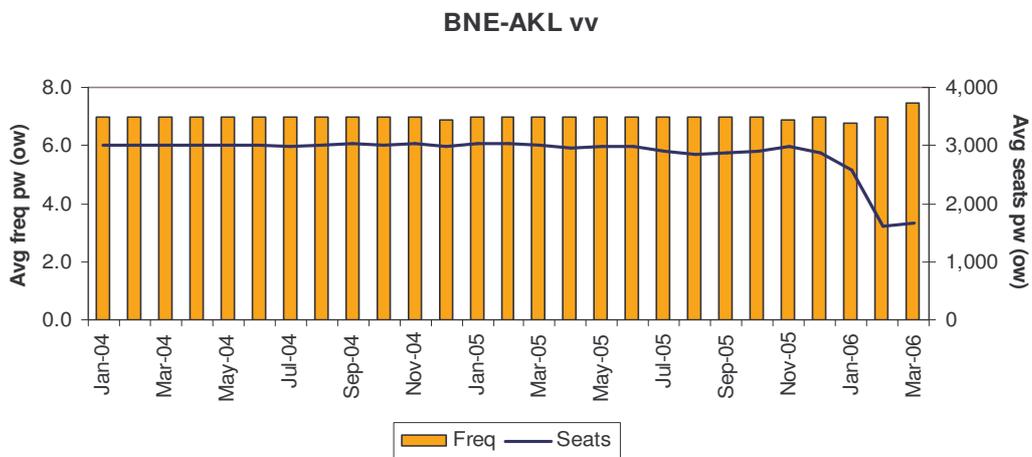
This graph shows that apart from some minor operational changes, Qantas' frequency on the Melbourne-Auckland route has been relatively constant. The obvious variations in average seats per week are explained as follows:

- (a) In the period from April 2004 to June 2004 Qantas decided to operate a mixture of B738 and B767 aircraft on the route, instead of a complete B767 fleet.

- (b) In the period from late January 2006 Qantas moved its B747 "through" service to Los Angeles (Brisbane-Auckland-Los Angeles) from a Brisbane departure to a Melbourne departure. This B747 service (now QF25/26 Melbourne-Auckland-Los Angeles) replaced an existing B767 service (Melbourne-Auckland only). This change was implemented in the context of Australia-USA schedule considerations.

Brisbane – Auckland

Below is a graph illustrating Qantas' average weekly frequencies and available seats for the period from January 2004 to March 2006.

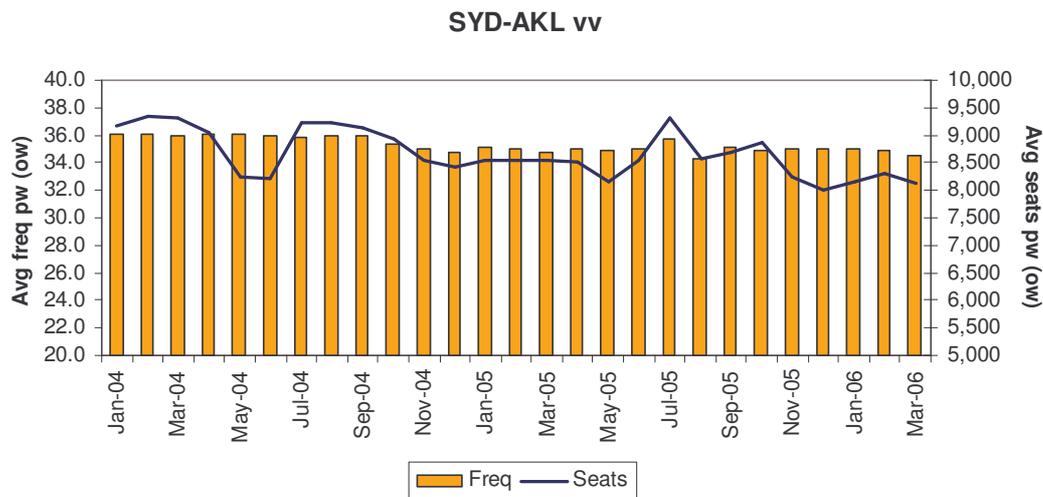


This graph shows that apart from some minor operational changes, Qantas' frequency and seats on the Brisbane-Auckland route have been relatively constant until January 2006. The obvious dip in average seats per week in late 2005/early 2006 arose from the Qantas decision to move the B747 Brisbane-Auckland-Los Angeles flight to Melbourne-Auckland-Los Angeles, as outlined above.

