

**IN THE HIGH COURT OF NEW ZEALAND
AUCKLAND REGISTRY**

CIV 2003 404 6590

UNDER the Commerce Act 1986

IN THE MATTER OF an appeal from determination of the
Commerce Commission

BETWEEN AIR NEW ZEALAND
QANTAS AIRWAYS LIMITED
Appellants

AND COMMERCE COMMISSION
INFRATIL GROUP
VIRGIN BLUE
GULLIVERS PACIFIC
Respondents

Hearing: 5-9, 12-16, 20-22, 26-30 July and 2 August 2004

Appearances: JA Farmer QC, PRT Taylor, DJ Cooper and D Blacktop for Air New
Zealand
JA Farmer QC, AM Peterson, SC Keene and J Turnbull for Qantas
Airways Limited
HB Rennie QC, DJ Goddard QC, NM Pender and L Theron for the
Commerce Commission
JL Land and RE Keenan for Gullivers Pacific
JE Hodder and AM Glenie for Infratil Group

Judgment: 17 September 2004

**JUDGMENT (No 6) OF RODNEY HANSEN J AND
KERRIN M VAUTIER CMG (LAY MEMBER)**

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Introduction

[1] The appellants appeal against the decision of the Commerce Commission (Determination No 511, 23 October 2003) to decline the application of Qantas Airways Limited (Qantas) for authorisation of a proposed share purchase agreement (the proposed acquisition) and the appellants' application for authorisation of a proposed strategic alliance arrangement (the proposed arrangement). The proposed acquisition provided for the purchase by Qantas of 22.5% of the voting equity capital of Air New Zealand. The proposed arrangement is a strategic alliance which would, among other things, create a joint airline operation. The two transactions are collectively called "the proposed Alliance".

[2] The applications were advanced on the basis that the two transactions were interdependent; one would not occur without the other. The applicants (appellants) accepted that the proposed Alliance would result in a lessening of competition in some of the relevant markets, but contended that any lessening of competition would not be substantial and the proposed Alliance would, in any event, result in such a benefit to the public that the transactions should be permitted.

[3] The key issues which the Commission was required to consider were whether the proposed Alliance would substantially lessen competition in relevant markets, the nature and extent of any efficiency detriments and public benefit likely to result from the proposed Alliance, and whether the likely public benefit outweighed the likely detriments.

[4] In its 371-page determination, the Commission found a substantial lessening of competition in the key markets. It determined that the proposed Alliance would result in allocative, productive and dynamic inefficiencies of between [] and [] in the third year following the implementation of the proposed Alliance. The most likely outcome was assessed as being \$195m. The Commission quantified public benefit from the proposed Alliance as in the range of \$22.5m - \$56.5m by year three,

with the most likely outcome being \$40.5m. As annual detriments would substantially outweigh public benefit, the Commission concluded that both applications should be declined.

Appeals

[5] Separate appeals were lodged by Air New Zealand and Qantas. For convenience, they were heard together. The appellants were each represented by Mr JA Farmer QC.

[6] Gullivers Pacific Limited, Virgin Blue Limited and a consortium known as Infratil Group, sought and were given party status. Infratil Group comprises:

Infratil Limited
Major Accommodation Providers of New Zealand Incorporated
Kerry Leigh Prendergast, Mayor of Wellington City
Wellington International Airport Limited
Talley's Fisheries Limited

[7] Gullivers Pacific and Infratil Group opposed the appeal and also filed cross-notice supporting the Commission's decision on other grounds. Virgin Blue participated in interlocutory procedures but ultimately advised that it neither supported nor opposed the appeal and took no part in the substantive hearing.

[8] The Commission led the opposition to the appeal. That was appropriate. Since *Goodman Fielder Limited v Commerce Commission* [1987] 2 NZLR 10 (CA), it has been recognised that it is right for the Commission to take an active role in appeals against its determinations, especially if there is no other party to put public interest considerations adequately before the appellate Court. See also the recent discussion in *Commerce Commission v Southern Cross Medical Care Society* [2004] 1 NZLR 491 (CA). As Infratil and Gullivers Pacific represent particular interests and were also challenging aspects of the Commission's approach, it was appropriate that the Commission play a full part in the proceeding.

Principles governing appeal

[9] An appeal against a determination of the Commission is, by virtue of r 718(1) of the High Court Rules (as it was before amendment of the Rules on 24 November 2003), an appeal by way of rehearing. It is to be distinguished from an appeal *de novo* in which it is the duty of the appellate Court to reach its own independent findings and decision on the evidence which it hears or admits: *Shotover Gorge Jet Boats Limited v Jamieson* [1987] 1 NZLR 437, 440. In contrast, an appeal by way of rehearing is heard on the record of evidence given in the Court or tribunal of first instance and any further evidence received by the appellate Court pursuant to r 718(3) and (4). The approach to be taken to an appeal by way of rehearing was discussed in *Fletcher Metals Limited v Commerce Commission* (1986) 6 NZAR 33, 37 where Davison CJ said:

“The approach of the Court on an appeal by way of rehearing is that the Court considers the materials which were before the Tribunal appealed from and any additional material before the Court itself, such as further evidence received at the hearing of the appeal, and then makes up its own mind, carefully weighing and considering the decision appealed from and reversing it if on full consideration it comes to the conclusion that the decision was wrong: see *Coghlan v Cumberland* [1898] 1 Ch 701 applied in *EMI Manufacturing (NZ) Ltd v Collector of Customs* [1984] 2 NZLR 326, 342.”

[10] In the usual way, the onus of proof is on the appellants. They must show that the decision appealed from was wrong. It has been said that the onus is harder to discharge where a specialist tribunal, such as the Commission, has made findings in its specialist area: *Fisher & Paykel Limited v Commerce Commission* [1990] 2 NZLR 731 at 757 and *Rugby Union Players Association v Commerce Commission (No 2)* [1997] 3 NZLR 301 at 311. This recognises that the constitution of the Commission, its powers of inquiry and the expertise and resources available to it, equip it, rather than the Court, to be the primary fact-finding and adjudicative body: *Foodstuffs (Auckland) Limited v Commerce Commission* [2004] 1 NZLR 145, 151 (PC), *Goodman Fielder Limited v Commerce Commission* (supra) at 16.

[11] In this case, the Commission carried out an extensive investigation over a period of ten months. The record of materials received and considered by it runs to

78 volumes. It issued a draft determination on 10 April 2003. It received submissions on the draft determination from 24 interested parties and extensive oral submissions from 14 parties in the course of a conference held under s 69B of the Commerce Act 1986 (the Act) which lasted six days. We have been referred to only a fraction of the evidence and written materials considered by the Commission. We must perforce give considerable weight to the advantages enjoyed by the Commission when reviewing its findings.

[12] In his submissions in reply, Mr Farmer QC sought to demonstrate that in reality the Court on appeal from the Commission will readily substitute its own views for those of the Commission. He referred in particular to judgments of this Court in *Fisher & Paykel Limited v Commerce Commission* (supra), *Telecom Corporation of New Zealand Limited v Commerce Commission* (1991) 4 TCLR 473, *Southern Cross Medical Care Society v Commerce Commission* (2001) 10 TCLR 25 and *Brambles New Zealand Limited v Commerce Commission* (2003) 10 TCLR 868 and of the Court of Appeal in *Telecom Corporation of New Zealand Limited v Commerce Commission* [1992] 3 NZLR 429 and *Commerce Commission v Southern Cross Medical Care Society* (supra).

[13] We see nothing in these decisions to suggest departure from the principles governing appeals by way of rehearing as repeatedly articulated in the authorities. In each case there were clear and compelling grounds for the Court to depart from the findings of the Commission. The Court did not simply adopt its preferred view of the facts. The significant onus on the appellant to demonstrate error was discharged. The cases confirm that respect for the advantages enjoyed by the Commission will not mean that its decision is to be rubber-stamped – see the Court of Appeal’s judgment in *Telecom v Commerce Commission* (supra) at p 434. On the other hand, they affirm that there can be no proper basis for intervention unless the Commission has been shown to have erred in a material way.

Additional evidence

[14] Any additional evidence received at the hearing of an appeal must be taken into account: *Fletcher Metals* (supra) at para [10]. As observed in Judgment (No 2)

of 18 May 2004 in this proceeding, at para [11], where further evidence is received the Court must try to put itself in the same position as the Commission would have been in were it hearing the case at the date of appeal and to seek to reach the decision which the Commission ought to have reached in those circumstances – see also *New Zealand Cooperative Dairy Co Limited v Commerce Commission* [1992] 1 NZLR 601 at 611.

[15] In this case, we received and heard a substantial body of evidence which was not available to the Commission. The background to and the reasons for the admission of this evidence are discussed in the first judgment delivered in this proceeding on 6 May 2004 and in Judgment (No 2) (*supra*). The evidence falls into two categories:

- a) Evidence relating to the economic modelling used by the Commission for the purpose of quantifying allocative inefficiencies which would be likely to flow from the proposed Alliance.
- b) Evidence of an updating nature and expert commentary arising out of that evidence.

[16] Leave was given to file additional evidence on modelling because, as a ground of appeal, the appellants complained that they had not been given an opportunity to comment on changes made to the Commission's model following the conference. Evidence in relation to the revisions made to the model was filed by the appellants, the Commission, Gullivers Pacific and Infratil.

[17] The updating evidence filed reflected the dynamic nature of the airline industry. It provided a full picture of developments in the relevant markets since the Commission's determination. This evidence was provided by way of affidavits. It included documents discovered by the parties themselves (including Virgin Blue) and by one non-party, Emirates Airlines. The circumstances in which the order for non-party discovery was made are discussed in Judgment (No 2) (*supra*).

[18] Expert evidence was also filed commenting on the updating evidence. Some of this evidence (and of the evidence of experts in relation to modelling issues) was objected to as inadmissible. In Judgments (No 3) and (No 5) of 20 May 2004 and 23 June 2004 in this proceeding, substantial portions of the evidence filed were excluded as falling outside the terms on which leave had been granted or lacking the necessary qualities of freshness and materiality.

[19] Expert witnesses in relation to modelling met before the hearing for the purpose of narrowing the issues and defining areas of agreement and disagreement. They filed a joint report recording the positions reached.

[20] Eight of the experts who swore affidavits gave evidence at the hearing in response to notices to appear for cross-examination. Cross-examination was permitted for the reasons discussed in paras [97] – [103] of Judgment (No 5) (supra). They gave their evidence in a collective process known colloquially as a “hot tub”. Each expert was given the opportunity to state succinctly his or her position and respond to the statements of others. There was scope for intervention by opposing witnesses in the course of cross-examination. The process helped to expedite the oral evidence and to elucidate and narrow areas of difference.

[21] The additional written evidence by way of affidavits and exhibits ran to many hundreds of pages. Oral evidence occupied five days. We also received extensive written submissions before the hearing and heard three weeks of oral argument. It will be readily understood that we can acknowledge only a small part of what we have heard and read and taken into account.

Confidentiality

[22] Much of the information provided to the Commission and the additional evidence received on appeal is subject to confidentiality orders and undertakings. Any confidential information referred to in this judgment will be enclosed in square brackets. The confidential information will be included in copies of the judgment distributed to counsel but omitted from any copies accessible to the public.

Applications – procedural

[23] As earlier mentioned, the proposed Alliance has two elements. One is the agreement for Qantas to acquire 22.5% of the equity capital of Air New Zealand (the acquisition). The other is the proposed arrangement. Under the arrangement, a joint airline operation (JAO) would be created. The JAO network would include all Air New Zealand flights and all Qantas flights which arrive into, operate within or depart from New Zealand. Although day-to-day flying operations would remain the responsibility of each airline, the JAO would be commercially managed by Air New Zealand and the parties would coordinate pricing, capacity and all other aspects of the normal business operations of an airline.

[24] Authorisation of the proposed acquisition was sought under ss 47 and 67 of the Act. Section 47(1) provides:

“47. Certain acquisitions prohibited –

- (1) A person must not acquire assets of a business or shares if the acquisition would have, or would be likely to have, the effect of substantially lessening competition in a market.”

Section 67 provides the statutory mechanism by which authorisation may be given to a person proposing to acquire the assets of a business or shares.

[25] Authorisation of the proposed arrangement had to be the subject of a separate application. It comes within s 27 which proscribes contracts, arrangements or understandings which have the purpose, effect or likely effect of substantially lessening competition in a market. The price fixing provisions of the arrangement are, in any event, deemed by s 30 to substantially lessen competition. Section 58 allows the Commission to authorise a person to enter into a contract arrangement or understanding which contravenes s 27. An application for such authorisation is determined under s 61.

[26] Although the two applications were therefore brought under separate provisions of the Act, because they were interdependent the Commission determined to consider them together. This was supported by the applicants (the appellants) but

objected to by Infratil Group. Infratil took issue with the legal form of the application and with the manner in which the applications were processed.

[27] The objection to the form of the application was rejected by the Commission which pointed out, at para [37] of the determination, that s 60(4) of the Act gave the Commission express power to receive applications which were not in the prescribed form. The Commission did not fully consider the objection to process because it did not understand it to involve a challenge to its proposed determination, counsel for Infratil having stated at the conference that the procedural errors be noted “so that the Commission can avoid them in future cases”. The Commission also considered that the issues raised by Infratil in relation to process did not affect the determination of the application. At paras [45] – [49] of the determination, it explains why the analysis of the two applications would involve substantially the same considerations. The Commission saw the applications as “properly interdependent”, arising “in the same commercial proposal and representing one interdependent business plan” (para [48] of the determination).

[28] In the context of this appeal, Infratil has sought to renew its challenge to the procedure adopted by the Commission. It does so by way of cross-notice in which it seeks to support the Commission’s decision on other grounds. For the Commission, Mr Rennie QC submitted that Infratil could not mount a challenge to the Commission’s procedures by this means. He said Infratil should have sought judicial review or filed a cross-appeal. We agree that a challenge of this nature cannot be brought by the means adopted.

[29] Infratil is not seeking to challenge the determination. It fully supports the Commission’s decision. That is why it did not cross-appeal. Instead, in accordance with established practice, it filed a cross-notice in which it purported to support the decision on other grounds. This procedure permits a respondent to advance arguments in support of the determination, including in some circumstances, an argument not raised at the hearing – see, for example, *Owners of the Ship “Shin Kobe Maru” v Empire Shipping Co Inc* (1994) 120 ALR 12 at 14 (HCA).

[30] But what Mr Hodder is seeking to do here is to advance an argument which is, in substance, an attack on the Commission's decision. If successful, it would require that the determination be set aside. That is not, of course, the outcome which Mr Hodder seeks. Rather, he seeks to have the issue resolved in order to ensure there is a clear and binding ruling on the procedure to be adopted. That can be achieved only by the means suggested by Mr Rennie – judicial review or cross-appeal.

Applications – statutory tests

[31] The statutory requirements for the grant of an authorisation of an acquisition are found in s 67(3) which provides:

- (3) Within 60 working days after the date of registration of the notice, or such longer period as the Commission and the person who gave the notice agree, the Commission shall—
 - (a) If it is satisfied that the acquisition will not have, or would be likely to have, the effect of substantially lessening competition in a market, by notice in writing to the person by or on whose behalf the notice was given, give a clearance for the acquisition; or
 - (b) If it is satisfied that the acquisition will result, or will be likely to result, in such a benefit to the public that it should be permitted, by notice in writing to the person by or on whose behalf the notice was given, grant an authorisation for the acquisition; or
 - (c) If it is not satisfied as to the matters referred to in paragraph (a) or paragraph (b) of this subsection, by notice in writing to the person by or on whose behalf the notice was given, decline to give a clearance or grant an authorisation for the acquisition.”

In *Brambles New Zealand Limited v Commerce Commission* (supra), the Court remarked on the apparent drafting error in s 67(3) (and its counterpart in s 66(3)) which, read literally, would have the plainly unintended consequence of requiring authorisation if the Commission is satisfied that the acquisition will have the effect of substantially lessening competition but not if it would be likely to have that effect. As the Court said in *Brambles* at para [53], the paragraph should be read as if there is

a “not” after the word “would” in the first line of para (a). That is plainly required in order to make sense of the paragraph as a whole and to achieve the purpose of s 47.

[32] The application for authorisation of the proposed arrangement is made under s 58. The test for granting the authorisation is in s 61(6) which provides:

“The Commission shall not make a determination granting an authorisation [pursuant to an application under section 58(1) to (4)] of this Act unless it is satisfied that—

- (a) The entering into of the contract or arrangement or the arriving at the understanding; or
- (b) The giving effect to the provision of the contract, arrangement or understanding; or
- (c) The giving or the requiring of the giving of the covenant; or
- (d) The carrying out or enforcing of the terms of the covenant—

as the case may be, to which the application relates, will in all the circumstances result, or be likely to result, in a benefit to the public which would outweigh the lessening in competition that would result, or would be likely to result or is deemed to result therefrom.”

[33] The tests under ss 61 and 67 are substantially the same. Both require a consideration of whether there is or is likely to be a lessening of competition and an assessment of public benefit. The way in which public benefit is required to be weighed is subtly different, but the practice of the Commission, sanctioned by the Courts, is that there is no material difference between the tests mandated by the two sections. In *Ravensdown Corporation Limited v Commerce Commission* (High Court, Wellington, AP.168/96, 16 December 1996, Panckhurst J and Professor Lattimore), a s 67 case, the Court said at pp 50-51:

“What is required is that the Commission make a facts-based assessment of benefits and detriments, adopting a quantitative approach where possible, and on the basis of that assessment decide if it is satisfied the acquisition is at least likely to result in such benefit to the public that it should be permitted. In short, the test of likelihood is to be applied at the end of the process.”

That passage was quoted and the approach taken in *Ravensdown* adopted in a s 61 case, *Rugby Union Players Association v Commerce Commission (No 2)* (supra) at 320.