To alleviate this consequential reduction in total seats, Qantas added three 737 frequencies per week in late March 2006 (which explains why this most recent adjustment is not reflected in the above graph).

Sydney – Auckland

Below is a graph illustrating Qantas' average weekly frequencies and available seats for the period from January 2004 to March 2006.



This graph shows that apart from some minor changes associated with seasonal frequency and operational changes, Qantas' frequency on the Sydney-Auckland route has been relatively constant, with between 34 and 36 flights per week (the current schedule is 35 flights per week).

In contrast, total seat capacity has shifted somewhat over the nominated period for the following reasons:

- (a) Marginal adjustment of seat capacity to meet demand by adjusting the types of aircraft employed on the Tasman. Some examples of this include:
 - (i) During April – June 2004 Qantas operated a mix of B738/B763 and B747 aircraft instead of a mix of B763 and B747 aircraft, due to lower demand.
 - (ii) In July 2005, some B763 services were upgraded to B744 services during a demand peak.
- (b) Broader Qantas network decisions, which have a flow-on impact upon Tasman capacity allocation. Some examples of this are:
 - (i) In October 2004, the QF155/156 Sydney-Auckland-Los Angeles service ceased operations. This decision was made because Qantas had sufficient long range aircraft to make this service into a Sydney-Los Angeles service which was more preferable for Qantas' customers.
 - (ii) From November 2005 the QF43/44 B747 service was progressively replaced with a B767 service, because the B747 aircraft was required elsewhere in the network. However, Qantas was able to maintain its frequency of services on the route.
 - (iii) Fleetwide changes of international B767 configuration from 236 seats to 229 seats.

All of these capacity changes occurred at the margin and could be implemented by Qantas whilst maintaining an overall competitive level of frequency because of the size of the Auckland route.

[RESTRICTION OF PUBLICATION CLAIMED]

5. The ACCC notes that there are discrepancies between the Applicants current capacity as appearing in Annexure D and in Annexure I. Can the Applicants indicate which of the two annexures is correct?

See response provided on 13 June 2006.

Type of Passengers

6. Australian Passenger Card data from the Department of Immigration and Multicultural and Indigenous Affairs (DIMIA) indicate that in 2005 Qantas carried 29.9% of New Zealand origin/destination passengers travelling for the purposes of business (including to attend conventions) and Air NZ 20.8%. How would these proportions compare on a route-by-route basis?

See response provided on 13 June 2006.

Profitability

7. What were the EBIT outcomes for Qantas and Air NZ (including Freedom Air) for each of the trans-Tasman routes and trans-Tasman overall for each of the financial years 2002/3 to 2004/5?

[RESTRICTION OF PUBLICATION CLAIMED]

8. Are Qantas/Air NZ required to pay lay-over costs in NZ/Australia? If yes, are these costs the same as for non-domestic airlines (i.e. such as 5th Freedom carriers)?

See response provided on 13 June 2006.

Revenue

9. What was Qantas' and Air NZ's turnover from their trans-Tasman operations in the last financial year?

[RESTRICTION OF PUBLICATION CLAIMED]

10. What were Qantas' and Air NZ's revenue per seat sold, in each cabin class and overall, per month on each of the nine main trans-Tasman routes between January 2000 and February 2006 (or the most recent month for which data is available)?

General Comments

The data provided by both Qantas and Air NZ is the revenue per seat sold in both the

business and economy cabin (Air NZ also provides data for first and premium economy classes), excluding revenue generated from frequent flyer passengers. Revenue for both carriers includes the fuel surcharge but excludes airport charges and government taxes such as passenger movement charges, security charges and noise levies.

The data includes revenue from passengers travelling on through and connecting flights, where the trans-Tasman leg comprises only part of the passenger's journey, for example, passengers travelling on a trans-Tasman service as part of a longer international journey or connecting to a domestic Australian or NZ service. For such passenger, a portion of the total revenue derived from these passengers is allocated to the trans-Tasman leg. A number of methodologies are used to allocate such revenue and these also differ between carriers.

The proportion of revenue derived from through and connecting passengers and which is allocated to the trans-Tasman sector can differ considerably by route, particularly for international passengers. For example, the revenue allocated to the Sydney/Auckland leg of a Sydney/Auckland/Los Angeles service may be substantially different from the revenue allocated to the Sydney/Auckland leg of a Sydney/Auckland/Singapore service. It follows that differences in the mix of passengers over time could potentially result in significant variability in average fares for a single route. This impact is likely to be more acute for the business cabin given the much lower number of passengers.

Differences in the mix of passengers between routes and between carriers may also result in differences in the average fare calculated at any one point in time. Again, the impact of differences in passenger mix is likely to be more acute in the business cabin due to the lower passenger base.

Qantas Response

Qantas' revenue per seat sold (or average fare) in its two cabin classes (Business Class or J Cabin and Economy Class or Y Cabin) and overall for each of the nine main Tasman routes between January 2000 and March 2006 inclusive are attached separately to these responses at **Annexure A**.

Air NZ Response

Air NZ's revenue per seat sold (or average fare) in each of first, business, economy (and premium economy) cabin classes and overall for each of the nine main Tasman routes between December 2000 and April 2006 inclusive are attached separately to these responses at **Annexure B**. Air NZ's average fare data includes pro-rated long haul fares, which incorporates first class and premium economy fares.

This data has been sourced from Air NZ's revenue accounting database. It was converted from NZ\$ using the relevant monthly exchange rate, which was obtained from the Air NZ Finance Group.

11. **[RESTRICTION OF PUBLICATION CLAIMED]**

The Applicants have received clarification from the Commission regarding this question

and a response is currently being prepared. It will be submitted to the Commission as soon as possible.

Fleet

12. What is the current status of Qantas' fleet renewal program?

See response provided on 13 June 2006.

Could the Applicants please provide details of new aircraft added to the trans-Tasman route in the past 12 months and new aircraft proposed to be added to these routes in the foreseeable future, including aircraft type?

See response provided on 13 June 2006.

13. In his statement to the Tribunal in March 2004, Mr Thompson, Air NZ Group General Manager, Marketing Network & Sales, referred to Air NZ's decision to use A320s to fly its trans-Tasman routes and provided a schedule for the proposed roll-out of the A320 fleet. Air NZ expected that the replacement of the majority of its wide bodied aircraft fleet would be completed by February 2006.

What were the reasons for Air NZ's decision to replace wide bodied aircraft with narrow bodied aircraft on the trans-Tasman?

[RESTRICTION OF PUBLICATION CLAIMED]

Has Air NZ's fleet replacement occurred as planned? If no, please indicate why.

[RESTRICTION OF PUBLICATION CLAIMED]

What is Air NZ's current strategy regarding its trans-Tasman fleet?

[RESTRICTION OF PUBLICATION CLAIMED]

14. According to Qantas' 2004-2005 annual report, Jetstar lowered its cost base in the 2nd half of year to 7.62 cents per ASK. Can the Applicants explain the factors which have led to Jetstar now having a cost base of [RESTRICTION OF PUBLICATION CLAIMED] cents per ASK as per page 76 of the proposed TNA agreement?

See response provided on 13 June 2006.

15. Qantas' 2004-2005 annual report stated that Jetstar's entrance to the trans-Tasman route would boost Qantas' capacity to 1500 seats per week. How has the introduction of Jetstar on trans-Tasman routes impacted on Qantas' profitability? What has been the basis of selecting the routes to be operated by Jetstar?

See response provided on 13 June 2006.

16. Are Qantas and/or Air NZ currently using aircraft on trans-Tasman routes which continue on to/come from long-haul routes? In particular, what routes are the

following aircraft also operated on by Air NZ:

- (a) Brisbane – Auckland (daily B747);
- (b) Sydney – Auckland (5 x B777); and
- (c) Melbourne – Auckland (daily B747).

See response provided on 13 June 2006.

Connections

17. What is the proportion of Qantas and Air NZ trans-Tasman passengers connecting to, or transferring to, (i) international flights and (ii) domestic flights?

See response provided on 13 June 2006.

18. To what extent do Jetstar trans-Tasman flights connect/interline with other Qantas flights? To what extent do Freedom trans-Tasman flights connect/interline with Air NZ flights?