Substantial lessening of competition in a market

[34] The Act itself provides guidance as to what is meant by substantial lessening of competition in a market. “Competition” is defined in s 3(1) as “workable or effective competition.” Section 3(2) provides:

“In this Act, unless the context otherwise requires, references to the lessening of competition include references to the hindering or preventing of competition.”

[35] Section 2(1A) defines “substantial”, for the purposes of ss 61 and 67, as meaning “real or of substance”. “Substantial” has also been defined as meaning “not insignificant, not ephemeral, not nominal or minimal”: *Tillmanns Butcheries Pty Limited v Australasian Meat Industry Employees’ Union* (1980) 42 FLR 331, 348. This formulation is recognised as the likely origin of the New Zealand statutory definition – see *Gault on Commercial Law* at para CA27.14 – and has been adopted in a number of New Zealand cases, e.g. *Fisher & Paykel v Commerce Commission* (supra) at 740, *Commerce Commission v Port Nelson Limited* (1995) 6 TCLR 406; (1995) 5 NZBLC 103,762.

[36] The test requires the Commission to consider whether a substantial lessening of competition is likely. The public benefit test also requires an examination of likely results. In this context, likely refers to probable outcomes rather than possible or speculative effects: *Air New Zealand v Commerce Commission* [1985] 2 NZLR 338, 341-342 citing *Re Queensland Cooperative Milling Association Limited v Defiance Holdings* (1976) 1 ATPR para 40-012, p 17,223 at p 17.243. The degree of probability is:

“... above mere possibility but not so high as more likely than not and is best expressed as a real and substantial risk that the stated consequence will happen.”

Port Nelson Limited v Commerce Commission [1996] 3 NZLR 554 at 562 (CA).

[37] “Market” is defined in s 3(1A) as:

“... a market in New Zealand for goods or services as well as other goods or services that, as a matter of fact and commercial commonsense, are substitutable for them.”

The purpose of market definition is to identify the area or areas of close competition and to identify the constraints which operate on participants.

[38] There was unanimity that a fact-specific examination of the defined markets was essential to a resolution of the key issues. This has been emphasised in the leading cases. On the issue of market definition, the Court of Appeal said in *Power New Zealand Limited v Mercury Energy Limited* [1997] 2 NZLR 669 at 678-9:

“The identification of the appropriate market or markets must accord with the commercial realities, and take account of the activities of the parties involved. It must expose the constraints on the individual firm.”

[39] The onus is on an applicant to establish that no substantial lessening of competition will, or is likely to, result. The standard of proof is the balance of probabilities: *Commerce Commission v Southern Cross Medical Care Society* (2002) 10 TCLR 269 (CA) at para [7].

Substantial lessening of competition – framework for analysis

[40] In examining whether a substantial lessening of competition would or would be likely to occur, the Commission adopted the established approach (dating from *Dandy Power Equipment Pty Limited v Mercury Marine Pty Limited* (1982) 64 FLR 238; see *Tru Tone Limited v Festival Records* [1988] 2 NZLR 352 at 382-363). After defining the markets, it sought to determine whether any diminution in competition would be likely in each market by comparing the likely state of competition if the proposed Alliance proceeded (the factual) with the likely state of competition if the proposed Alliance did not proceed (the counterfactual).

[41] Mr Farmer argued that an analysis of the factual and counterfactual could be avoided by first determining whether the proposed Alliance would result in the appellants acquiring market power in the sense of being “sufficiently free from

market pressures to ‘administer’ their own production and selling policies at their discretion”: *Re Queensland Cooperative Milling Association Limited* (supra) at pp 17,245 - 17,246. He submitted that if an analysis of the market leads to the conclusion that market power would not be acquired, a finding that there had been no substantial lessening of competition in that market would inevitably follow. He said an examination of market power was “a necessary and natural precursor” to the application of the factual/counterfactual instrument.

[42] We accept that an absence of market power would suggest there had been no substantial lessening of competition in a market but do not see this as a reason to forsake an analysis of the counterfactual as well as the factual. A comparative judgment is implied by the statutory test which now focuses on a possible change along the spectrum of market power rather than on whether or not a particular position on that spectrum, i.e. dominance has been attained. We consider, therefore, that a study of likely outcomes, with and without the proposed Alliance, provides a more rigorous framework for the comparative analysis required and is likely to lead to a more informed assessment of competitive conditions than would be permitted if the inquiry were limited to the existence or otherwise of market power in the factual.

[43] It is also to be borne in mind that the price fixing provisions of the proposed arrangement are deemed by s 30 to substantially lessen competition in all the affected markets. The extent of that lessening and any further lessening resulting from other aspects of the arrangement must, however, be assessed in order to determine the efficiency detriments which form part of the overall welfare assessment.

Economic analysis

[44] For the purpose of considering the key question of whether there was likely to be substantial lessening in competition, the Commission undertook a qualitative analysis and a quantitative analysis in relation to each market. The qualitative analysis involved an examination of the structure of the markets and the behaviour of participants for the purpose of establishing the extent to which market participants were constrained in their behaviour by actual or potential competitors. As part of its

quantitative analysis, the Commission employed economic modelling techniques to estimate the likely effect of the proposed Alliance on prices and allocative efficiency.

[45] The elements of market structure which are conventionally singled out for examination are:

- the number and size distribution of independent sellers: especially the degree of market concentration;
- the height of barriers to entry and expansion;
- the extent to which the products of the industry are characterized by extreme product differentiation and sales promotion;
- the character of vertical relationships with customers and with suppliers and the extent of vertical integration; and
- the nature of any formal, stable and fundamental arrangements between firms which restrict their ability to function as independent entities.

See *Re Queensland Cooperative Milling Association Limited* (supra) at p 17,246, *Tru Tone* (supra) at 363.

[46] In this case most attention focused on the first two of these elements – the significance of concentration and the nature and impact of any barriers to entry and expansion. The proposed Alliance would result in the appellants acquiring the predominant share of the market in most of the markets identified. In some markets, proposed Alliance partners would be the only participants. The implications of such a high and extensive level of concentration are therefore of critical significance, as is the extent to which actual and potential entrants may constrain the exercise of market power.

[47] The economists who gave evidence were agreed that an examination of the implications of concentration and of conditions of entry and expansion was crucial in this case. But they differed on the relative significance of those factors.

[48] While accepting that concentration was an important element, witnesses for the appellants argued that conditions of entry were such that the high levels of concentration which would result from the proposed Alliance would not result in higher prices. They said there were no, or no significant, barriers to new entrants or for existing competitors to expand. Their analysis of the key markets led them to the view that existing and potential competition would provide a sufficient constraint on the proposed Alliance partners.

[49] The expert witnesses for the respondents did not accept that conditions of entry and expansion could be relied on to provide a sufficient constraint in markets as concentrated as those envisaged under the proposed Alliance. They said both the level of concentration and the number of players in a market were key to understanding the competitive process and the ability to charge higher prices with impunity. Their concern was not whether new entry could occur or that the threat of entry would provide a constraint on the proposed Alliance. Rather, it was whether, with the level of concentration likely to result in this case, competition would be as vigorous and prices as low with the proposed Alliance as without it.

[50] All experts were in agreement, however, that for the purpose of assessing the constraints offered by potential entrants, the so-called LET test should be applied. That involves an assessment of the likelihood, extent and timeliness of entry into the relevant markets. It accords with the Commission's Business Acquisition Guidelines and with the practice in other jurisdictions which are required to consider whether a substantial lessening of competition is likely.

[51] The experts also agreed that the judgments on the key issues should draw on a careful examination of the available evidence. This accords with the approach sanctioned by the Courts. In *Telecom Corporation of New Zealand Limited v Commerce Commission* (supra), Richardson J emphasised the importance in Commerce Act cases of a careful enquiry into the facts. He said at p 446:

“But pure speculation as to the impact of constraints and simple intuition are no substitute for hard data drawn from empirical studies and evidence from participants in the industry. In the end the value judgment should be as informed by practical evidence as possible.”

It might then seem paradoxical that in this case there was extensive reference to and reliance on experience in overseas markets. However, as the next section of this judgment will show, only in comparatively recent times have airline markets within Australasia been exposed to the winds of competition. And only in the last few years has the low cost carrier business model, exemplified by Virgin Blue, been present in the region. Studies of overseas markets can help to compensate for this lack of experience.

Industry overview

[52] In common with many other countries, the aviation markets of Australasia were highly regulated. The Government-owned national airlines enjoyed a state-endorsed monopoly. There was no foreign competition in New Zealand domestic markets until Ansett entered in 1986. That followed the opening of New Zealand aviation markets to foreign-owned airlines in 1983.

[53] Air New Zealand is 74% government-owned. It provides long-haul international services to nine destinations in Asia, North America and Europe and short-haul international services across the Tasman and to Pacific destinations. It operates domestic trunk and regional services throughout New Zealand. These were rebranded in 2001 as New Zealand Express. Air New Zealand has a wholly-owned subsidiary, Freedom Air, which operates four aircraft across the Tasman offering fifty return flights a week to four destinations in Australia from six New Zealand cities.

[54] Air New Zealand also provides ground handling, loading and engineering maintenance services for overseas airlines at international airports in New Zealand. These earned revenue in excess of \$800m in the company's 2003 financial year, almost a quarter of its total revenue of \$3.6b.

[55] Qantas is the world's fifteenth largest airline, with revenue for the June 2003 year of A\$11.4b. At the time of the hearing, some 19% of its shares were owned by British Airways. Qantas services 142 destinations in 32 countries worldwide. It also operates domestic services in Australia and, since 2001, in New Zealand through its subsidiary JetConnect. Qantas also owns 46% of the shares of Air Pacific which operates services to and from Fiji. Air Pacific is a party to the proposed Alliance.

[56] Both Air New Zealand and Qantas are members of international airline alliances, Qantas of oneworld Global Airline Alliance, Air New Zealand of the Global Star Alliance. The function of international airline alliances is summarised at para [176] of the Commission's determination:

“... An airline's alliance with global or regional partners (sometimes involving equity) can enable it to interface networks to provide seamless travel, or to share facilities or services, yielding synergies. An alliance can be an easier way for an airline to gain economies of scope and scale than by creating its own networks abroad or becoming a 'mega-carrier' through mergers and acquisitions (which are often prevented by the bilateral system of air rights regulation).”

[57] Both Qantas and Air New Zealand also have code-sharing agreements with other airlines. Code-sharing involves an airline purchasing a block of seats on another airline's flight which it sells to passengers under its own brand name. It is an economical way for an airline to improve flight frequency on a particular route without bearing the costs of running an aircraft. Code-sharing can be used on “thin” routes where there is insufficient passenger demand to sustain the operations of two airlines. It can also be used where capacity on a route between two countries is artificially limited by agreement.

[58] Qantas and Air New Zealand are both full service airlines (FSAs). This is the traditional airline business model. It has three essential features identified in evidence by Dr Michael Tretheway, an economist retained by the appellants. They are:

- Network extent and connectivity;
- In-flight and on the ground service levels; and

- High probability of last minute seat availability.

[59] The alternative model to the FSA is the low cost carrier (LCC). It provides a simpler product focused on providing short-haul, point-to-point services at a low price. The essential elements of its business model are:

- Simple point-to-point services with no or limited interconnectivity on short-haul routes;
- Fewer in-flight and on the ground amenities; and
- Single class operations which increases seat density and reduces costs per seat.

[60] The genesis of the LCC business model was that adopted by Southwest Airlines which commenced services in the United States in 1971. It is widely regarded as having set the benchmark for LCCs world wide, reporting its thirty-first consecutive annual net profit in December 2003. The model has expanded rapidly over the last decade and exists in Canada, Brazil and Asia as well as the United States and Europe.

[61] Virgin Blue is the only LCC operating in Australasia. It entered the Australian domestic market in 2001. It became a publicly listed Australian company in December 2003. In accordance with plans announced before the Commission's Determination, Virgin Blue commenced operations on trans-Tasman routes in March 2004 under the Pacific Blue brand. (In this judgment we will refer to both Virgin Blue and Pacific Blue as "Virgin Blue".)

Regulatory framework

[62] As earlier noted, New Zealand domestic aviation markets have been open to foreign-owned airlines since 1983. Provided an airline meets the requisite safety standards, an airline can start up and fly domestically.

[63] The provision of international air services is restricted by the regulation of international freedom (air) rights and foreign ownership. New Zealand is required to comply with the directives of the inter-government International Civil Aviation Organisation (ICAO) which was established in 1947 after the Chicago Convention on International Civil Aviation. ICAO develops international standards and recommended practices for the safe and efficient conduct of international air transport.

[64] The Chicago Convention recognised that every State has complete and exclusive sovereignty over the airspace above its territory and provides that no scheduled international air service may be operated over or into the territory of a contracting State, except with the authority of that State. This is achieved through Air Service Agreements (ASAs) which are usually negotiated bilaterally. They exchange aviation rights of passage (commonly known as freedoms) and regulate such matters as entry, frequency, capacity, routes and prices. The international airline industry is therefore highly regulated.

[65] At the time of the Commission's decision, New Zealand was party to ASAs with forty-six countries. National policy is to be as liberal as possible, as such agreements open markets for trade and tourism. The Commission noted that, unlike most other countries, New Zealand started negotiations from an 'open skies' position. Its aim is to remove most of the traffic and market access constraints and reduce the extent of government involvement in the aviation industry. New Zealand's open skies agreements generally permit unrestricted services by the airlines of the parties.

[66] Among the so-called freedoms of the air, which can be conferred by an ASA, the fifth freedom has most relevance in this case. It allows an airline of one country to land in a foreign country, pick up and deliver traffic, and then fly to a second foreign country. Fifth freedom rights have particular relevance for the Tasman market but are confined to flights that originate or terminate in the airline's home country. All countries that have open skies agreements with New Zealand could, in theory, fly on the Tasman routes. Any constraints that remain are due to ASAs involving Australia and another country.

[67] Australia and New Zealand signed an ASA in 2002. It provides for a single aviation market (SAM). In practical terms, this means that any New Zealand or Australian-owned, controlled and operated airline can operate within and between New Zealand and Australia without restriction, so that travel between the two countries is like travel within one of them. Qantas, Virgin Blue, Air New Zealand and Freedom Air are all designated SAM passenger airlines, as is freight operator Asian Express.

[68] In summary, within the domestic and international regulatory framework, New Zealand is now operating at the most liberal end of the regulatory spectrum. Entry and operational decisions affecting relevant markets are by and large being determined by commercial, not governmental, assessments.

Market definition

[69] For the purpose of its analysis, the Commission identified three product markets – passenger air services, belly-hold freight services and travel distribution services. The following eight geographic markets were identified for passenger air services:

- [a] New Zealand main trunk
- [b] New Zealand provincial
- [c] Tasman
- [d] New Zealand-Asia
- [e] New Zealand-Pacific Islands
- [f] New Zealand-US
- [g] (Other) International

There is no dispute as to the appropriateness of these market definitions.

[70] The separate product market for air freight was divided into three separate geographic markets - New Zealand domestic, Tasman and international. The Tasman and international markets were restricted to belly-hold freight, that is, freight carried in the belly-hold of passenger aircraft. The appellants maintain that this was an error and that the product dimension of all markets should encompass all air freight services. We will address their arguments when we come to consider the Commission's competition analysis.

[71] The appellants also take issue with the functional element of the Commission's definition of the market for travel distribution services, which the Commission confined to the wholesale level. The appellants argue that it should have included retail activities as well. We will consider that argument also when we come to discuss the competition analysis.

Factual and counterfactual – general

[72] The Commission prefaced its assessment of the individual markets with an overview of the likely factual and counterfactual scenarios. It acknowledged that the aviation industry is a particularly difficult one in which to make predictions, with uncertainty increasing as time horizons become more distant. On a pragmatic assessment of the information available to it, the Commission concluded that, in the absence of the proposed Alliance, the future would include the following features:

- A gradual recovery in the financial position of Air New Zealand and financial viability over the short to medium term;
- Air New Zealand remaining a substantial competitor on the Tasman and domestic New Zealand routes, with capacity being expanded in line with market growth;
- Freedom Air remaining a significant low cost niche operator on the Tasman, with its capacity also expanding in line with market growth;

- Qantas remaining a substantial competitor on the Tasman and expanding its route structure in the domestic New Zealand market;
- Continuing competition from fifth freedom carriers on routes between Auckland and Australia;
- Entry and gradual expansion by Virgin Blue in the Tasman market and subsequently in the New Zealand domestic market; and
- Air New Zealand and Qantas continuing to compete in the other markets where both are currently present, including New Zealand to Asian, Pacific and US destinations.

[73] If the proposed Alliance were to be implemented (the factual), the Commission foresaw that Qantas would no longer act as a competitive restraint on the JAO networks but, rather, would be in a position to exert a substantial degree of influence over Air New Zealand's operations through its shareholding, board representation and its representation on the Strategic Alliance Advisory Group which would support Air New Zealand's management of the JAO networks.

[74] The Commission concluded that, with the proposed Alliance, the future would include the following features:

- The competition currently existing between Air New Zealand and Qantas, both directly and indirectly (through Qantas being a near or potential entrant, or through offering an indirect route alternative to Air New Zealand's route), would be eliminated;
- Air New Zealand would be likely to shift from the Star Alliance to join Qantas in the oneworld Alliance;
- Freedom Air and Air Pacific would be prevented from competing against the JAO Networks or operating in a manner contrary to the interests of the proposed Alliance;

- Continuing competition from fifth freedom carriers on routes between Auckland and Australia;
- Virgin Blue would enter new routes to a limited extent but no other new entrants were identified or likely; and
- Competition on New Zealand provincial routes offered by Origin Pacific would be reduced by the termination of its code-sharing arrangement with Qantas.

[75] The Commission's findings on the likely extent and effect of market entry and expansion by existing and potential competitors are of central importance. The constraints offered by Virgin Blue as a potential competitor in the Tasman and New Zealand domestic markets has particular significance. As a low cost carrier, it offers competitive influences of a kind not previously experienced in Australasia.