See response provided on 13 June 2006.

THE APPLICATIONS

The Counterfactual

19. Can the Applicants provide further information/explanation as to their proposed counterfactual, in particular outlining their respective strategies?

[RESTRICTION OF PUBLICATION CLAIMED]

20. In the counterfactual, what are Qantas and Air NZ's likely strategies for the deployment of their low-cost carrier (LCC) subsidiaries on trans-Tasman routes?

[RESTRICTION OF PUBLICATION CLAIMED]

Code-share

21. At paragraph 2.12 of their submission, the Applicants state that flights 'operated by Jetstar or Freedom Air will not automatically form part of the code-share arrangements, but may be introduced at a later date'. Schedule 9 outlines the terms and conditions upon which Jetstar and Freedom may be included in the code-share. Can the Applicants indicate whether they are likely to have any short to medium term plans to include Jetstar and/or Freedom in the code-share arrangements as per Schedule 9 of the TNA agreement?

See response provided on 13 June 2006.

Further, will Qantas code-share on Jetstar and Air NZ on Freedom Air?

See response provided on 13 June 2006.

22. **Can the Applicants confirm (as per Schedule 9 of the TNA agreement) that *all* flights operated by Qantas and Air NZ on the trans-Tasman are required to be part of the code-share arrangements?**

See response provided on 13 June 2006.

23. **What existing code-share arrangements does each of the Applicants have with third party airlines on trans-Tasman routes? Are the arrangements block sale code-share arrangements or free sale code-share arrangements? How will the TNA affect each Applicant's code-sharing arrangements with third party airlines?**

This response has been prepared by Air NZ.

Existing Code-share Arrangements

Air NZ has free sale code-share arrangements with other members of the Star Alliance on Tasman routes. These carriers are Air Canada, Asiana Airlines, Austrian Airlines, Singapore Airlines, Thai Airways and United Airlines. None of these code-share airlines offer origin/destination Tasman fares from points of sale in Australia or New Zealand.

Impact of the TNA

It is Air NZ's view that the impact of the TNA on its code-share partners will be minor for the following reasons:

- (a) Wellington – Brisbane is unaffected because Air NZ does not currently code-share with any other airline on this route.
- (b) In terms of Wellington – Melbourne, only **[RESTRICTION OF PUBLICATION CLAIMED]** of passengers carried by Air NZ travel on United or Austrian Airlines' code (the two carriers Air NZ code-shares with on that route). Furthermore, the number of passengers *interlining* from these code-share carriers on this route is **[RESTRICTION OF PUBLICATION CLAIMED]** than the number of passengers travelling on United or Austrian's code on this route, suggesting that interlining remains a popular and viable choice for those carriers.⁴ Interlining on Air NZ code on these routes remains available under the TNA.⁵
- (c) For completeness, Thai Airways has also had the right to place its code on Air NZ's Wellington – Melbourne services since July 2005, **[RESTRICTION OF PUBLICATION CLAIMED]**
- (d) A similar scenario emerges on Queenstown – Sydney, where only **[RESTRICTION OF PUBLICATION CLAIMED]** of total passengers carried by Air

⁴ Figures for FY 05.

⁵ **[RESTRICTION OF PUBLICATION CLAIMED]**

NZ travel on United's code (the only airline Air NZ codeshares with) yet **[RESTRICTION OF PUBLICATION CLAIMED]** passengers interline from United with Air NZ.

For further details regarding Qantas' existing code-share arrangements and the impact of the TNA, please refer to the response provided on 13 June 2006.

Proposed Schedule Spread

24. **Annexure I to the supporting submission contains a proposed schedule spread under the TNA versus the current schedule, while Schedule 11 to the proposed TNA agreement includes a 'Draft Initial Tasman Networks Plan'. However, there appears to be two discrepancies between these. Specifically:**
- (a) **for the AKL-BNE route Schedule 11 shows two NZ145 flights which do not appear in Annex I. In addition, Annexure I shows 6DF flights at 14.30 which do not appear in Schedule 11; and**
 - (b) **for the AKL-MEL route, Schedule 11 shows NZ900 using a B772 while Annexure I shows a B763.**

Can the Applicants indicate which proposed schedule the ACCC should refer to? If it is Annexure I, could the Applicants provide the proposed TNA schedule for all trans-Tasman routes?