[76] The Commission acknowledged that the experience in North America and Europe had been that the entry of LCCs typically resulted in lower fares and fewer restrictions attached to fares, the availability of more routes, the stimulation of demand, reduced ability for FSAs to price discriminate with a resultant undermining of their financial viability, and some reduction in capacity.

[77] The Commission did not, however, see the European and North American markets as directly comparable to New Zealand. Among other things, it pointed to the much greater size and density of populations in the overseas markets, the availability of less expensive secondary airports, and opportunities to pioneer new routes which did not exist to the same extent in Australasia. The Commission also concluded that experience with the entry of Virgin Blue into the Australian domestic market suggested a lesser impact on fares than achieved by LCCs in overseas markets. It judged the establishment and growth of Virgin Blue in the Australian domestic market to have been greatly assisted by the collapse of Ansett.

[78] The Commission concluded that Virgin Blue was likely to enter both Tasman and New Zealand domestic routes whether or not the proposed Alliance went ahead,

but it considered entry would be at a lesser level if the proposed Alliance proceeded. And it did not believe that entry would result in a reduction in average fares to the extent experienced in North America and Europe.

[79] The Commission saw fifth freedom carriers as having only limited competitive impact in the Tasman market. It acknowledged that the arrival of Emirates Airlines had significantly increased capacity on some routes but was uncertain whether that capacity could be sustained in the long-term. It said the limited frequency of services and inferior schedules of fifth freedom operators would significantly limit their effectiveness.

[80] The updating evidence, to the extent it is relevant to the issues raised in the appeal, will be discussed as the separate markets are considered. Generally, the evidence does not change the broad assessments made by the Commission.

New Zealand domestic – main trunk market

Commission's findings

[81] The Commission identified main trunk routes between Auckland, Wellington and Christchurch as a separate market, distinguished from provincial routes by the numbers of passengers carried (approximately 80% of total domestic passengers), size and type of aircraft used (usually jets, whereas turbo-props are used on provincial routes) and a greater frequency of services.

[82] At the time of the Commission's Determination, three airlines were present in the market – Air New Zealand, Qantas and Origin Pacific. The market share of Origin was very small. It has since run into serious financial troubles and has exited the main trunk market. This has vindicated the Commission's view that existing competition would not constrain the proposed Alliance which would control 100% of the market. In the counterfactual, however, the Commission saw Qantas and Air New Zealand as continuing to compete vigorously. There is nothing in the updating evidence to change that assessment.

[83] In considering whether the proposed Alliance would result in a substantial lessening of competition, attention focused on whether it would be constrained by potential entrants. It is not in issue that only Virgin Blue looms as a foreseeable entrant. The question is whether the Commission correctly assessed the likelihood, extent and timeliness of entry and the effect of potential or actual entry on the competitive process.

[84] The Commission identified five conditions of entry which could act as barriers to entry in the main trunk market:

- Capital requirements
- Loyalty schemes operated by incumbent market participants
- The potential response of incumbent market participants
- Access to airport facilities
- Access to feeder services

The Commission decided that capital requirements and access to feeder services would not constitute barriers to entry but concluded that the others would affect entry for Virgin Blue in both the factual and counterfactual.

Loyalty schemes

[85] The Commission referred to evidence of the proportion of business travellers – more than half of the passengers on main trunk routes – who were likely to be most attracted by loyalty schemes. It saw the absence of a frequent flyer programme as a barrier to entry by Virgin Blue, greater in the factual than the counterfactual because under the proposed Alliance Air New Zealand and Qantas frequent flyer members would each be entitled to accrue and redeem air points by travel on both airlines, and Air New Zealand frequent flyer members would also be entitled to accrue and redeem points on sectors flown by Qantas outside the JAO network.

Incumbent response

[86] The Commission determined that the entry of Virgin Blue into the New Zealand main trunk market would provoke a vigorous response from the incumbents. It saw the threat of such a response, as well as the response itself, as a barrier to entry in both the factual and counterfactual. The Commission relied primarily on past instances of responses by both Qantas and Air New Zealand to entry by Virgin Blue in Australia and across the Tasman. These included the introduction of their low priced services and the expansion of capacity on routes entered by Virgin Blue. Virgin Blue itself identified strategic or predatory conduct as a barrier to entry and expansion in the New Zealand domestic and Tasman markets.

[87] The Commission foresaw a more vigorous response (and hence a greater barrier to entry) in the factual than in the counterfactual. Both airlines would be more profitable and better placed to bear the cost of increased capacity if the proposed Alliance proceeded. The Commission saw Qantas in particular as not well placed to respond absent the proposed Alliance because Qantas is currently incurring losses on its New Zealand main trunk routes (on a stand-alone basis) []].

Access to airport facilities

[88] In its determination, the Commission referred to difficulties faced by Virgin Blue obtaining access to domestic terminal facilities at Auckland International Airport (AIA). (According to updating evidence, these difficulties have yet to be resolved and are the subject of ongoing negotiations between Virgin Blue and airport management.) Any problem exists only in the counterfactual, however. If the proposed Alliance proceeds, Air New Zealand has agreed to provide Virgin Blue with access to facilities at AIA. The explanation for this is suggested by the Commission as:

“Absent the proposed Alliance, the [appellants] will be in vigorous competition and not willing to assist a competitor.” (para [605])

[89] The Commission concluded that the factual is only mildly pro-competitive in comparison with the counterfactual as only domestic facilities at AIA for Virgin Blue would be affected. There would be no difficulty obtaining access to facilities at either Wellington or Christchurch airports in either the factual or counterfactual.

Access to feeder services

[90] The Commission found that access to feeder services and economies of scale would also constitute barriers to entry for Origin Pacific (but not Virgin Blue) which would be greater in the factual than the counterfactual.

Commission's conclusion on barriers to entry

[91] Overall, in respect of the New Zealand main trunk market, the Commission concluded that, on the balance of probabilities, barriers to entry and expansion would be greater in the factual than the counterfactual.

Applying the LET test

[92] The Commission applied the LET test to the factual and counterfactual, asking whether the likelihood, extent and timeliness of entry would operate as a constraint on market power in the New Zealand main trunk market. For this purpose, it said the mere possibility of entry would be an insufficient constraint on the exercise of market power to alleviate market competition concerns.

[93] The Commission found that Virgin Blue would be highly likely to enter the market in both the factual and counterfactual within a two-year timeframe. However, it judged that the extent of entry would be greater in the counterfactual. Based on the previous and current behaviour of Air New Zealand and Qantas, it foresaw that they would respond to entry by expanding capacity on the routes on which Virgin Blue was seeking to enter or expand. However, the Commission considered that both airlines would have a greater ability to mount a capacity response acting together than they would acting individually. It saw the proposed

Alliance as better able to recoup the losses or sustain the reduced profits which would result. The Commission concluded that the likely entry of Virgin Blue would be sufficient to constrain appreciably Air New Zealand and Qantas acting individually on main trunk routes but not if they joined forces.

[94] The Commission's modelling (which we will discuss in greater detail later in this judgment) supported this qualitative conclusion, indicating that average fares would be 17% higher if the proposed Alliance proceeded than if it did not.

[95] Origin Pacific was not seen by the Commission as affecting its assessment. It considered it would not be likely to expand in the main trunk and was more likely to contract its services in the factual. It did not see it as likely to provide any constraint on the proposed Alliance.

[96] On this basis, the Commission said it was not satisfied, on the balance of probabilities, that the proposed Alliance would not have or would not be likely to have the effect of substantially lessening competition in New Zealand's main trunk market.

[97] The updating evidence relating to this market does not materially impact on any of the Commission's findings. The exit of Origin Pacific, though not anticipated, does not affect the Commission's analysis; its presence was not seen to provide any significant constraint. Virgin Blue has not yet entered the market. In a recent statement, its Chief Executive Officer said in response to concerns that Virgin Blue's entry into the New Zealand market was slower than first expected:

“We'll cherry-pick and when the right opportunity comes along, I believe we will get into those markets. But it is not today. It's a totally irrational market there and it's smarter to steer clear of those things.”

This tends to confirm that the timing and extent of Virgin Blue's entry is uncertain.

Appellants' submissions

[98] The appellants challenge the Commission's finding that frequent flyer programmes constitute a barrier to entry into the New Zealand domestic main trunk

market. They also criticise the Commission for treating the response of incumbents as a barrier to entry. They say, in any event, that the predicted response of the proposed Alliance would not deter Virgin Blue from entering or from constraining prices to counterfactual levels.

[99] The appellants take issue with the Commission's finding that Virgin Blue would not be able to access the "entire segment" of business travellers. They take the Commission to mean that this segment is foreclosed to an entrant which does not have a frequent flyer programme. We do not think that is what the Commission meant. We think it is clear from the context that the Commission was saying that Virgin Blue would be able to access some but not all of the business segment. That is consistent with the evidence the Commission had earlier referred to and with Virgin Blue's own assessment.

Barriers to entry - discussion

[100] There was disagreement among the economists who gave evidence as to what constituted a barrier to entry, or indeed whether the analysis should be concerned with barriers or some broader category of impediments to entry. We think the differing views are largely accommodated by the formulation of Tipping J in *Commerce Commission v Southern Cross Medical Care Society* (2002) 10 TCLR 269 at para [73]:

"Anything is capable of being a barrier to entry or expansion if it amounts to a significant cost or limitation which a person has to face to enter a market or expand in the market and maintain that entry or expansion in the long run, being a cost or limitation that an established incumbent does not face. The height of the barrier is a function of the degree of the differential. A barrier to entry or expansion reflects the extent to which an established firm can, in the long run, raise price above marginal cost (supra-competitive pricing) without inducing potential competitors to enter or expand in the market."

To broadly similar effect are the Commission's guidelines which, citing *Southern Cross*, define a barrier to entry as:

"anything that amounts to a cost or disadvantage that a business has to face to enter a market that an established incumbent does not face. A barrier to entry reflects the extent to which an incumbent can, in the long run, raise price above the competitive level without inducing potential competitors to

enter and expand in the market. The relevant assessment focuses on the time of entry, and the cost or disadvantage faced by the entrant compared with the incumbent at that time.”

[101] Before us, it was debated whether costs faced by a new entrant which an incumbent does not now have to bear but in the past had to bear, constituted a barrier to entry. The Commission argued that the *Southern Cross* formulation, which refers to “a cost or limitation which an established incumbent does not face”, excludes costs already incurred. The appellants refer to the definition in the leading text, Carlton and Perloff, *Modern Industrial Organisation* (3rd ed, 2000) p 77, that a barrier to entry is “a cost that must be incurred by a new entrant that incumbents do not (or have not had to) bear”. In *Brambles* (supra) this Court preferred the latter interpretation.

[102] The application of the *Southern Cross* test leads us to a clear view of what amount to barriers to entry or expansion in this case. In any event, the question of whether conditions in a market which have the potential to prevent, impede or slow entry and expansion, are or are not barriers to entry or expansion, may be less important than whether or how they will affect the likelihood, extent and timeliness of entry – the LET test – in the factual as compared to the counterfactual.

Frequent flyer scheme

[103] In our view, the appellants’ frequent flyer schemes could not be regarded as a barrier to entry by a low cost carrier. There is no necessity for a new entrant to introduce an equivalent scheme or to incur any other costs in order to attract new business. It is disadvantaged only in its ability to appeal to that class of potential customers who are members of a loyalty scheme and who face some disincentive to switch to another airline. That may be regarded as a barrier to expansion in the sense that the new entrant faces a limitation not shared by incumbents, but it is not, in our view, a barrier to entry.

[104] Whether a frequent flyer programme is a significant limitation is open to question. The new entrant is not prevented from accessing all potential customers. It merely faces a competitive disadvantage in appealing to a section of them. The

Commission referred to a recent publication by Professor AE Kahn, in *Lessons from Deregulation: Telecommunications and Airlines after the Crunch* (2004, AEI-Brookings Joint Centre for Regulatory Studies) p 14, in which he noted that frequent flyer credits were “a brilliant competitive innovation” which provide “strong inducements for travellers to concentrate their flights on the airline that offers the greatest number and variety of flights where they live.” He went on to say:

“Entirely apart from the genuine improvements in service made possible by alliances, rewards for exclusive patronage make it difficult for competitors that are in all other respects equally efficient to challenge them – not only on routes to and from hubs, but in spoke cities as well. The question, then, is whether the combining of those benefits with alliances – while doubtless attractive and beneficial to travellers – would not also create or reinforce monopoly power. I use the term in the historical antitrust sense of power not only over price but to exclude otherwise equally efficient competitors.”

In a passage omitted from the Commission’s submission, Professor Kahn makes it clear he is referring to competitors who are in all other respects equally efficient. However, where two competing models are involved, one of which (the LCC model) typically does not feature a loyalty scheme, it is difficult to assess the extent to which its absence might limit the new entrant’s ability to expand.

Incumbent response

[105] The Commission identified the anticipated response of Air New Zealand and Qantas to entry or threatened entry as a barrier to entry. It is the case, as the Commission pointed out, that in *Magic Millions Limited v Wrightson Bloodstock Limited* [1990] 1 NZLR 731, 757 Tipping J accepted that an incumbent’s response could be treated as a barrier to entry. But the facts of that case were exceptional and we would doubt that, as a general rule, the anticipated response of incumbents to the threat of additional competition should be regarded as anything other than a normal part of the competitive process. As Professor Janusz Ordovery, giving evidence for the appellants, said: if the response of incumbents to entry or threatened entry in a market is a barrier to entry, many markets which economists would regard as workably competitive would be viewed as subject to entry barriers. We consider it preferable to examine the likely behaviour of the appellants to anticipated entry by

Virgin Blue in the context of a broader enquiry into the constraints it will impose on them.

Entry and expansion in this case

[106] Mr Farmer submitted that where barriers to entry are low, conventional economic theory is that an incumbent will not increase output for the purpose of excluding an entrant and then recover its losses once the strategy has succeeded. He also questioned why Virgin Blue would not be deterred from entering a fiercely competitive market in the counterfactual – a market which Dr Michael Tretheway, an expert witness for the appellants, argued could only support two airlines – but would be deterred from entering a market where there was only one competitor.

[107] These arguments go to the question of entry. But that is not the critical issue in this case. It is accepted that Virgin Blue is able to enter the market and the Commission has assumed that it will. The question is whether entry will be effective enough to restore prices to counterfactual levels or to prevent them from rising in the first place. There can be no lessening of competition if the threat of entry or entry itself would be as effective to constrain prices if the proposed Alliance went ahead as they would be if it did not. The appellants' case is that increased prices will not follow when barriers to entry are low, the product is differentiated and where the entrant is employing a low cost strategy to stimulate demand – all conditions which they say prevail in the main trunk market.

[108] It is common ground that in airline markets the threat of entry and actual entry constrain pricing, the latter to a greater degree than the former. (Among the studies referred to us in support of this proposition were Hurdle and others, "Concentration, Potential Entry and Performance in the Airline Industry", *Journal of Industrial Economics*, December 1989, and Steven Morrison, "Actual, Adjacent and Potential Competition: Estimating the Full Effect of South West Airlines", *Journal of Transport, Economics and Policy*, 35 (2)). It is also common ground that prices will be constrained to differing degrees depending on the firm which is entering the market or threatening to do so. All other things being equal, a low cost carrier will constrain prices to a greater extent than a full service airline. There is no issue that

the anticipated entry of Virgin Blue in the New Zealand domestic market will constrain prices and may already have done so. The question is, to what extent Virgin Blue will influence prices if the proposed Alliance proceeds.

[109] The experts agreed that in airline markets the extent to which prices would be constrained by entry may vary according to the level of concentration in the market, that is, to the number, size and distribution of competitors and potential entrants. They differed on the likely effect of concentration in this case. The appellants' witnesses saw concentration as of slight significance relative to the effect of a low cost carrier in the market and low entry barriers. On the other hand, Professor Denis Carlton, giving evidence for the Commission, said concentration would affect competition in the market. He said, as a matter of "simple economics", that three firms in a market will be more competitive than two. He believed this would affect the speed and extent of entry. In his view, the incentive would not exist for Virgin Blue to replace the capacity lost as a result of the proposed Alliance and so restore prices to counterfactual levels.

[110] It is not in issue that Virgin Blue has the ability to expand capacity. The question which divided the experts is whether it would have the incentive to expand in sufficient time and to such a degree as to restrain prices to counterfactual levels.

[111] There is no relevant experience of the New Zealand domestic markets which would assist with that prediction. The basic proposition put forward by Professor Carlton (that competition reduces with fewer competitors) suggests that, with the proposed Alliance, Virgin Blue would not have the same incentive to restore prices to counterfactual levels in the short to medium term. That is supported by experience in markets overseas. Studies have shown that prices in airline markets are higher when the number of participants reduces, even when an LCC is present in the market.

[112] The only comparable study of Australasian airline markets supports those findings. Professor Steven Morrison and Dr Clifford Winston gave evidence to the Commission on behalf of the appellants of a study of prices on Australian domestic routes between February 1998 and June 2002. Qantas was present on all routes

throughout the period. Ansett and Virgin Blue were present for part of the period. The study was introduced for the purpose of showing that Virgin Blue exerted a greater discipline on the incumbent, Qantas, than did a full service airline. The data were reworked by Professor Jerry Hausman, giving evidence for Infratil to the Commission, and then by the Commission itself – see its determination at paras [514] – [517] and Appendix IV. Although the results of each analysis of the data varied, each showed that the presence of a second FSA (Ansett) in the market provided a constraint on the prices of the other FSA (Qantas) even when an LCC (Virgin Blue) was present in the market.

[113] Mr Farmer points to three features of the New Zealand main trunk market and of Virgin Blue’s business strategy to show that, contrary to the Commission’s position, in the circumstances in this case Virgin Blue would have the incentive to increase capacity and restore prices to counterfactual levels. As earlier mentioned, the factors he identifies are low barriers to entry, differentiation of the “price-product-service packages” offered by the firms and Virgin Blue’s strategy of pursuing a low price strategy to stimulate demand.

[114] However, these features are not unique to the New Zealand market or to Virgin Blue. They are present in the Australian domestic market, the subject of the Morrison and Winston study. The American studies also typically involve markets with low barriers to entry and the presence of a low cost carrier.

[115] It is not clear why neither entry nor the threat of entry is often insufficient to constrain prices in airline markets. It may be because of the way in which entry occurs. Typically, new entry into a market can be expected to occur on one or a few routes, not across an entire market network. (This has occurred to date with Virgin Blue in Australia and in the Tasman market.) The predictable competitive response of the incumbents would be to increase capacity and reduce price on those routes. This conveys to the entrant the likely conditions of expansion while permitting the incumbent to maintain prices on other routes. The Commission argues, in our view with logical force, that the proposed Alliance has stronger incentives to respond to entry in this way because it reaps the benefits if it succeeds in delaying or deterring entry on other routes on which it has a higher and, as yet, uncontested market share.

[116] The appellants argue that the New Zealand main trunk market could not support three airlines. Dr Trethewey said New Zealand routes can support only one FSA and one LCC. This influenced him to the view that the proposed Alliance would not be harmful for competition in the New Zealand main trunk market. However, there was no empirical data put forward to support the claim that the market could only support two airlines. As Mr Goddard submitted, that view appears to rest on the history of entry in New Zealand markets to date, the current profit levels of incumbents and on analogies with the Australian experience. In our view, such information does not enable any conclusions to be safely reached as to the number of players which the New Zealand main trunk market would accommodate and we do not think the Commission can be criticised for proceeding on that assumption. We are sympathetic to the view that, in the absence of empirical data which would permit a conclusion to be safely reached, it is for the competitive process, not the Commission or the Court, to determine the number and identity of participants in the market.

Conclusion

[117] Predictions of the likely behaviour of firms in a dynamic market at some point in the future typically involve the application of economic theory, previous experience (in the market or other markets having shared characteristics) and known facts about the structure of the market and the behaviour of competitors and potential competitors. Such predictions have often been referred to as “value judgments” – see, for example, *Lion Corporation Limited v Commerce Commission* [1987] 2 NZLR 682 at 693; *Fisher & Paykel Limited v Commerce Commission* (supra) at 766 and *Telecom v Commerce Commission* (CA) (supra) at para [46]. They are judgments which the Commission is especially constituted and qualified to make and, if open to the Commission on the evidence before it, are findings with which an appellate Court will be slow to interfere: see *Boral Besser Masonry Limited v Australian Competition and Consumer Commission* (2003) 195 ALR 609; 77 ALJR 623 (HCA).

[118] The Commission's conclusion that the proposed Alliance would result in a substantial lessening of competition in the New Zealand domestic main trunk market is in this category. The Commission was required to consider whether and the extent to which, on the basis of all the information and advice available to it, the proposed Alliance would or would be likely to result in reduced capacity/output and higher prices than would pertain if it did not proceed. Ultimately, that was a value judgment which the Commission made after full enquiry. It applied established principles. It was informed by a vast amount of evidence, only a fraction of which was referred to us. Its judgment was broadly consistent with economic theory and supported by experts of international eminence. The appellants have not discharged the burden of showing the decision to have been wrong.

New Zealand provincial market

[119] At the time of the determination, Air New Zealand accounted for most ([]) of the provincial market. There were a number of smaller operators, most of which provided highly localised services. The most significant of these was Origin Pacific which flew twenty routes and had a code-sharing arrangement with Qantas. This was the extent of Qantas' involvement in the market.

[120] The Commission found that only Origin Pacific provided Air New Zealand with any degree of competitive constraint. It postulated a continuation of the code-sharing arrangement between Origin Pacific and Qantas in the counterfactual and the possible entry of Qantas. It also foresaw the possibility of Virgin Blue entering the market in both the factual and counterfactual. However, it saw any such entry by Virgin Blue as uncertain, confined to provincial routes which could be served by its jets, selective, and unlikely to constrain the proposed Alliance on a substantial number of its provincial routes.

[121] The Commission concluded that a substantial lessening of competition would occur if the proposed Alliance proceeded as a result of the termination of the code-share arrangement between Qantas and Origin Pacific and the consequential retrenchment of Origin Pacific's operations. The possibility of Qantas independently entering the market would also be foreclosed.

[122] Since the Determination, Qantas has terminated its code-sharing arrangement with Origin Pacific and the retrenchment, which the Commission anticipated would follow, has occurred. Qantas has instead expanded its presence with daily services on the so-called tourist routes between Auckland, Christchurch, Queenstown and Rotorua. Virgin Blue has confirmed that it continues to consider entry into provincial routes serviced by seven capable airports “if a profitable opportunity arises”.

[123] The appellants submit that the Commission reached the wrong conclusions about competitive effects on provincial routes, pointing to the respects in which events have differed from what was projected by the Commission. However, if anything, subsequent events seem to confirm that a substantial lessening of competition would result from the proposed Alliance. The competition previously provided by Origin Pacific has been replaced by the direct involvement of a more formidable competitor, Qantas. That competition would be lost in the factual. Only a much weakened Origin Pacific would provide constraint. The timing and extent of entry by Virgin Blue is no less uncertain.

[124] Based on its modelling of four of the more significant provincial routes, the Commission predicted price increases of 19% in year three in the factual. (The 16% referred to in para [684] of the determination is incorrect. It was a percentage of the higher price when, in accordance with the Commission’s normal practice, it should have been expressed as a percentage increase over the lower counterfactual price.) The appellants’ criticisms of this calculation will be considered later.

Tasman routes

Background

[125] The Tasman market includes all routes between Australia and New Zealand. At the time of the determination, they were served by Air New Zealand, Qantas and fifth freedom carriers. (As earlier mentioned, fifth freedom carriers are those who have rights to land in Australia and to fly to New Zealand or vice versa. The flights must originate or terminate in the airline’s home country.) Since the determination,

Virgin Blue (as anticipated in the determination) has entered the market as an additional competitor.

[126] Based on capacity (i.e. available seats) at 31 December 2002, the market shares of Air New Zealand and Qantas were respectively 43% and 40%, the balance of 17% being accounted for by fifth freedom carriers. In terms of passengers carried, that overstated the market share of fifth freedom carriers as their load factors (proportion of seats filled), is generally lower. Air New Zealand's share included that of its wholly owned subsidiary, Freedom Air. Freedom Air was introduced in response to the trans-Tasman service commenced by Kiwi International in August 1995 and was seen by industry participants to have played a part in the demise of Kiwi International.

[127] Effective from 29 October 2003, Air New Zealand announced a new "Tasman Express" service across the Tasman. It was said to offer an average reduction of 20% on the full range of fares, including business class.

Commission's findings

[128] The Commission decided that existing competition in the form of fifth freedom carriers would provide only a small competitive constraint on the proposed Alliance. It saw the limited frequency of their services and inferior schedules as significantly limiting their effectiveness. With the exception of Emirates which flies from Auckland and Christchurch to Melbourne, they fly only from Auckland to Sydney and Brisbane. The Commission also observed that fifth freedom operators frequently enter and exit the market and adjust their schedules. It was uncertain whether the increase in capacity by Emirates was sustainable in the long-term.

[129] The Commission saw the only likely entrant in the Tasman market as Virgin Blue. It acknowledged that there were holders of fifth freedom rights who were not currently flying and who could enter but did not see their potential for entry as providing any measurable constraint. By the time of the Determination, Virgin Blue had announced its intention to operate its New Zealand-based subsidiary, Pacific Blue, from Christchurch; flights to Brisbane would commence on 1 February 2004.

The Commission accepted that Virgin Blue would enter the market whether or not the proposed Alliance went ahead.

[130] As with the New Zealand main trunk market, the Commission identified loyalty schemes and the response of incumbents as the barriers to entry and expansion in the Tasman market. Also in common with its analysis of the main trunk market, the Commission thought the combined loyalty programmes of the proposed Alliance would create a higher barrier to entry in the factual than the counterfactual. However, it considered that the barriers themselves would be lower than for the New Zealand main trunk routes because the proportion of business travellers on Tasman routes was lower.

[131] Virgin Blue had identified the expected strategic responses of Air New Zealand and Qantas as the major impediment to its entry and expansion on Tasman routes. Freedom Air was identified as having a key role; indeed, Virgin Blue originally proposed the divestiture of Freedom as a condition of any approval of the proposed Alliance with a constraint on the introduction of an equivalent service. The subsequent introduction by Qantas of JetConnect caused Virgin Blue to change its position on that issue. It said:

“Originally we pointed out that the easiest way to resolve this would be the divestiture of Freedom Air with a constraint on the reintroduction of a ‘Freedomair 2’. Since then a number of changes have taken place including Qantas’ introduction of JetConnect, an equally potent weapon that can be just as easily trained on Air New Zealand as upon ourselves. The introduction of JetConnect devalues the Freedomair divestiture as it is effectively ‘Freedomair 2’. While this situation is not ideal, it is a de facto reality ...”

(Quoted by the Commission at para [732] of the Determination.)

[132] The Commission saw the introduction of JetConnect and of Tasman Express by Air New Zealand as part of the incumbents’ response to anticipated entry by Virgin Blue. It referred also to a recent announcement by Air New Zealand of eleven new Tasman flights, seven based in Christchurch, Virgin Blue’s Tasman entry point in New Zealand. It noted that Air New Zealand had doubled its number of flights from Christchurch to Brisbane, the route on which Virgin Blue had announced it would first enter.

[133] The Commission concluded the entry of Virgin Blue would continue to provoke a vigorous response from Air New Zealand and Qantas in the factual. If the proposed Alliance proceeded, it foresaw (as it did in the New Zealand domestic main truck market) an enhanced ability to respond by subsidising over-capacity. Virgin Blue made the same assessment, advising the Commission that it expected a “stronger anti-competitive response” from the proposed Alliance.

[134] The Commission concluded that Virgin Blue would enter the Tasman routes in the short-term, the extent of entry depending on incumbent response and demand. It saw entry as likely to be less in the factual and insufficient to act as a constraint on the proposed Alliance. Its modelling (which assumed that Virgin Blue would, by year three, achieve 20% market share in the counterfactual and 15% in the factual) showed prices in the factual would be 16% higher than in the counterfactual, well in excess of the 5% benchmark which the Commission assessed as indicating a substantial lessening of competition.

Updating evidence

[135] Since the determination, Virgin Blue has, as expected, commenced flying selected Tasman routes. On the Brisbane-Christchurch, Melbourne-Christchurch, Sydney-Christchurch and Sydney-Wellington routes where it has entered, it has already achieved market shares (based on seat capacity) of between 16% and 35%, an average of 23% for these routes and an average of 6.5% of the total Tasman routes.

[136] Emirates has also entered the market, while two other fifth freedom operators on routes out of Auckland have withdrawn. According to the most up-to-date information on passengers carried (for the month of March 2004), Air New Zealand and Qantas had a total market share of 84%, Virgin Blue 7% and fifth freedom carriers the balance. Based on capacity, the equivalent figures are Air New Zealand and Qantas 73%, Virgin Blue 7% and fifth freedom carriers 21%. The significantly higher capacity share for fifth freedom carriers reflects their much lower load factors.

Appellants' submissions

[137] The appellants contend that the Commission reached the wrong conclusions about conditions of entry and expansion in the Tasman market and the likely competitive impact of Emirates and Virgin Blue. They say there are no barriers to entry or expansion on Tasman routes and that both Emirates and Virgin Blue are able, within a short period of time, to deploy capacity in response to any opportunities arising on the Tasman as a result of price increases or reduced capacity/output. The appellants say Virgin Blue is and will remain the price leader on the Tasman because of its low cost model and that Emirates is able to price aggressively at marginal cost.

[138] The appellants argue that the evidence contradicts the Commission's findings that incumbent response and frequent flyer programmes constitute barriers to entry or expansion. They refer to the ease and rate of entry and expansion achieved in New Zealand and Australia, and to the response of the incumbents, as showing they regard LCC entry and expansion as inevitable. They point out that in only a few months since entry, Virgin Blue has already exceeded the route shares predicted by the Commission (15-20% on a route by route basis five years after entry on to a route). They say this continues the pattern of growth shown by Virgin Blue in Australia.

Discussion

[139] In our discussion of the New Zealand main trunk market, we doubted that either frequent flyer programmes or incumbent response should be categorised as barriers to entry while allowing that frequent flyer programmes arguably may constitute a limitation on expansion. Those views apply equally to the Tasman market. To the extent that the frequent flyer programmes of the appellants may constitute a limitation on expansion by Virgin Blue, we accept that it is likely to be greater in the factual than the counterfactual.

[140] Although we do not accept that the response of incumbents is a barrier to entry, we accept that their likely behaviour goes to the likelihood, extent and timeliness of entry and is properly part of the competition analysis. It is also properly part of the analysis of what happens following entry.

[141] A feature of Australasian airline markets has been the inability of new entrants to consolidate their position in the market. With the sole exception of Virgin Blue, new entrants over recent years have failed to build significant market share and have exited in the short to medium term. This suggests there are forces at work which may not be fully understood and which affect the ability of an entrant to achieve sustained entry. These may include the capital and human resources of entrants.

[142] That said, Virgin Blue has an established presence in Australian domestic markets and has achieved greater than expected (by the Commission) penetration on the Tasman routes it has entered. Fifth freedom carriers also have an established presence in the market. There is no question that the appellants face powerful competitive constraints in the Tasman market. The question is whether those constraints will lessen if the proposed Alliance goes ahead.

[143] The Commission concluded that they would, and the constraints offered by Virgin Blue in particular would be reduced as a result of the anticipated response of the proposed Alliance partners in the factual. The Commission thought the response of the proposed Alliance would be more vigorous, and entry by Virgin Blue more tentative. That was supported by the evidence of Virgin Blue itself. It told the Commission its decision making was very much affected by its expectation of what the appellants would do, describing an incumbent's use of capacity as a "key weapon to stifle new entrant competition". There is evidence also that Virgin Blue withdrew from a route in Australia as a result of a vigorous response from Qantas. [

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[144] As discussed in relation to the New Zealand main trunk market, the Commission's conclusion that there would be a lessening of constraints in the factual

is consistent with experience in the Australian domestic market and in airline markets elsewhere. Greater concentration will result in higher prices, even in the presence of a low cost carrier.

[145] The precise reasons for this are less clear. The Commission may be right in attributing it to a more vigorous incumbent response and to more tentative entry by Virgin Blue. And, as discussed in relation to the New Zealand domestic main trunk market, it is arguable that the proposed Alliance would have stronger incentives to engage in strategic behaviour in response to new entry than the two airlines separately and would be better placed to do so. It would have a larger network across which to re-optimize prices. We bear in mind too that because an incumbent can adjust prices very quickly in response to entry, it is possible to maintain supra-competitive profits on particular routes until entry occurs, while cutting prices and adding capacity on routes where there is entry.

[146] The appellants argued, as they did in relation to the New Zealand main trunk market, that because of Virgin Blue's lower cost structure and commitment to low fares, it would constrain fares to the same extent regardless of market concentration. However, as we explained in our discussion of that market, the effects of concentration have not been shown to be fully dissipated by the presence of a low cost carrier.

[147] We have no reason to differ from the Commission's view that fifth freedom carriers provide little additional restraint in either the factual or counterfactual. The entry of Emirates was anticipated. The pattern of relatively short-lived entry and withdrawal by fifth freedom carriers has continued. We acknowledge that Emirates has, in a short time, achieved a conspicuous presence on some Tasman routes. And, together with other fifth freedom carriers who also have relatively low load factors, Emirates is well placed on the routes it has entered to absorb demand switched from higher priced FSAs. However, the nature of their operations on Tasman routes limits the ability of fifth freedom carriers to deploy additional capacity in response to price increases.

Conclusion

[148] As with the New Zealand main trunk market, the Commission was required to assess whether constraints from entry or expansion by Virgin Blue (or others) in the factual would prevent the proposed Alliance from substantially increasing market power. The Commission decided, on the evidence available to it, that Virgin Blue's capacity in the factual would not be as great as in the counterfactual and that LCC (and other) operations in the Tasman market would not adequately compensate for the loss of FSA competition between Qantas and Air New Zealand. That was also in the nature of a value judgment which we are satisfied it was entitled to make.

New Zealand-Asia markets

Commission's findings

[149] Air New Zealand flies direct from Auckland to Japan, Taipei, Hong Kong and Singapore. Qantas does not fly to any of these destinations directly from New Zealand but provides services from Australia, some by way of code-sharing arrangements. Although by s 30 of the Act there is a deemed substantial lessening of competition on all routes, the Commission doubted there would be any actual lessening of competition on the Auckland-Hong Kong and Auckland-Singapore routes. However, it found a substantial lessening of competition on the remaining two routes from Auckland to Japan and Auckland to Taipei.

[150] Qantas offers a service from Brisbane to Japanese destinations by way of a code-sharing arrangement with Japan Airlines (JAL). The Commission saw these flights as readily substitutable for passengers flying from New Zealand, particularly those originating from Wellington and Christchurch who would have to fly to Auckland to connect with an Air New Zealand flight. It noted that 90% of the passengers are leisure passengers who would be relatively flexible in their flight requirements. The only other constraint currently offered is by Air Caledonie (Aircalin) which flies once a week from Auckland to Tokyo via Noumea. The Commission concluded that the removal of the indirect competition offered by

Qantas would result in a substantial lessening of competition. It thought it unlikely that existing competition would constrain the proposed Alliance in the factual. The Aircalin service is too infrequent and the JAL service from Brisbane hampered by the need to interline (connect) in Australia. As the New Zealand to Asia sector is low yielding, the Commission considered that no constraint would be offered by potential competition. On that basis, a substantial lessening of competition would arise from the proposed Alliance.