See response provided on 13 June 2006.

25. **Since the applications were lodged, has the proposed TNA schedule undergone any revisions? If so, could the Applicants provide the ACCC with a copy of the latest proposed schedule, for all trans-Tasman routes?**

See response provided on 13 June 2006.

26. **Can the Applicants indicate whether a reduction in capacity on certain routes as a result of the proposed TNA agreement will result in a reduction in staff? If so what is the magnitude of the expected reduction, and where is it likely to occur?**

See response provided on 13 June 2006.

27. **Based on information contained in Schedule 11 to the TNA agreement, it would appear that the Applicants would substantially increase capacity on a number of routes (Brisbane/Adelaide/Cairns to Auckland, Brisbane/Melbourne to Christchurch). How do the Applicants reconcile these capacity increases with the claimed benefits associated with the removal of excess capacity?**

This response has been prepared by the Applicants.

The Northern Summer 2005 (NS05) schedule was used by the Applicants for comparison purposes because the default TNA schedule (i.e. the Draft Initial Network Plan set out in

Schedule 11 of the TNA) is itself a Northern Summer schedule. A comparison between this "base schedule" and the default TNA schedule is graphically depicted at Annexure I to the Applicants' submission.

The Applicants have endeavoured to address each of the identified routes below relative to the "base schedule" of NS05. As each Applicant has developed its own counterfactual scenarios, they have not jointly analysed the differences in capacity as between the counterfactual future and the Draft Initial Networks Plan.

(a) *Adelaide – Auckland*

See response provided on 13 June 2006.

(b) *Brisbane – Auckland*

See response provided on 13 June 2006.

(c) *Cairns – Auckland*

See response provided on 13 June 2006.

(d) *Brisbane – Christchurch*

(Qantas) Relative to the base schedule of NS05, there is no change in the number of frequencies being offered by the Qantas Group under the Draft Initial Networks Plan. However, because Jetstar A320s replace the Qantas B737-300 services in the Draft Initial Networks Plan, there will be an increase of approximately 400 seats per week (each way).

It is important to note that this increase in total seat capacity under the Draft Initial Networks Plan compared to the base schedule of NS05 now simply reflects the current state of affairs on Brisbane-Christchurch, as Qantas introduced Jetstar services on this route in December 2005 (which post-dates the NS05 base schedule).

(Air NZ) In relation to Air NZ, the position is complicated by the fact that for the first two months of NS05 (April and May 2005) the Air NZ Group operated 10 weekly Christchurch - Brisbane frequencies (8 by Air NZ and 2 by Freedom Air). The two Freedom Air services were removed as of June 2005 and an additional Air NZ frequency was added, giving a total of 9 Air NZ Group frequencies per week, i.e. one less than at the beginning of NS05.

Under the Draft Initial Networks Plan, Air NZ operates 10 weekly frequencies, which is the same number as the Air NZ Group (i.e. Air NZ and Freedom Air) operated at the beginning of the NS05 scheduling period, though one frequency less than it operated at the end of that period.

(Conclusion) Relative to the base schedule there is in fact a slight reduction in the Applicants' frequencies and a limited change in net total seat capacity on this

route under the TNA.

(e) *Melbourne – Christchurch*

(Qantas) Relative to the base schedule of NS05, Qantas is swapping a daily B737-300 service for nine weekly Jetstar A320 services under the Draft Initial Networks Plan, which involves two extra frequencies per week and an increase of approximately 700 seats per week (each way).

Once again, this increase in total seats under the Draft Initial Networks Plan compared to the NS05 base schedule now simply reflects the current state of affairs on Melbourne-Christchurch, since Qantas introduced Jetstar services on this route in December 2005 (which post-dates the NS05 base schedule).

(Air NZ) In light of Jetstar's increased deployment on Christchurch - Melbourne in place of Qantas aircraft, the Applicants took the view that demand on the route could support an additional "full service" frequency relative to the base schedule of NS05. As a result, Air NZ's frequencies increase from 9 per week in NS05, to 10 per week under the Draft Initial Networks Plan.