[151] Air New Zealand flies direct from Auckland to Taipei twice a week, code-sharing with EVA Air. The only alternative service offered is by Qantas from Sydney which also code-shares with EVA Air. This service was judged by the Commission to provide some constraint which would be removed by the proposed Alliance. As with the New Zealand-Japan route, the Commission did not see prospective entrants as offering any constraint. Accordingly, there would be a substantial lessening of competition on this route also.

Appellants' submissions

[152] The appellants make the following criticisms of the Commission's findings:

- a) The Commission was wrong to treat Qantas indirect flights as a constraint on Air New Zealand.
- b) The Commission took account only of Qantas indirect routes, ignoring many other indirect routes between New Zealand and Taipei and New Zealand and Japan including, for example:
 - An indirect route to Taipei offered by Cathay Pacific via Hong Kong and by Singapore Airlines via Singapore.
 - An indirect route to Japan offered by Cathay Pacific via Hong Kong and by Singapore Airlines via Singapore and by Malaysian Airlines via Malaysia.

- c) A high proportion of passengers to Japan and Taipei are leisure passengers (90% on NZ-Japan and 80% on NZ-Taipei). Any attempt to raise prices to a supra-competitive level would result in those passengers travelling to alternative destinations.
- d) The Commission's analysis overlooks competition offered by JAL (on NZ-Japan routes) and EVA (on NZ-Taipei routes) by way of code-share agreements they have with Air New Zealand. There is no proposal to terminate these code-shares in the factual. They would continue to impose a significant competitive constraint as they commit the code-share partners to provide a fixed number of passengers without any restriction on price.

Discussion

[153] The appellants introduced evidence that Qantas carried very few New Zealand passengers to Taiwan and Japan. The figure was estimated at [] of total capacity. Although the [] figure is criticised as misleading by the Commission, as representing the proportion of passengers to available capacity and not the proportion of passengers carried, it shows that currently relatively few New Zealand passengers are opting to travel by the indirect route. However, the fact that most passengers prefer direct flights from New Zealand gives no real guidance as to what would occur if prices were to increase on the direct routes flown by Air New Zealand.

[154] The Commission concedes that there are other indirect routes which could provide a constraint on prices for direct flights, while complaining that this information was not provided to it notwithstanding that the issue of indirect flights was raised in the draft determination. The Commission also points out that no information is put forward (in the form of waiting times, relative cost and substitution opportunities generally) to show that the removal of Qantas indirect flights would have no effect on competition.

[155] The Commission appears to have overlooked the likely impact on direct flights of the code-sharing arrangements. Unless terminated, they would continue to operate as a restraint in the factual as well as the counterfactual. On the face of it, this will provide a more effective constraint than indirect services.

[156] The further evidence which was not made available to the Commission, or is not referred to in the determination, does not establish that no substantial lessening of competition could result. But it is of sufficient cogency to raise doubts as to whether, had it been considered by the Commission, the same conclusion would have been reached. Seen in the revised context, the service offered by Qantas from Australia appears to offer only modest constraints to Air New Zealand.

[157] Having regard to the deemed loss of competition, we would not differ from the Commission's conclusion but doubt that any allocative inefficiency could be shown to result from the lessening of competition in the NZ-Asia market. The Commission calculated allocative welfare losses of \$12.3m on the basis of an assumed price rise of 5%. This was modified to \$11.7m in the course of the hearing. We consider the figure should be disregarded for the purpose of weighing detriments and benefits.

New Zealand-Pacific market

[158] The New Zealand-Pacific market comprises routes between New Zealand and major Pacific Island destinations, between the Pacific Islands and Los Angeles and between some of the Islands.

New Zealand-Fiji

[159] Air New Zealand flies nine times a week from Auckland to Fiji, code-sharing with United Airlines on eight of those services. Air Pacific provides the only other service between New Zealand and Fiji. It is Fiji's national airline, owned as to 53.68% by the Fijian Government and 46.32% by Qantas. Qantas code-shares with Air Pacific on its services between New Zealand and Fiji. The Commission decided

that competition between Air New Zealand and Qantas (through Air Pacific) would be likely to continue in the counterfactual. In the factual, the proposed Alliance would have 100% market share and face no competition from any incumbent carrier.

New Zealand-Samoa

[160] Air New Zealand flies three times a week from Auckland to Samoa, code-sharing with United Airlines, and has one flight per week which continues to Los Angeles via Tonga. Qantas code-shares on one of Polynesian Airlines direct services to Samoa and on one of their two indirect services from Auckland to Samoa via Tonga. Polynesian Airlines also operates a weekly service from Wellington to Apia via Tonga. Polynesian Airlines is Samoa's national airline. It also operates services to Samoa via Sydney and code-shares on Qantas from Auckland to Melbourne two times a week.

[161] Qantas currently provides feed and network advantages to Polynesian Airlines which it would have difficulty replacing if its arrangements with Qantas came to an end following the proposed Alliance. Polynesian Airlines itself saw the proposed Alliance as potentially fatal to it unless it was included. The Commission concluded that Polynesian Airlines would be unable to compete and would exit the market if the proposed Alliance went ahead leaving the proposed Alliance with a 100% market share.

New Zealand-Tonga

[162] Air New Zealand flies direct services from Auckland to Tonga five times a week. Polynesian Airlines flies once a week and also operates one flight from Wellington. Royal Tongan Airlines flies from Auckland to Tonga four times a week.

[163] Despite suggestions from at least one industry participant that the continuation of Royal Tongan Airlines services was uncertain, the Commission found that the same level of service was likely to continue in the factual. It decided

that Royal Tongan Airlines would provide some constraint on the proposed Alliance but that it would be limited and insufficient to constrain the proposed Alliance. However, since the determination, Royal Tongan Airlines has run into financial difficulties and ceased operations in April 2004.

New Zealand-Tahiti

[164] Air New Zealand operates two direct flights weekly from Auckland to Tahiti and three indirect flights via the Cook Islands. The only other service from New Zealand to Tahiti is provided by Air Tahiti Nui which provides two flights, both of which are code-shared by Qantas.

[165] The Commission took the view that the loss of its code-share arrangement with Qantas would cause serious difficulties for Air Tahiti Nui. The Commission observed that Pacific routes are relatively thin as the frequency of code-sharing arrangements show. It concluded that Air Tahiti Nui would be unlikely to provide effective competition to the proposed Alliance on the NZ-Tahiti route.

Fiji-Los Angeles, Tahiti-Los Angeles, Samoa-Tonga

[166] Air Pacific and Air New Zealand are the only operators providing services between Fiji and Los Angeles. The proposed Alliance would therefore have a 100% market share on this route.

[167] The Tahiti-Los Angeles route is serviced by Air Tahiti Nui and Air France. The Commission saw those services as likely to continue.

[168] The only airlines currently flying between Samoa and Tonga are Polynesian Airlines and Air New Zealand. No constraint would therefore be provided by existing competition on that route.

Potential competition

[169] The only potential entrant into the market identified by the Commission was Virgin Blue which had expressed interest in entering the Auckland to Fiji route and had secured landing rights in Fiji. However, the Commission found there was considerable uncertainty as to whether entry would occur and the likely timing of any entry. It saw the potential entry of Virgin Blue as providing at best only a weak constraint on the proposed Alliance. It saw no evidence of potential entry on the other Pacific routes.

[170] The economic modelling carried out by the Commission indicated that the lessening of competition arising from the proposed Alliance would lead to prices being 11% higher on the New Zealand-Fiji route and 19% higher on the Fiji-Los Angeles route.

[171] The appellants dispute the Commission's findings in relation to potential entry on Pacific routes. They argue there are no barriers to entry and the same potential for entry by Virgin Blue as in the domestic main trunk and Tasman markets. They rely on recent announcements by Virgin Blue of its intention to commence flights between Australia and the Pacific Islands and between New Zealand and the Pacific as part of an Australia-New Zealand-Rarotonga route. They point out that the threat of entry by Virgin Blue has already provoked a competitive response from Air New Zealand in the form of Pacific Express. The appellants point also to plans by Flight Centre/Airworks to enter the New Zealand-Fiji route.

[172] We accept that there is potential for entry by Virgin Blue on Pacific routes, although nothing has happened since the Commission's determination to undermine its conclusion that the timing and extent of entry is uncertain. The only route which Virgin Blue has announced it will enter is New Zealand-Rarotonga but no commencement date has been given and at the date of the hearing Virgin Blue had still not obtained the necessary government approval. Flight Centre's plans to provide a holiday charter service to Fiji using an aircraft chartered from Airworks came to nothing. Airwork has received approval from the Fijian Government to

commence flights to Fiji but there is no indication of when these flights might commence.

[173] The only finding of the Commission which, in our view, requires reassessment as a result of the updating evidence concerns the New Zealand-Tahiti route. Evidence which was not before the Commission indicates that Qantas places very few passengers on Air Tahiti Nui services between New Zealand and Tahiti. Based on this information, the Commission now accepts that the proposed Alliance would have less of an impact on Air Tahiti Nui than it had anticipated. This has an insignificant effect on the calculation of allocative detriments. The revised estimate of the Commission produced a small net welfare benefit of \$49,000 in year three.

[174] The appellants criticise the Commission's calculation of welfare detriments for the Fiji-Los Angeles route (\$2.2m). The Commission used a figure of 15% for the percentage of New Zealand passengers on flights between Fiji and Los Angeles. That figure was provided by the appellants. Updating evidence filed by the appellants is, however, that less than [] of passengers carried by Air Pacific between Fiji and Los Angeles in the year to March 2004 were New Zealand origin/destination passengers. The Commission accepts that the figure of 15% may be too high; it was provided as an average figure for all long-haul Pacific routes. However, as the new evidence provides only figures for passengers carried by Air Pacific, it gives no clear guidance as to the overall proportion of New Zealanders flying on Air Pacific and Air New Zealand flights as part of a longer journey from New Zealand to Los Angeles. As submitted by the Commission, if the proportion of New Zealand passengers on this sector has been over-estimated, it will not invalidate the overall calculation of welfare detriments. It would simply mean that some of the welfare effects on the New Zealand to US routes had been incorrectly taken into account in the New Zealand-Pacific market.

[175] Finally, the appellants renew a submission made to the Commission that, as the New Zealand-Pacific market caters largely to leisure travellers, demand is highly elastic and travellers would respond to an increase in fares by switching to other destinations. The Commission accepted that there was some elasticity of demand but concluded that substitution would be unlikely to constrain the proposed Alliance

as it would primarily take place between Pacific routes which are all similarly affected. We see no reason to differ from that conclusion.

[176] The appellants have not shown the key findings of the Commission to be in error. The smaller operators in the market are plainly vulnerable as the demise of Tongan Airlines has shown. Routes are thin. The proposed Alliance would result in a higher level of concentration on most routes. Only Virgin Blue is a realistic contender for entry but there can be no certainty as to the timing and extent of entry.

New Zealand-United States market

Commission's findings

[177] Air New Zealand operates seventeen direct services each week from Auckland to Los Angeles and four indirect services via Fiji and Tahiti. On the direct services, it code-shares with four other international airlines. Qantas operates nine weekly direct flights from Auckland to Los Angeles, on which American Airlines and British Airways code-share. The only other airline servicing the route is Air Tahiti Nui. At the time of the determination it operated two flights each week from Auckland to Los Angeles via Tahiti and one return flight from Los Angeles to Auckland via Tahiti. It has since increased the Auckland-Los Angeles service to three flights per week and Los Angeles-Auckland flights from one to two per week.

[178] The proposed arrangement makes provision for Air New Zealand and Qantas to continue to compete on the New Zealand-US route for a period of two years. However, other aspects of the arrangement left the Commission doubting that there would be effective competition between them. That finding is not challenged.

[179] The Commission found the proposed Alliance would have almost 100% share of the market. It thought Air Tahiti Nui would be unlikely to provide any real constraint on the proposed Alliance as it provided only two weekly indirect flights. The substitutability of its service was further reduced by its having fewer return flights.

[180] The Commission found there is unlikely to be any potential entry which might constrain the proposed Alliance. It heard evidence that potential entrants were either suffering financial difficulties, concentrating their resources on other markets or were partners in one or other of the alliances of which Air New Zealand and Qantas were members.

[181] The Commission heard evidence that the NZ-US route is a long thin route that was not capable of supporting three carriers. Even if financial circumstances permitted, it assessed entry as unlikely. This included entry by United Airlines which had withdrawn from the route in April 2003 and Singapore Airlines, which had obtained the right to fly the route almost two years earlier but had showed no sign of an intention to enter.

[182] The Commission also referred to evidence that fares on the route had increased since United Airlines had withdrawn. It noted that that had not led to new entry. It concluded there was no potential entrant which might constrain the proposed Alliance. Economic modelling suggested that the resultant reduction of competition would be likely to lead to prices 14% higher than would prevail in the counterfactual.

Appellants' submissions

[183] The appellants challenge the Commission's finding that the proposed Alliance would not be constrained by potential entrants. They point out there are low barriers to entry and expansion and a large number of airlines who could enter under bilateral and multilateral open skies accords. Among likely entrants identified were:

- Emirates, which has publicly stated it is considering the possibility of entry. A link with the US west coast would, it is submitted, fit in with its goal of becoming a global airline as it does not have the right to fly from Australia to the US.

- Singapore Airlines, which has rights to fly New Zealand-US and has a presence in both Auckland and Los Angeles.
- United Airlines, which is emerging from its financial difficulties and has publicly stated it would enter the route if operating margins make it profitable to do so.
- Virgin Blue, which is in the process of obtaining regulatory approval to fly Australia-US and whose parent company has ambitions to expand to the US.

[184] The appellants also point out that the New Zealand-US route is part of other larger routes. Many passengers are travelling the sector as part of a trip to Europe via the US or from Australia to the US via New Zealand. [] of Qantas passengers are in this category and [] of Air New Zealand passengers. The appellants submit the availability of alternative routes, e.g. to Europe via Asia, will provide a constraint, as will the feeder-service provided to the New Zealand domestic market by the route. Any increase in fares would result in passengers choosing other destinations and impact on the number of passengers flying Air New Zealand domestic services.

Discussion

[185] The evidence of entry is equivocal, confirming that it would be wrong to place too much reliance on statements of future intention. United Airlines has recently stated that it has no plans to re-enter the route. The Chairman and Chief Executive Officer of United Airlines was quoted as saying it was not a route his company could fly profitably. A combination of cost and demand would have to change to persuade them to re-enter. In evidence before the Australian Competition Tribunal, an Emirates witness said it had no plans to fly to the US from the Pacific over the next five years.

[186] There is no reliable evidence that any airline will enter the market in the short-term. We think the Commission was entitled to conclude that constraints

offered by potential entrants are insufficient to replace those which the appellants currently impose upon each other.

[187] The appellants made the point that the question the Commission should have asked is not whether another competitor will enter the route but whether another competitor would enter the route if the proposed Alliance sought to increase prices to supra- competitive levels. In argument, these were suggested as being prices higher than those now prevailing.

[188] We agree that the correct test is as put in argument by the appellants, but we see no sign that the Commission's failure to explicate the test in relation to this market (and the others) made any difference to its findings. The Commission's guidelines require that it consider entry in response to an assumed exercise of market power (see Merger and Acquisition Guidelines 2004 para 6.2). We take that to be the inarticulated premise whenever the Commission is exploring the constraints offered by potential entrants.

[189] The Commission acknowledged that the Auckland-LA route is part only of the journey for some passengers but noted that for a substantial number Los Angeles is the terminus. We accept that some measure of constraint may be provided by indirect alternative routes and the competition which exists in other parts of a longer journey undertaken by some passengers. However, these constraints exist in both the factual and the counterfactual. There is no evidence they would neutralise the effect of the concentration on the Auckland-Los Angeles route which will arise from the proposed Alliance.

[190] The withdrawal of United Airlines from the Los Angeles-Auckland route in March 2003 presented an opportunity to test the appellants' hypothesis that existing constraints (including potential entrants) prevent the exercise of market power by the incumbents. The Commission said that fares increased after United Airlines withdrew. The appellants were critical of the anecdotal nature of this evidence and relied on fare data for the period July 2001 to August 2003 as indicating a reduction in fares following the exit of United Airlines. As the data concern only the five months following withdrawal by United Airlines and (we were told) incorporate

fares set before withdrawal, they are of limited assistance. The data also provide only equivocal support for the appellants' case. Fares decreased in three of the months compared to the corresponding period in the previous year but increased in each of the other two months. No updating evidence was provided on this particular issue. We are therefore unable to assess any longer term effect of a change in concentration on this route.

[191] In the result, we find no material error in the Commission's assessment of the likely effect of the proposed Alliance on competition in the New Zealand-US market and see no reason to depart from its conclusion.

Other international market

[192] The Commission found that there is strong competition on other international routes flown by both appellants and that there was unlikely to be any actual lessening in competition as a result of the proposed Alliance.

Domestic air freight market

[193] The Commission found that a competing service operated by New Zealand Post provides a sufficient degree of constraint to prevent any substantial lessening in competition arising from the proposed Alliance.

Tasman belly-hold freight market

Market

[194] Internationally, air cargo is carried by aircraft dedicated as freight carriers and in the belly-hold of aircraft operating scheduled passenger services. The Commission accepted the advice of industry participants that dedicated freight services and belly-hold freight services are not substitutable. It defined a separate

market for belly-hold freight. It separated the Tasman from other international markets because of route density and possible backhauling.

[195] The appellants criticise the separation of dedicated freight and belly-hold freight into separate markets. They say there is clear evidence that the two services are substitutable. First, they each price similarly. Secondly, most freight can be carried by either means – 95% of Tasman air freight and the majority of all international freight can be carried by either method. Thirdly, and contrary to the Commission’s view, the appellants say the marginal cost of belly-hold freight is not significantly less than that of dedicated freight.