(Conclusion) As a direct result of the TNA, there will be an increase in the Applicants' frequencies and total seat capacity in the order of one Air NZ flight per week. Though relative to the NS05 base schedule there are also two extra Jetstar frequencies per week, it must be understood that these are frequencies which have been added since the NS05 base schedule was set and are currently being operated.

It is important to reiterate that the Draft Initial Networks Plan is simply the proposed "going in" schedule for the TNA, which represented the Applicants' most appropriate allocation of TNA capacity taking into account market dynamics at the time the TNA was negotiated. Whilst the TNA has the overall objective of assisting the Applicants reduce capacity, as the market changes the Applicants will continue to monitor market dynamics and match capacity requirements accordingly.

- 28. At 11.26 of the Applicants' submission it states one of the benefits of the TNA would be more direct route options. Except for the Perth and Cairns to Auckland routes currently operated by Air NZ, have the Applicants considered other direct route options? If yes, can the Applicants please advise the routes considered and advise whether they are likely to be seasonal routes?**

See response provided on 13 June 2006.

- 29. In relation to the increased likelihood of new services, the Applicants state, at paragraph 11.27 and 11.28 that they are not currently forecasting any new direct services but there is an increased likelihood that this will occur under the TNA. What would be the likely new services under the TNA?**

See response provided on 13 June 2006.

30. In the event that the TNA results in the reduction of capacity, would the associated landing 'slots', in particular at (i) Sydney and (ii) Auckland airports, be retained by the Applicants, or placed in the coordination pool for another airline to use?

See response provided on 13 June 2006.

TNA Payment Model

31. Can the Applicants confirm (as appears to be confirmed by clause 8.1 of the TNA) that *all* revenue earned by the Qantas and Air NZ groups on the trans-Tasman sector (including that from Jetstar and Freedom flights) will be included in the TNA revenue pool (i.e. regardless of whether it was sold as part of the code-share, or by the marketing/operating carrier)?

See response provided on 13 June 2006.

32. Can the Applicants further explain why, absent the tariff setting provisions in the TNA, each airline would have the ability and incentive to act to further its own interests at the expense of the TNA (refer to paragraphs 2.17 and 2.18 of the supporting submission).

This response has been prepared by the Applicants.

There are two important elements of the response to this question:

- (a) Tariff setting is critical to achieving the objectives of the TNA - without the ability to set tariffs, the parties would not agree to set schedules, capacity and frequency in the manner set out in the agreement;
- (b) Absent the ability to set tariffs, the parties would have the incentive and ability to act to further their own interests, at the expense of the objectives of the TNA.

Tariff Setting is a Critical Component of the TNA

The principal objective of the TNA is to secure cost reductions by removing some inefficient excess capacity on Tasman routes without, at the same time, reducing the frequency of services offered (i.e the "city presence") or the overall network offering of each Applicant. Given the different yields available at different times of the day and on different days of the week, without the TNA the Applicants' individual incentives would not be capable of bringing about an efficient withdrawal of some capacity (such as a reduction in wing-tip flying).

The TNA provides for the Applicants to determine jointly, for Tasman services:

- (a) the routes to be served;
- (b) the frequency of services on each route and the schedule for each route; and
- (c) the total capacity to be made available on each route.

In order to utilise the scheduled capacity most efficiently the parties must have an incentive to sell seats on their joint Tasman services without preference, ie, both Qantas and Air NZ must be indifferent between booking a passenger on its own flight or that of the other operating carrier. The Applicants must not be restricted – as between them – in relation to the number of passengers they can each place on any one flight, eg, by means of a pre-determined limit that each could sell, say, only 50 per cent of seats on each Tasman service. Any such limitation would lead to inefficiencies, particularly in circumstances where each airline faces a potentially different (but unpredictable) demand for their services on any one flight.

In order to coordinate capacity in the manner described above, the Applicants must effectively operate as a joint business. In other words, they must have the ability to develop sales targets, forecast load factors, and to manage yields and share revenues as one. The ability to determine tariffs jointly is a critical part of this process. Without the ability to do so, it would not be possible effectively to develop sales targets, forecast load factors or manage yields. Independent decisions and forecasts could result in total revenue not being optimised. For example, independently constructed sales targets could result in projected sales being significantly greater or less than available capacity. Capacity decisions would also be difficult to determine in the absence of tariff setting since it would be difficult for the parties to reach a consensus on the prospective relative performance of each route.

Without the ability to set tariffs, the Applicants would have the incentive and ability to act to further their own interests

Absent the ability to set tariffs jointly, Qantas and Air NZ would each have the incentive and ability to further its own interests by:

- (a) booking passengers on its own services in preference to those of the other carrier;
- (b) seeking to operate services at times of peak demand and to avoid services at other times when demand is not as strong; or
- (c) manipulating the arrangements so as to divert revenue from the TNA.

Absent the tariff setting and revenue sharing provisions of the TNA, neither Applicant would genuinely be indifferent as to the operating carrier on which it placed passengers. This is because in these circumstances the potential exists for each carrier to optimise its own returns at the expense of the other, rather than promote the performance of the TNA's total revenue pool. This incentive becomes stronger as the date at which the agreement could potentially be terminated becomes closer.

Further, if the Applicants have any incentive to book passengers on their own services, they will each seek to operate the more profitable flights at times of peak demand, thereby undermining the objectives of the TNA.

Unless revenue is shared (and so tariffs co-ordinated) the Applicants would also have an incentive to structure their fares and apply discounts in a way that would divert revenue

out of the TNA.

33. **Can the Applicants provide further explanation about the one-off alignment of the basis for paying incentive commissions to travel agents?**

See response provided on 13 June 2006.

Cost Savings

34. **Can the Applicants provide further explanation/detail on the basis for the cost savings identified in Annexure G which are predicted to accrue to Qantas and Air NZ?**

See response provided on 13 June 2006.

35. **[RESTRICTION OF PUBLICATION CLAIMED]**

[RESTRICTION OF PUBLICATION CLAIMED]

36. **Are the cost savings referred to in Annexure G estimated by reference to a situation in which the Applicants each continue to operate their current level of services on trans-Tasman routes if the TNA is not concluded? If not, what is the assumption underpinning the estimated cost savings presented in Annexure G?**

See response provided on 13 June 2006.

37. **Could the Applicants provide a more detailed explanation of the statement in para 11.12 of their submission that “Under the TNA, the Applicants can achieve equivalent or better aircraft utilisation via other means, reducing the level of wingtip flying”.**

See response provided on 13 June 2006.

38. **What were Qantas’ and Air NZ’s total costs associated with their trans-Tasman operations for 2002-03, 2003-04 and 2004-05?**

[RESTRICTION OF PUBLICATION CLAIMED]

Benefits

39. **The Applicants claim that the TNA is necessary to achieve all the benefits identified by the Applicants. Could the Applicants provide more detail as to why the TNA is necessary to achieve these benefits?**

This response has been prepared by the Applicants. Each of the claimed public benefits associated with the TNA are addressed separately below.

However, at the outset it is important to state that the TNA is the result of a commercial agreement between the Applicants following lengthy negotiations. From the Applicants’

perspective, the TNA offers a “package” which meets the Applicants’ respective business objectives while also delivering a suite of public benefits.

The primary commercial objective of the Applicants is to cut costs by removing some surplus capacity without adversely impacting upon the frequency of flights, the network offering and the city presence of each airline. By code-sharing and jointly setting schedules under the TNA, the Applicants are able not only to maintain, but also to *improve*, their network connectivity and schedule spread, which creates a higher standard of service offering for passengers while at the same time removing excess capacity and reducing costs. In order to co-operate effectively to set capacity and schedules, the Applicants must share revenue, which in turn requires the tariff setting mechanism provided for in the TNA.

At present, there is no other option available to the Applicants which achieves this alignment between the Applicants’ commercial objectives, as outlined above and the public benefits addressed below.

The public benefits which flow from the TNA should be considered as a package. While it may be possible for one or more of the benefits outlined below to be achieved by other means, the TNA offers the only commercially viable means of obtaining all the benefits in the current market place.

Therefore, in weighing up the benefits of the TNA for the purposes of the authorisation test, the Commission should not attempt to “un-bundle” the suite of benefits contained in the TNA in order to consider each benefit independently. Nor is it appropriate to pose alternative hypothetical commercial arrangements (absent any real commercial agreement between the Applicants) whereby one or more of the benefits outlined below may be separately obtained. When considering whether the benefits of the TNA outweigh any detriments, the benefits should be considered as a package which results from the commercial negotiations of the Applicants and would not be on offer in a different form.