[196] The Commission acknowledged these arguments in rejecting the market definition proposed by the appellants. It relied on evidence that the nature and frequency of the services offered were clearly distinguishable. Dedicated freight services serve a limited number of destinations with limited frequency. Belly-hold services are much more frequent. As a result, exporters of perishable goods, which comprise a substantial proportion of air freight, told the Commission they only use belly-hold freight services. Dedicated freighters are used primarily by shippers who are able to ensure space in advance and deal with large quantities.

[197] The Commission concluded that dedicated freighters do not have the necessary frequency of service or comprehensive route network of belly-hold freight services to enable them to act as significant competitors. They concluded there is neither demand-side nor supply-side substitution between the two services.

[198] The appellants have not shown error in the Commission’s approach. The conclusion it reached seems to us to follow logically from the evidence relied on. We consider the Commission’s reasons for finding there was limited substitutability on the supply side as well as the demand side were justified. In particular, its assessment of the economies of density and of scope available to belly-hold freight operators has not, in our assessment, been satisfactorily answered.

[199] In *Brambles* (supra) at para [137], this Court pointed out that the adoption of a narrow market definition will not lead to error provided any constraints offered by

goods or services which are potentially substitutable are taken into account in the competition analysis. The Commission acknowledged (at para [296] of its determination) that substitutability between belly-hold and dedicated freight may increase with flight distance. Appropriately, it had regard to the possibility of substitution when considering the international belly-hold freight market at para [864] of the determination.

Competition analysis

[200] The Commission said that as belly-hold freight services are a by-product of passenger services, the competition analysis of the Tasman passenger market is largely applicable to the Tasman freight market. It accepted that the introduction by Air New Zealand of narrow-bodied jets would significantly reduce its market share but estimated the proposed Alliance would nevertheless have a market share of [] at year three. The Commission did not see fifth freedom carriers, including Emirates, as likely to provide a significant degree of constraint. Information provided to the Commission indicated that fifth freedom carriers were likely to allocate a large percentage of their freight capacity to long-haul services. They were disadvantaged by the time delays in unloading freight in Australia en route to their final destination. The Commission also observed that fifth freedom carriers provide a differentiated service in that they operate limited frequencies and networks which would make the competing service offered by the proposed Alliance more attractive.

[201] As with the passenger market, the Commission identified Virgin Blue as the only entrant with the potential to constrain the proposed Alliance. However, Virgin Blue informed the Commission that freight is not part of its core business, although if profitable freight-carrying opportunities arise, it will take them. The Commission noted, however, that LCC airlines typically do not carry freight which could jeopardise their goal of achieving quick and efficient turnarounds of their aircraft. The Commission concluded that Virgin Blue's entry into the Tasman belly-hold market in the factual would be insufficient to constrain the proposed Alliance when compared with the counterfactual, largely for the reasons given in its analysis of the Tasman passenger market.

[202] The Commission concluded that there would be insufficient constraints from existing competitors, or new entrants and no constraint from buyers or suppliers. Accordingly, there would be a substantial lessening of competition in the market.

[203] The appellants submit the Commission gave insufficient weight to the diminishing influence of Air New Zealand resulting from the phasing in of its new wide-bodied jets. The freight capacity of each jet reduces from [] tonnes to [] tonnes. Much of the cargo must be hand-loaded which is more costly. Market share, as measured by capacity, has fallen sharply as a result and will continue to do so as more of the new jets arrive.

[204] The appellants further submit that the updating evidence clearly shows that fifth freedom carriers, Emirates in particular, constrain the appellants in the market. They refer to increased market shares (by reference to capacity) and evidence that, as a result of the entry of Emirates, Qantas has been obliged to reduce prices but has still lost customers to Emirates.

[205] The Commission took account of the reducing output of Air New Zealand and the updating evidence does not show that the assumptions it made as to future market shares were incorrect. The updating evidence indicates that the expansion of Emirates' services may be having a greater impact than expected, although it is not clear whether the increased capacity is available for trans-Tasman freight or is largely committed to long-haul services. (The Commission thought the latter.) There is no challenge, however, to the Commission's assessment of the competitive disadvantages faced by fifth freedom carriers which limit the constraints they impose.

[206] The updating evidence suggests that competitive restraints may be greater than assessed by the Commission. It does not, however, go far enough to undermine the Commission's finding that the proposed Alliance would be likely to result in a lessening in competition in the Tasman belly-hold freight market. The constraints offered by a more vigorous than anticipated presence by fifth freedom carriers in this market are still limited. The competition offered by an expanded presence by Virgin Blue is also likely to be similarly limited.

[207] We note that a contrary finding would not have affected the Commission's overall assessment. It did not quantify any detriments in respect of freight markets or take detriments into account in its quantitative estimate of the overall impact of the proposed Alliance.

The international belly-hold freight market

[208] The Commission took the same approach to the international belly-hold freight market as it did to the Tasman market. As belly-hold freight services are a by-product of passenger services, the Commission relied largely on its analysis of the NZ-Asia, NZ-Pacific and NZ-US and other international passenger services markets. While, as earlier noted, when acknowledging an enhanced possibility of substitution with long-haul services, the Commission concluded that no constraint was offered the proposed Alliance by existing or potential competition in the NZ-Asia routes to Japan and Taipei, New Zealand Pacific routes other than Tahiti-Los Angeles, and the NZ-US market.

[209] The appellants renew their criticisms of the Commission's approach to the relevant international air passenger service markets. Otherwise they base their challenge to the Commission's findings mainly on its failure to give adequate weight to evidence of the constraints offered by indirect freight services. They say that indirect flights are much more popular for freight than they are for passengers; whereas passengers are deterred by a wait for a connecting flight, freight is generally unaffected by a delay. The appellants say that virtually all freight to most destinations can be transported on indirect services. They point to evidence submitted to the Commission that [] of Hong Kong-North America air freight and [] of Taiwan-North America air freight is hubbed through Auckland. Approximately [] of Los Angeles-Auckland freight is routed indirectly through Asian hubs and more than [] of Los-Angeles-Auckland freight carried by Air New Zealand is trans-shipped to Asian destinations. This also shows, say the appellants, that the Commission has overstated Air New Zealand's share of freight on the Auckland-Los Angeles route. Much of it originates from or is destined for Asia.

[210] The appellants also complain that the Commission failed to take account of evidence produced during the investigation to show that there would be no aggregation in the New Zealand-Taiwan route and the proposed Alliance would only have a 26% share of freight on this route.

[211] The Commission did not refer to any of this evidence in its determination. Had it done so, it would have been bound to conclude that in the Asian and US markets the availability of alternative indirect services provided some constraints. It would also have called into question the Commission's conclusion that the proposed Alliance would not be constrained by existing competition on the New Zealand-Taiwan route.

[212] It seems doubtful that these constraints (with the possible exception of Auckland-Taiwan) would operate to neutralise the market power acquired by the proposed Alliance. While we think the evidence should have been taken into account by the Commission and referred to in its determination, we are less sure that its failure to do so is fatal to its overall finding.

[213] As with the Tasman belly-hold market, no attempt was made to quantify detriments. Accordingly, this finding also has little impact on the Commission's overall assessment.

National wholesale travel distribution services market

Market

[214] The Commission defined the relevant market as the New Zealand national market for the wholesale distribution of travel services. The appellants take issue with the functional (i.e. wholesale) dimension of this market definition. They say that, as in the *Bodas* decision (Decision No 278: *Air New Zealand/Ansett Holdings/Bodas*, 3 April 1996), the market should have encompassed both wholesale and retail levels.

[215] The travel distribution industry operates through five different types of firm:

- Consolidators, which purchase airline tickets from the airlines and on-sell them to travel agencies and travel management companies. These tickets are generally complicated due to their involving combinations of carriers or tickets. Airlines prefer to sell through a few consolidators rather than through travel agencies.
- Travel wholesalers, which purchase tickets from airlines and package them with other products.
- Travel agencies, which purchase tickets or packages from travel wholesalers and tickets from consolidators and sell them to the general public.
- Travel management companies, which purchase tickets from airlines and consolidators and package them with other products for sale to large businesses.
- Airlines, which sell tickets variously to consolidators and travel wholesalers and direct to the public through the internet, by phone, through airline-owned retail travel centres and directly to businesses.

[216] The Commission said that the travel distribution industry had changed markedly since the *Bodas* decision due to the widespread use of the internet and telephone call centres. It noted that the internet was being used by airlines to sell directly to the public. They had become much more active and competitive participants in the market for the retailing of airline tickets. Air New Zealand had reported that on average 29% of bookings on NZ Express are made through the internet. The Commission noted that in Australia around half of all domestic air ticket sales are made through the airlines, either through call centres or through the internet. The Commission saw the role of travel agents as changing, with an increasing focus on “value added” services.

[217] At paras [312] and [313] of the determination, the Commission explained its reasons for identifying a separate wholesale market for wholesale travel distribution services:

- “312. The Commission is of the view, however, that the proposed Alliance is likely to affect the wholesale distribution of travel services to a greater degree than the retailing, the latter merely experiencing the flow-on effect from the changed airline-wholesaler relationship. The Commission also believes that the product that can be purchased directly from the airlines – an air ticket – is substantially different from that which is purchased from a wholesaler, where the air ticket is bundled with other services.
313. The Commission considers that it is the relationship between the airlines and the travel wholesalers that is relevant to this matter, rather than the downstream purchase by the end consumer. Accordingly, the Commission is of the view that the ability of consumers to purchase directly from airlines is irrelevant. The Commission therefore concludes that, for the purpose of considering the current Applications, there is a separate functional market for wholesale travel distribution services, and that it is this market that requires analysis.”

[218] The appellants criticised the Commission’s reasoning on two grounds. It said the ability of consumers to purchase direct from the airlines operated as a constraint on wholesalers and demonstrated a single functional market. Secondly, they argued that the Commission’s market definition appears to be based on the “perceived incidence of the hypothetical conduct of the proposed Alliance”. This, they said, is inconsistent with accepted principles for defining markets.

[219] As the Commission’s Guidelines state (para [3.1]), the Commission will seek to define relevant markets in a way that best assists the analysis of the competitive impact of the acquisition under consideration. Consistent with that objective, the functional divisions appropriate to any market definition are those which “... will best expose the play of market forces, actual and potential, upon buyers and sellers”: *Telecom Corporation of New Zealand Limited v Commerce Commission* (1991) 4 TCLR 473, 502.

[220] The Commission identified as the key area of concern the effect of the proposed Alliance on wholesale distribution of travel services. It opted for a functional market which would best illuminate an analysis of relationships and

transactions affecting that market. We see that as appropriate and in accordance with the goals of defining markets, provided always that any constraints not captured by the definition are, nevertheless, taken into account in the competition analysis which follows.

Competition analysis – Commission’s findings

[221] The Commission determined there was likely to be a substantial lessening of competition in the market as defined. It considered the proposed Alliance would “have the ability to restrict access to services, in terms of airfare rates, to independent travel wholesalers”. It found that competition at the airline level would be insufficient to address these concerns even allowing for the entry of Virgin Blue.

[222] Both Air New Zealand and Qantas supply wholesale and retail travel distribution services as well as retail and corporate booking services through their vertically integrated businesses. There are a number of independent wholesale and retail travel distributors. The Commission’s concern is that the proposed Alliance would have both the ability and the incentive to discriminate against them.

[223] The Commission said that in the counterfactual travel wholesalers would have the ability to leverage between Qantas and Air New Zealand in order to receive discounted rates. The wholesalers controlled by the airlines do not have a competitive advantage as each airline relies on the business of other wholesalers who can transfer business to their competitors. Accordingly, the Commission believed that strong competition would continue between travel wholesalers, since competition between the airlines is strong.

[224] The Commission’s concern was that the removal of competition at this upstream level may increase the incentive for Air New Zealand and Qantas together to give preferential rates in the form of discounted airfares to their vertically integrated downstream wholesalers. The Commission considered that the ability of independent wholesalers to sell the airline tickets of long-haul carriers or fifth freedom carriers would not provide sufficient competition to constrain the proposed Alliance. The possibilities they offer for wholesalers are limited by the infrequency

of their services, lack of connectivity, awkward schedules and the fact that many do not have frequent flyer schemes. The Commission concluded they were unlikely to provide anything more than a very limited alternative for independent wholesalers.

[225] Because Virgin Blue is likely to enter on only a limited scale (particularly in the factual) and cannot offer the same network advantages as Air New Zealand and Qantas, particularly for Pacific and Asian destinations which are a significant proportion of revenue in downstream markets, the Commission thought the constraint it would offer to the proposed Alliance would be extremely limited.

Appellants' submissions

[226] The appellants submit that, as in other markets, the Commission understated the constraint provide by fifth freedom carriers and other full service airlines and by the entry of Virgin Blue. They say that any attempt by Qantas and Air New Zealand to raise fares to wholesalers would be met by wholesalers increasing sales of other airline products.

[227] The appellants argue that the airlines would have no incentive to discriminate against independent wholesalers. Their goal is to maximise the number of seats sold. The appellants say it would not be rational for them to restrict a wholesaler's access to tickets or to price discriminate, particularly in New Zealand where travel distributors are vertically integrated with retailers to a far greater degree than in Australia.

[228] The appellants further submit that it would be illegal for the proposed Alliance to price discriminate and any such action could be met by enforcement action.

Discussion

[229] There is nothing in the arguments advanced by the appellants to persuade us that the Commission misjudged the extent of the constraints offered by other airlines.

Their presence will continue to be limited (and non-existent on some routes which are important to the travel distribution market). And the competition they provide is diminished by the limited services they offer in many of the air passenger markets.

[230] The key issue raised by the appellants' submissions, in our view, is whether the proposed Alliance would have the incentive to discriminate against independent wholesalers. The appellants submit that economic theory suggests otherwise, relying on *Tru Tone Limited v Festival Records Retail Marketing Limited* (supra) at 362 where the Court, in the context of a discussion of maximum price stipulations, quoted with approval a passage from the dissenting judgment of Harlan J in *Albrecht v The Herald Company* 390 US 145 (1968) at pp 157-159, who said in part:

“Other things being equal, a manufacturer would like to restrict those distributing his product to the lowest feasible profit margin for in this way he achieves the lowest overall price to the public and the largest volume.”

[231] The Commission's concerns were confined to price discrimination. Mr Land, for Gullivers, argued that the scope for discrimination was much wider, including an ability on the part of the proposed Alliance to:

- Prefer their own distribution channels by providing information relating to schedules, pricing yields, seat availability and the like to their own distributors or preferred distributors.
- Further their own distribution channels by offering corporate and government clients discounts and other inducements in return for booking exclusively through their own distribution channels.
- Offer discounted travel on their own websites and through their own distribution systems which would not be made available to independent travel distributors.
- Bundle fares with other services such as additional air points, upgrades and access to clubs and executive lounges to encourage customers to use their distribution channels.

[232] Mr Land also complained that the proposed Alliance would use its market power to reduce or eliminate commissions to travel distributors and that, in addition to being denied commission, travel agents would be prevented by the proposed Alliance from adding value by sourcing the best available fare, commonly known as the “best fare of the day”. He said a large part of their business would disappear and they would be forced to exit the market. That outcome, if it occurred, would not result from the exercise of market power in the travel distribution market but as a direct consequence of the lessening of competition in the air passenger market.

[233] There is no doubt that the proposed Alliance partners will have an enhanced ability to discriminate against independent wholesalers in relation to price and by the means referred to by Mr Land. The question is whether they will have the incentive to do so. The appellants’ submission that there would be no such incentive was acknowledged by the Commission at para [874] of the determination but was never addressed.

[234] For our part, we can see no reason why the proposed Alliance partners would seek to discriminate against other wholesalers. The interests of the airlines are best served by maximising the number of seats sold. That goal will not be achieved if competing wholesalers are offered terms less favourable than those available to the proposed Alliance’s own wholesalers. In our view, this answers the Commission’s concern that the proposed Alliance would result in a substantial lessening of competition in the market as it defined it. We conclude that it erred in coming to the conclusion that there would be a lessening of competitive constraints in this market if the proposed Alliance were implemented.

Public detriments and benefits

[235] The Commission could authorise the proposed Alliance under ss 61(6) and 67(3)(b) only if it determined it would result or would be likely to result in a benefit to the public which would outweigh the lessening of competition that would result, would be likely to result or would be deemed to result from the proposed Alliance. That requires a weighing of likely detriments and likely public benefits. For this purpose, the Commission has a responsibility to attempt to quantify detriments and

benefits where possible: *Telecom Corporation of New Zealand v Commerce Commission* [1992] 3 NZLR 429, 447 (CA). For this purpose, assumptions of inefficiency should not be made on the grounds of economic doctrine alone – *Telecom* (supra) at p 439 per Cooke P.

[236] For the purpose of quantifying detriments and public benefits, the Commission accepted the approach taken by the appellants of adopting the third year following implementation of the proposed Alliance as representative of what is judged likely to occur over a five-year period. This was seen to achieve a reasonable balance between detriments and benefits which were likely to materialise at differing rates.

Detriments

[237] The Commission adopted the accepted approach of analysing detriments by reference to three potential categories of inefficiencies – allocative, productive and dynamic. These detriments are sometimes referred to collectively as “welfare losses”, reflecting the detriment to the economic welfare of New Zealand which such inefficiencies represent.

[238] For the purpose of determining both detriments and benefits, the longstanding practice has been to ignore wealth transfers from New Zealand consumers to producers that result from higher prices. The underlying principle is that the welfare effect of changes in the distribution of income, where one group within the public of New Zealand gains while another group simultaneously loses, is neutral.

[239] Mr Land, for Gullivers, submitted that the introduction in 2001 of s 1A of the Act required a change in approach. Section 1A provides:

“The purpose of this Act is to promote competition in markets for the long-term benefit of consumers within New Zealand.”

It was submitted that the reference to consumers signalled a shift in the balance which the Act seeks to achieve between the interests of consumers and economic efficiencies. Mr Land submitted that s 3A which requires the Commission to have

regard to any efficiencies in determining whether conduct will result or will be likely to result in a benefit to the public, should be read subject to s 1A so as to exclude benefits which do not flow directly to consumers.

[240] The appellants and the Commission both oppose Gullivers' submissions. They submit that the purpose provision does not override s 3A which requires the Commission to have regard to 'any efficiencies' in its assessment of benefit to the public. They say that had Parliament intended to change the established meaning of the public benefit test it would have done so explicitly as it did in 1990 with the introduction of s 3A. Rather, the words 'benefit to the public' remain intact; the term 'public' is intentionally broader than 'consumers'; and an efficiency gain that benefits producers is still a benefit to the public.

[241] We are satisfied that the introduction of s 1A should not disturb the Commission's established practice of treating as neutral any wealth transfers between New Zealand consumers and producers. Determinations of authorisation applications under the Act are properly concerned with balancing any efficiency detriments associated with breaches of the statutory competition standard, against any efficiency gains that may result from the business acquisition or contractual arrangement in question. It is the balancing of these real resource impacts on the economy that best serves the long-term interests of consumers. The inclusion of *ad hoc* wealth transfers, which are not losses to society, would distort the efficiency assessment by assuming additional economic harm to the public of New Zealand. In any event, consumers might well be the ultimate beneficiaries.

[242] This issue is confined to wealth transfers within New Zealand. Transfers between New Zealand and other countries are not necessarily regarded as welfare neutral.

Allocative inefficiencies

[243] Allocative efficiency losses measure the economic effect of the price increases which are expected to result from the proposed Alliance. They reflect the "cost" to society of an increase in price which leads either to an unsatisfied demand

or the purchase of a less preferred substitute. The allocative inefficiency (or welfare loss) arises from the diversion of society's scarce resources to the production of the less preferred substitute.

[244] The impact of the proposed Alliance on allocative efficiency was quantified with the aid of economic modelling which sought to simulate the effects of the transactions in the factual and market outcomes in the counterfactual. The difference between the two, summed over all the affected markets, gave the expected allocative welfare loss.

[245] The model used by the Commission was developed following consideration of two models put forward in the course of its investigation. One was proposed by the Network Economics Consulting Group (NECG) as advisers to the appellants. The other was put forward by Professor Timothy Hazledine who initially appeared before the Commission in his own right and was retained by Gullivers.

[246] Both models were based on the standard Cournot model (named after the economist, now deceased, who devised it) which is designed to predict average price increases in oligopoly markets, i.e. markets with few firms and a standardised product. The behaviour exhibited by airlines in aviation markets was thought to be "roughly consistent" with that depicted in the Cournot model which assumes that suppliers act independently in setting their capacity levels. Prices are determined on the basis that a supplier chooses a level of capacity or output on the assumption that other market participants hold their observed supply levels constant. The model predicts that, where a merger results in a reduction in the number of firms, the enhancement of market power from this change in market structure will lead to lower output (capacity) and higher prices, assuming costs would not change and other factors, including entry, remained the same.

[247] The Commission regarded the Cournot model as useful in making transparent, and focusing attention on, key parameters, assumptions and verifiable economic arguments as well as for producing quantitative estimates. It did not see the model as being able to produce proof of a substantial lessening of competition; nor could it supplant the Commission's exercise of judgment. Rather, the

Commission regarded the Cournot model as providing “a useful framework” in which the impact of the proposed Alliance could be analysed.

[248] The Commission judged NECG’s version of the Cournot model to be deficient in a number of respects. It considered the Hazledine version also had shortcomings, but less serious than those of the NECG model. The Commission’s own version – referred to in argument as the “revised model” – was developed from that of Professor Hazledine with the assistance of two Canadian experts, Professor David Gillen and Professor Anming Zhang in circumstances described in more detail in earlier judgments in this proceeding, especially Judgment (No 4) delivered on 18 June 2004.

[249] For the purpose of the final determination, the Commission’s quantitative analysis indicated allocative welfare losses totalling \$90m in air passenger markets. That was an intermediate figure in a range of \$80m - \$110m. The results for the New Zealand domestic and Tasman markets were calculated using the revised model. A simple Cournot-style framework was used for the Auckland-LA, Auckland-Nadi and Nadi-LA routes on the basis that the competition and welfare analysis was more straightforward. For the two remaining markets, Auckland-Asia and Other Pacific, the Commission simply assumed, on the basis of its qualitative analysis, price rises of at least 5% and corresponding welfare losses.

[250] There were a number of criticisms of the design of the revised model and the way in which it was implemented as well as of the Commission’s other methods of quantification. Some of the criticisms were accepted by the Commission and its calculation of allocative detriments amended to \$126.4m. Of the remainder, it was found on analysis that most had relatively little effect on the final outcome. Attention ultimately focused on two “fundamental errors” which affected the calculation of allocative detriments on Tasman and New Zealand domestic routes.

[251] The first is the assumption for modelling purposes that Air New Zealand and Qantas have equal (symmetric) capacity shares on all routes within the defined markets. This is referred to as the “asymmetry issue”. The second arises from the assumption made in the revised model that LCC capacity on the Tasman and New

Zealand routes would not exceed 20% of total capacity on any route in the counterfactual and 15% of total capacity on any route in the factual. The appellants took issue with the Commission's failure to make provision in the model for the additional capacity provided by the incumbent airlines in the factual which was assumed to have brought about the reduction in LCC capacity. This issue is called the "output deterrence issue".

The asymmetry issue

[252] The Commission's revised model assumes that Qantas and Air New Zealand are identical, i.e. symmetrical, in all respects on all routes (with the exception of the allocation of profits between the airlines). In fact, route shares are far from symmetric. On many routes capacity shares are quite disparate. On some routes one of the appellants is not present at all.

[253] If actual capacity on each route is factored into the revised model, welfare losses are substantially reduced. Two factors combine to produce this outcome. First, the Cournot model assumes that differences in market shares reflect differences in marginal costs; the higher the market share the lower the inferred marginal costs. Secondly, the appellants assumed (for the purpose of their recalculation) that, post-Alliance, their marginal costs on each route would fall to the level of the airline (Air New Zealand or Qantas) with the lower marginal costs.

[254] Professor Robert Willig, for the appellants, argued that the introduction of actual route shares resulted in a proper welfare evaluation. He said the model would then recognise that Qantas and Air New Zealand have significantly more complementary strengths and significantly less direct competition between them than is accounted for in the Commission's modelling. He also said the assumption that Air New Zealand would have lower marginal costs on one route and Qantas lower marginal costs on another was entirely plausible, as calibrated marginal costs in the model incorporate many other aspects of airline competition such as the size and extent of the flight network, vertical product differentiation, the level of traffic density, passenger feed and city presence.

[255] Dr Gustavo Bamberger, who gave evidence on this question for the Commission, initially defended the symmetry condition in the revised model. He criticised the incorporation of asymmetry because it generated an implausible outcome, namely that LCC costs were higher than those of FSAs. However, following criticism of his methodology, he concentrated on testing the sensitivity and plausibility of Professor Willig's approach.

[256] In particular, Dr Bamberger took issue with the assumption that 100% of the difference in the incumbents' inferred costs would be eliminated as a result of the proposed Alliance, i.e. by a fall in the marginal costs of the higher cost carrier to the level of the lower cost carrier. He said this would have the "unwarranted and unsupported" consequence that the proposed Alliance would substantially reduce Air New Zealand's marginal costs on seven of eight trans-Tasman routes and substantially reduce Qantas' marginal costs on the eighth trans-Tasman route and two New Zealand main trunk routes. Dr Bamberger agreed that differences in carrier shares can reflect a variety of demand and cost factors other than differences in physical marginal cost. But he said the extent to which the marginal costs of the higher cost carrier would reduce under the proposed Alliance would depend on both the source of observed market share differences on each route and the extent to which those market share determinants would be affected by the proposed Alliance. (Those issues were not addressed by Professor Willig and Ms Margaret Guerin-Calvert.)

[257] Dr Bamberger reworked the revised model, adopting actual market shares but without the assumption that marginal costs would fall in the factual. He found that net welfare loss increased by \$16m. He also experimented with the use of weighted average costs and found that large welfare detriments would result when this assumption was introduced. We leave for later discussion the implications of this work, and of tests carried out by Professor Willig in response, for the quantification of welfare detriments.

[258] It suffices to say at this stage that, leaving to one side the way in which marginal costs should be treated in the factual, we are satisfied that the appellants' criticism of the assumption of symmetry in the revised model is justified. We can

see no reason why the Commission should have chosen to adopt this assumption when evidence of asymmetry on all routes was available for modelling purposes. After the conference, in response to criticism, the Commission disaggregated its model to a route-by-route basis for other purposes but did not do so in respect of the capacity shares of the appellants. We heard nothing in evidence or argument to justify this approach.

The output deterrence issue

[259] The second issue – output deterrence – arises from the Commission’s decision to model the presence of a low cost carrier by assuming market share rising to 20% in the counterfactual but only to 15% in the factual. The reduced market share in the factual is assumed to arise from aggressive deterrent responses by the proposed Alliance partners. Such responses would involve targeted increases in capacity, whereas the model assumed an overall capacity decrease for the proposed Alliance. The appellants’ experts said the revised model should be adjusted to reflect the increased capacity assumed to be injected by the appellants.

[260] In response, Dr Bamberger sought to show that variations to low cost carrier capacity had little impact on welfare losses. Even when LCC capacity in the factual was assumed to double that in the counterfactual, there was little effect on welfare losses. While price increases were less, and the welfare loss for consumers also lower, the way in which the model calculated profits neutralised the effect on overall welfare losses for New Zealand. That is because a reduction in consumer welfare losses is offset by a fall in Air New Zealand profits.

[261] This does not, however, answer the appellants’ criticism. The Commission’s analysis assumed a fall in LCC capacity consequent on an injection of over-capacity by the incumbents. It reasoned the proposed Alliance partners would have a greater incentive and ability to mount an aggressive response to entry in the factual than in the counterfactual. The model provided for the consequences of that response – a reduction in LCC capacity - but not for its cause, an increase in proposed Alliance capacity. An adjustment to LCC capacity alone (as assumed in Dr Bamberger’s test) does not deal with the omission.

[262] We conclude that the Commission also erred in failing to provide in its model for what it described as the output-detering responses of incumbents.

Revised calculations of allocative detriments

[263] The appellants' calculations of the effect of rectifying these two errors in the New Zealand domestic and Tasman markets are shown at Table 1. They show the effects of an adjustment to implement asymmetry (second column of figures) and to implement both asymmetry and output deterrence (third column of figures). The effect on New Zealand consumer surplus and on profits is shown separately. It will be seen that the aggregate welfare loss calculated by the Commission of \$54.8m (\$37.4m on the Tasman, \$17.4m in domestic New Zealand) becomes, on the appellants' calculations, a net gain of \$13.0m (comprising a \$24.0m gain on the Tasman market less a welfare loss of \$11m in domestic New Zealand). This mainly results from lower projected rates of price increase which substantially reduce the welfare loss to New Zealand consumers (from the Commission's \$94m to \$23.1m). The net effect on New Zealand profits is modest, leaving the Commission's calculation largely intact.

TABLE 1: Impact of the proposed Alliance on New Zealand welfare with Implementation of Asymmetry and Output Deterrence (\$NZM Year 3)

	NZCC Revised Model (Assumes Qantas/Air NZ Symmetry)	Revised Model Implementing Asymmetry	Revised Model Implementing Asymmetry and Output Deterrence
Tasman			
Change in NZ profits	21.2	57.5	38.6
Change in NZ consumer surplus	-58.7	-49.4	-14.6
Net change in NZ welfare	-37.4	8.1	24.0
Domestic NZ			
Change in NZ profits	17.9	12.2	-2.4
Change in NZ consumer surplus	-35.3	-29.2	-8.5
Net change in NZ welfare	-17.4	-17.0	-11.0
Total Tasman and domestic NZ			
Change in NZ profits	39.1	69.7	36.2
Change in NZ consumer surplus	-94.0	-78.6	-23.1
Net change in NZ welfare	-54.8	-8.9	13.0

Notes to table:

[a] These figures preceded an adjustment for the domestic New Zealand market to allow for a higher percentage (than the 40% the Commission originally assumed) of New Zealanders on domestic New Zealand routes.

[b] The Commission's final figures which included this adjustment, were -\$110.5m and the appellants' final figure (which also included the adjustment) was +\$1.7m. Final results for all relevant markets are shown in Table 2.

[264] We accept that adjustments to the Commission's modelling to correct for the two errors will result in a substantial reduction in the Commission's calculation of welfare loss. But we share Dr Bamberger's concerns over some aspects of Professor Willig's recalculation of allocative inefficiency.

[265] There are substantial doubts whether the inferred marginal costs for the appellants are plausible. They amount to an average reduction of 21% on eight Tasman routes, according to Dr Bamberger. No specific insights were provided as to why such differences would in practice currently exist. Further, the modelled reduction in marginal costs across all routes in the factual exceeds any cost savings previously claimed by the appellants and, as the Commission submits, no attempt was made to reconcile Professor Willig's results with the earlier cost savings claims before the Commission. There is, in any event, a question as to the ability of the proposed Alliance partners to operate at the level of the lower cost carrier on all routes.

[266] The rival calculations of Professor Willig and Dr Bamberger showed that the way in which marginal costs and profitability are treated in the model has a major effect on the computation of welfare losses in the factual. When Dr Bamberger used weighted average costs and adjusted only for asymmetry, he calculated allocative

detriments at \$43.8m for the two markets. While continuing to defend his approach, Professor Willig responded by using the same weighted average cost concept but adjusting for both asymmetry and output deterrence. His figure for welfare losses came to \$21m.

[267] We are satisfied that there is no evidential or other basis for adopting marginal costs at the level assumed by Professor Willig in the factual. It is reasonable to assume that there will be a reduction in costs but there is no reliable indicator of what the level might be. If weighted average costs are adopted, allocative detriments (according to Professor Willig's untested calculation) would be \$21m.

[268] We are satisfied that the Commission's approach resulted in inflated figures for welfare losses from allocative inefficiency in the Tasman and New Zealand domestic markets. On the other hand, we have little confidence in the final figures put forward on behalf of the appellants. Their calculation of allocative detriments relies on an unsubstantiated level of marginal costs in the factual. The parties have combined to demonstrate that notwithstanding the best efforts of experts of international standing, both before the Commission and before us, the revised model has failed to produce a reliable guide to the quantification of allocative inefficiency.

[269] The limitations of the Cournot model (and its implementation) have been clearly shown. It has been inadequate to deal with the complexities of dynamic markets, particularly the interactions between established FSAs and an LCC newcomer. It has been unable to capture the reactions of players to one another let alone the overall dynamism of the airline industry. In addition, the simplifying assumptions required have severely limited the model's ability to replicate real-world outcomes.

[270] We can say with confidence only that the Commission's figure is too high and the appellants' calculation is unrealistically low. We add also that the calculation of allocative inefficiencies, as argued by the appellants, risks duplicating at least some of the cost savings claimed by the appellants as a public benefit. To the

extent that allocative detriments are reduced as a result of savings in costs, it is strongly arguable that public benefit derived from that source should be disregarded.

[271] For completeness, we set out in Table 2 the final figures for allocative detriments put forward by the Commission and the appellants in respect of each air passenger market. We have earlier concluded that the Commission's calculation of detriments for the Auckland-Asia market should be disregarded. Apart from the main trunk and Tasman markets, remaining differences between the Commission and the appellants are relatively minor, as are the figures for detriments themselves. We will give further consideration to the implications of these differences when discussing the weighing of detriments and public benefits in the final section of this judgment.

TABLE 2: Final estimates of welfare losses from allocative inefficiencies

DETRIMENTS		
Route	Commission's position	Appellants' results correcting Commission model
Tasman	(41.6)	24.0
Domestic Main Trunk	(67.1)	(21.6)
Main Provincial	(1.8)	(0.7)
Other Provincial	(0.0)	0
AKL-LAX	(1.3)	(1.3)
AKL-Nadi	(0.3)	(0.3)
Nadi-LAX	(2.2)	(2.2)
Auckland-Asia	(11.7)	0
Other Pacific	(0.4)	0
Total	(126.4)	(2.1)

Productive inefficiencies

[272] Productive efficiency losses measure the extent to which costs exceed the minimum amount necessary to produce a given output. The excess represents a

public detriment because resources which could be deployed productively elsewhere in the economy are being used unnecessarily by the inefficient firm.

[273] It is generally held that monopolists and other powerful firms are not as efficient as firms operating in a fully competitive market. This is because they are not subject to the same competitive pressures to minimise costs and avoid waste. This phenomenon is sometimes referred to as “slackness” or “X-inefficiency”.

[274] Another manifestation of substantial market power is that supra-normal profits may encourage ‘rent-seeking’ behaviour. A firm’s labour force or other input suppliers may seek to capture some of the profit in the form of higher remuneration or reduced effort, for example. Such wasteful activity is measured by the value of the resources devoted to it as well as to efforts to combat such activity.

[275] The sum of X-inefficiency and rent-seeking attributable to a particular transaction or arrangement is the amount of productive efficiency loss in a given case.

[276] The Commission considered that the proposed Alliance would likely give rise to productive inefficiencies in all markets where it expected a substantial lessening of competition to occur. It said the operations of both appellants within the JAO would be equally exposed to such inefficiencies. However, the productive inefficiency likely to arise in respect of Qantas’ operations in the defined markets would be relevant only to the extent that the resources used by Qantas were New Zealand-based.

[277] The Commission found that significant productive inefficiencies of both kinds – X-inefficiency and rent-seeking - would be likely to result from the proposed Alliance. Among the factors which influenced it to this view included:

- Under the proposed Alliance Air New Zealand and Qantas would cease to compete on a number of routes on which they are currently and prospectively the major (and in some cases, the only) operators. There would be greater market power under the proposed Alliance.