- (a) *Cost savings from the removal of some surplus capacity, which will enhance the scope for sustainably low fares for consumers, without reducing the network offering and city presence of the Applicants.*

The TNA allows the Applicants to utilise their combined fleets to more efficiently service the various Tasman routes. This means each airline is individually able to remove frequencies (and therefore seat capacity) from the Tasman routes, whilst maintaining and even enhancing the overall schedule it can offer to its customers. For each airline the removal of frequencies generates the cost reductions that are outlined in Annexure G to the Applicants’ submission of 13 April 2006.

It is possible that these cost savings could be achieved by either Qantas or Air NZ absent the TNA, if each airline unilaterally elected to remove Tasman frequencies. However, such cost savings would be likely to come at the expense of revenue. For example, if Air NZ alone removed frequencies from the Tasman such that it was able to save the equivalent of two or three aircraft, it would achieve cost savings but would suffer a significant revenue loss as its network offering would become less compelling and customers would be more likely to

turn to its rivals (who could satisfy more of their needs). As passenger numbers fall, there would also be a commensurate decline in connecting services across the Air NZ network that would further reduce Air NZ's relative network position.

That is, the TNA is unique in its ability to offer each airline cost savings (associated with the removal of frequencies) whilst allowing them to maintain a compelling network offering and city presence.

(b) *National Interest*

The TNA improves Qantas' competitive position on the Tasman, with flow on effects across its wider network, due to the cost savings outlined in (a) above. As a result, the TNA assists Qantas to strengthen its competitive position internationally and helps ensure it remains a strong airline uniquely placed to deliver important benefits to Australia.

(c) *Better spread of departure times – reduced wingtip flying*

The better schedule proposed under the TNA is of benefit to consumers and arises from a reduction in wingtip flying as between the Applicants. This removal of wingtip flying is a direct result of the TNA.

The airlines currently have significant incentives to schedule flights at roughly the same times because each will want to operate at times when there is the greatest level of high yield traffic. This is compounded on the Tasman by logistical issues that make leaving New Zealand in the morning a particularly attractive pattern for aircraft utilisation.

The co-operation involved in the TNA means Qantas and Air NZ will jointly agree a schedule that provides a broader spread of services. This comes from the carriers being comfortable that through the TNA mechanisms they can sell onto peak time flights (and share in the revenue derived from them) without actually flying them. This is of direct benefit to consumers.

(d) *Reduced waiting times for connecting passengers and an enhanced 'seamless' service*

The TNA enables the Applicants to provide a better schedule spread at connecting ports, thus reducing waiting times for connecting passengers and creating a "seamless" service.

Without the TNA, neither Applicant has an incentive to offer full connectivity with a competitor. Instead, as network airlines, Qantas and Air NZ are motivated to ensure any domestic passengers who continue their journey on the Tasman do so via the same carrier (i.e. Qantas domestic passengers travel on Qantas services across the Tasman).

(e) *Increased likelihood of more direct route options and new services*

Because the TNA allows the Applicants to jointly analyse potential route options and consider their viability collectively, rather than as individual airlines, it makes potential new services on routes with thin demand more viable than if those routes were being assessed by Qantas or Air NZ independently. This was addressed in the Applicants' response to Q29.

(f) *Greater flexibility for consumers to change itineraries*

This benefit is a result of the better schedule spread and code-share arrangements under the TNA. These outcomes are unique to the TNA and could not be achieved by either airline independently.

(g) *Increased benefits for each Applicant's respective frequent flyer members*

Under the TNA, members of each Applicant's frequent flyer schemes will be able to earn and redeem points on all services carrying the code of the airline of whose frequent flyer program they are a member. This benefit arises directly from the TNA. There would not normally be any benefit in entering into such an arrangement with a competing airline, other than when it is part of a broader suite of arrangements which together give rise to a net benefit to the participating airlines.

ANNEXURE A: QANTAS CONFIDENTIAL RESPONSE – Q10

[RESTRICTION OF PUBLICATION CLAIMED]

ANNEXURE B: AIR NZ CONFIDENTIAL RESPONSE – Q10

[RESTRICTION OF PUBLICATION CLAIMED]