- Virgin Blue is likely to enter on some routes and to have a limited impact in offsetting the anti-competitive impact of the proposed Alliance.
- The aviation industry is known to be prone to rent-seeking behaviour. Prices and profits were likely to rise significantly under the proposed Alliance. The profits (rents) would provide the incentive and the opportunity for rent-seeking behaviour.
- Both appellants carry a substantial amount of “legacy costs” arising from the complex nature of their operations and the length of time they had been in the business, which are likely to have been contributed to by previous rent-seeking behaviour.
- The lessening of competition is likely to result in managerial slack which may be exacerbated by difficulties in integrating two airlines with different cultures that have traditionally regarded each other as “the competition”.
- Provisions in the proposed arrangement designed to promote efficiency would not be as effective as market disciplines.
- Both airlines receive significant support from their respective governments.

[278] In the *Bodas* decision (supra), the Commission heard evidence from Dr Tretheway, then a witness for Qantas, of studies of Canadian airline markets which found inefficiencies in the range of 7-17% of the total costs of individual carriers in markets where there was an absence of full competitive pressures. In *Bodas* the Commission suggested, drawing on the Canadian experience, that productive inefficiencies arising in the domestic passenger air services market could fall within the range of 1-10% of current costs. Recognising, however, that the Canadian studies may reflect a difference between outcomes in regulated compared to competitive markets rather than between merged and non-merged firms in a generally competitive setting, the Commission opted in this case for what it referred to as a “conservative range” of 1-5% of costs. It applied that percentage range to the estimated variable costs of each appellant which related to their New Zealand-based

resources. This resulted in productive inefficiency detriments in the range of \$18-\$91m. The Commission expressed confidence that a material amount of detriment would arise in the factual compared to the counterfactual and considered the most likely actual outcome to be in the middle of the range. The Commission noted that the figures are not large in relation to the size of the airline operations involved.

Appellants' submissions

[279] The appellants submit the Commission's conclusions failed to reflect the intense competition the proposed Alliance partners would continue to face on both short and long-haul routes. They submit the two airlines would have the same incentives in the factual as in the counterfactual to achieve efficiencies, as both would face competition from Virgin Blue in Tasman, domestic New Zealand and Pacific Island markets; they would face increasing competition from Emirates and other fifth freedom carriers on the Tasman; and they would face intense competition on long-haul international routes when seeking to attract both New Zealand and foreign passengers to choose the proposed Alliance.

[280] The appellants pointed to 'compelling evidence' in the record and in the updating material of the pressure that Virgin Blue places on incumbent FSA carriers to strive for productive (and dynamic) efficiency gains. They attribute a A\$1b cost reduction programme undertaken by Qantas to competition from Virgin Blue and refer to the introduction of the Jet Star and Express products as initiatives introduced under pressure from actual or potential entry by Virgin Blue.

[281] The appellants say that in long-haul international markets there is a significant incentive to minimise costs to maintain (and build) market share and traffic density. Both airlines would continue to compete in both the factual and the counterfactual in these highly competitive markets. Competition in these markets is extremely important for Air New Zealand, as 75% of its assets are devoted to international flying but do not currently return their cost of capital. The discipline which these markets will exert is said to be confirmed by the updating evidence which shows that the average operating costs of Air New Zealand and Qantas are higher than all of their major Asian competitors.

[282] The appellants argue that as firms cannot operate with different degrees of managerial slackness in different parts of their operation, the competitive conditions on long-haul routes and the presence of Virgin Blue and Emirates on short-haul routes would combine to prevent any productive inefficiencies. They said productivity would also be enhanced by the airlines' ability to share information. Further, the appellants said that the proposed Alliance agreement itself contained structures and incentives to minimise any tendency toward inefficiency. They relied also on economic literature on airline alliances as supporting the view that productivity tended to be enhanced by economies of traffic density, cost savings from route rationalisation and the sharing of production inputs.

[283] Borrowing a phrase from the judgment of Cooke P in *Telecom v Commerce Commission* (CA) (supra) at p 439, the appellants characterised the Commission's attempt to quantify productive (and dynamic) efficiency losses as "theoretical and speculative" and not grounded in commercial reality.

Gullivers' submissions

[284] Gullivers support the Commission's finding that productive inefficiencies would follow from the proposed Alliance but argued that the Commission made inadequate allowance for the extent of those inefficiencies. In particular, Mr Land argues that the Commission should have applied a factor of 10% of costs to determine productive inefficiency losses and included an amount for the impact of inefficiencies on fixed costs as well as variable costs. He also submits that the Commission erred in excluding the freight and wholesale travel distribution markets for the purpose of quantifying productive inefficiencies.

Discussion

[285] Orthodox economic theory suggests that some lessening of productive efficiency would follow from the proposed Alliance. This follows from the general proposition that a powerful firm faces less incentives to be efficient than a less powerful firm.

[286] The appellants submitted that economic literature does not suggest that airline alliances lead to a deterioration in productivity. To the contrary, they point to evidence that alliances can enhance productivity: Oum, Park and Zhang, *Globalisation and Strategic Alliances: The Case of the Airline Industry*, (Oxford 2000). However, as one of the authors of that text, Professor Tae Hoon Oum, a witness for the Commission, explained in evidence, the question of whether productive efficiencies will or will not arise depends very much on the nature of the alliance. Oum, Park and Zhang classify alliances into two types: complementary and parallel. Complementary alliances are those where two firms link up their existing networks so as to feed traffic to each other. Parallel alliances refer to the collaboration between two firms who, prior to their alliance, are competitors on some routes of their networks. The study showed that a complementary alliance will likely increase total output and decrease fare price, with resultant benefits to consumer and economic welfare. The opposite is likely to occur with a parallel alliance. Professor Oum characterised the proposed Alliance as a parallel alliance.

[287] It is not in issue that the appellants are facing an unprecedented degree of competitive pressure in domestic and short-haul international markets. Both have responded by announcing major cost-cutting programmes. Qantas is embarking on a programme to reduce its costs by \$A1b (or 10% of its total costs) and Air New Zealand has announced that it intends []over four years.

[288] The Commission referred to the ongoing burden of past inefficiencies in the form of legacy costs, particularly in the cost of labour. There was evidence of waste and likely rent-seeking behaviour in evidence to the Commission which disclosed significant differences in labour costs as between the two appellants and within each organisation. [

]. The terms and conditions on which Qantas crews are employed vary between markets and between different sectors of the company.

[289] These disparities suggest that, contrary to the appellants' submission, the two firms may have operated with varying degrees of management slackness in different parts of their operation. And the disciplines of the international long-haul market

seem not to have produced uniform savings across the companies' operations. The experience of both airlines bears out economic theory. Competition by itself does not result in optimal levels of efficiency. It all depends on the nature, intensity and extent of the competition. The greater the competition, the greater the level of productive efficiency likely to be achieved.

[290] The Commission considered (at paras [1123] – [1126] of its determination) the appellants' argument that the proposed Alliance agreement contains provisions which would check any incipient tendency to X-inefficiency. These include a provision for monitoring performance and another for a subsidy margin to be paid by either airline if it were to insist on operating a flight that did not produce the highest margin available.

[291] However, we share the Commission's doubts as to the likely effectiveness of these measures. It appears likely, as the Commission submits, that they may simply be a mechanism to neutralise the benefit-sharing model in the agreement which creates incentives to increase capacity. As the Commission noted, the subsidy margin would apply only to new flights and would benefit the carrier with the largest margin, not necessarily with the lowest costs. These provisions may go some way to alleviating, but could not be expected to counter, the productive inefficiencies which can be expected to follow a substantial lessening of competition.

[292] We pass now to consider how productive inefficiency is to be measured and weighed. In *Ravensdown* (supra) the Commission recognised that the scope for productive inefficiency would vary according to the nature of the costs involved. It also recognised that the loss of productive efficiency may vary according to differing market conditions. It carried out a careful analysis of actual costs by reference to the markets in which the firm operated. It was, as the Court on appeal said (at p 59) a "quite intricate analysis".

[293] In this case, the Commission made no attempt to examine the actual or likely costs of the appellants. It took a more or less uniform approach to all air passenger markets. (Freight and travel distribution markets were excluded for want of information.) Yet the extent to which competitive pressures will relax (and

productive inefficiency likely grow) as a result of the proposed Alliance, will vary from market to market.

[294] It is true that the Commission recognised that some costs, e.g. fuel, would be less susceptible to productive inefficiencies than others. And its discussion suggested that it saw labour costs as the likely source of much of the inefficiency. It referred (at para [1089] of its determination) to a paper by JP Morgan (“Low-Fare Airline Industry: The Fastest Growth Segment in the Airline Industry”, 6 March 2001, London: JP Morgan) which argued that lower pay rates and higher productivity were key to the competitive advantages enjoyed by LCCs over “established airlines”. Their costs were 22% of revenue, compared to 32% for major airlines. Later (at paras [1173] – [1174] in addressing dynamic inefficiencies), the Commission referred to a study of Australian domestic airlines which concluded that labour productivity remained low compared to overseas airlines and labour remuneration had been increasing significantly in real terms. And at para [1108] the Commission referred to evidence of Qantas’ relatively higher labour costs and to the possibility that Qantas and Air New Zealand union staff would act in concert to pressure the jointly managed airline.

[295] We infer that the Commission saw productive inefficiencies as most likely to be reflected in higher labour costs. However, without a focus on actual costs and some recognition of varying market conditions, the determination fails to articulate how and where the predicted greater inefficiency will manifest itself.

[296] Any attempt to quantify detriments arising from the assumed behaviour of a firm or its employees - in a dynamic market in a hypothetical situation three years hence - risks condemnation as theoretical and speculative. In the absence of studies which might assist to quantify productive inefficiencies in New Zealand conditions, the Commission cannot be criticised for resorting to measures suggested by overseas studies. However, we assume that lack of information about actual costs required that it apply the measure to variable costs inferred from the model. As we have already discussed in relation to allocative detriments, they may bear no relationship to actual costs. Further doubts about the Commission’s attempt to quantify productive inefficiencies arise from this.

[297] In our view, the Commission was entitled to find that there would probably be greater productive inefficiency as a result of the proposed Alliance. But we are left with serious doubts as to the value of its attempt to quantify the loss which would ensue.

Dynamic inefficiencies

[298] Dynamic efficiency losses arise when a business is less innovative than it would be in a fully competitive market. It is postulated that a substantial decrease of competition in a market reduces the incentives for firms to innovate in order to match or keep ahead of rivals. This innovation can be achieved either through the introduction of new products or services or technologies. When the lessening of competition is associated with a greater concentration in the market, it will also reduce the number of centres from which innovation can spring.

[299] The economic literature refers to an “inverted U” relationship between innovation and concentration. Innovation is low at low levels of concentration/high levels of competition and also at high levels of concentration/low levels of competition. In highly competitive markets, firms may lack the resources to invest in research and development and the benefits from innovation may be short-lived. At the other extreme, monopolists have the resources to invest in research and development but lack the competitive pressure to invest and innovate.

Commission’s findings

[300] The Commission rejected the appellants’ submission that dynamic efficiency would be greater under the proposed Alliance, that harsh competition in the counterfactual would discourage innovation, and that more benign conditions in the factual would encourage innovation. It took the view that both the counterfactual and factual scenarios would lie on the right hand, downward-sloping portion of the inverted U-curve, indicating the proposed Alliance would be likely to result in reduced dynamic efficiency as a result of reduced incentives to innovate *vis a vis* the counterfactual.

[301] In addition to this general lessening of dynamic efficiency, the Commission decided there would be losses caused by Air New Zealand's likely switch from the Star Alliance to the oneworld alliance and from the likelihood of a reduction in value of accumulated air points holdings. The Commission said a switch of global alliances would seriously weaken the Star Alliance as compared to oneworld in Australasian markets and thereby reduce the benefits of competition between the two. The Commission foresaw that holders of frequent flyer credits with Air New Zealand would be disadvantaged by the switch, even if their frequent flyer credits were honoured, as Star Alliance is a larger alliance and serves a wider range of destinations than oneworld. Holders of air points would also be disadvantaged if they had accumulated points because they favoured the options available through Star Alliance.

[302] The Commission recognised that predictions of change in the rate of dynamic efficiency are inherently difficult to make and even more difficult to quantify. It estimated losses "conservatively" by assuming per annum costs would be higher than otherwise by between 0.5% and 1.5% of revenue, less than the 1-2.5% suggested in *Bodas* (supra) which reflected the results of a US-based study. This would produce a loss of between \$18m and \$54m in year three.

[303] The additional costs were assessed as:

- A likely exit fee [] payable to Star Alliance.
- One-off costs for changing such items as airport signage and upgrading IT systems as a result of the change of alliance.
- Losses in interline revenue, reducing to [] in year three.

[304] Spreading the one-off payments over a five-year period resulted in a range in year three of between [] and []. The Commission settled on a "most likely" estimate for year three of \$50m. It did not disclose how the figure was arrived at in order to avoid revealing the confidential information upon which the estimates were based.

Appellants' submissions

[305] As they did in relation to productive inefficiencies, the appellants maintain that they would have the same incentive to innovate in the factual as in the counterfactual. They also take issue with the way the Commission characterised the relevant markets as moving from a triopoly structure to duopoly/monopoly and hence along the inverted U-curve.

[306] The appellants challenge the way in which the Commission quantified detriments. They say the measure of dynamic inefficiency endorsed by the High Court in *Ravensdown* (supra) (0.5-1.5% of revenue) was specific to the circumstances of that case and inappropriate to the airline markets. The appellants say the [] should not have been included as they were factored into the consideration payable by Qantas to Air New Zealand under their agreement. They further submit the loss in value to consumers [] would be negligible. They submit there is very little difference between the two alliances; passengers will still have the choice of choosing to fly to all major international destinations on [] airlines. The appellants also point out that any theoretical loss of choice would be outweighed by the added benefit to consumers of being able to accrue frequent flyer points on New Zealand domestic, Tasman and Australian domestic travel on airlines within the same global alliance. Finally, the appellants submit that consumers with accrued frequent flyer points on Air New Zealand will not suffer any loss of choice or value.

[307] In short, the appellants said the Commission's conclusion that there would be a loss of dynamic efficiency of \$50m per annum was again theoretical and speculative and not grounded in commercial reality.

Gullivers' submissions

[308] Gullivers argue that dynamic efficiency losses should have been at least \$156.7m. It submits the Commission erred in not adopting the 2.5% figure cited in *Bodas*. Gullivers also contend that the Commission should have based its

calculation on the actual costs of both Air New Zealand and Qantas rather than on the total revenues of Air New Zealand alone.

Discussion

[309] As we said in our competition analysis, it is likely that there will be some lessening of constraints on the appellants if the proposed Alliance proceeds. The question is the extent to which incentives on the proposed Alliance partners to perform efficiently will be correspondingly reduced.

[310] In our view, the Commission was entitled to conclude that there would probably be some lessening of dynamic efficiency. In the counterfactual, Air New Zealand and Qantas are two full service airlines competing head-to-head across the full range of the product/service package, not just on price alone. (In fact, this can lead to higher prices to reflect additional services or quality improvements for which consumers are willing to pay.) This kind of competition is typically described as a “matching” form of competition. It affects most, if not all, elements of the competitive package. This competitive incentive for each airline to at least match the other will be lost under the proposed Alliance and would not be replaced by the expected competition from a price-focused low cost carrier.

[311] The quantification of dynamic inefficiencies is notoriously difficult, as the Commission itself acknowledged. We were referred to Canada’s draft Merger Guidelines (released for consultation, March 2004) which stated at para 8.30:

“Mergers that result in a highly concentrated market may reduce the rate of innovation, technological change, and the dissemination of new technologies with the resulting opportunity cost of economic surplus. Like dynamic efficiency gains, negative impacts on dynamic efficiency resulting from an anti-competitive merger are also difficult to measure and are generally considered from a qualitative perspective.”

[312] The measure of dynamic efficiency adopted in *Ravensdown* (supra) (0.5 – 1.5% of revenue) produced a figure described by this Court as modest and supportable. We accept that this measure was specific to the circumstances of *Ravensdown* but it is also consistent with evidence before the Commission of the rates of productivity growth by Qantas which could fairly be attributed to the

beneficial impact of competition on performance. The rate chosen also comes within the range suggested by an overseas study of airlines referred to by the Commission in *Bodas* (supra).

[313] The Commission said that in measuring dynamic efficiency, it took into account the loss of value which travellers would be likely to suffer from the erosion in value of their frequent flyer points holding. We are not persuaded that will involve any significant welfare loss but it does not appear to have had much effect on the measure finally adopted by the Commission. In our view, its approach to the quantification of dynamic inefficiencies generally is supportable although, when it comes to weighing detriments and benefits, allowance should be made for the necessarily abstract nature of the exercise.

[314] The one-off costs of Air New Zealand transferring from Star Alliance to the oneworld Alliance are in a separate category. We have difficulty in understanding why they should be considered as examples of dynamic inefficiency. They would seem to be more appropriately considered as a potential adjustment to the cost savings claimed as a public benefit by the appellants as they are a direct cost to New Zealand arising from the proposal.

[315] The appellants argue that these transfer costs should be excluded as they were taken into account in fixing the consideration payable by Qantas to Air New Zealand under the proposed arrangement. The appellants submit it is illogical to treat these transition costs as a separate detriment, given that they form part of the cost of the transaction which Air New Zealand board and management have decided is in the company's best interests.

[316] We are unable to accept this submission. In response to a submission by Professor Willig, the Commission agreed to ignore the capital payment to Air New Zealand from Qantas and as a corollary to disregard the share of Air New Zealand profits payable to Qantas for the purpose of calculating welfare losses. It does not follow, however, that costs which were taken into account when the purchase consideration was fixed should be excluded. The consideration reflects the entire package of benefits and disbenefits of the acquisition and the arrangement to both

parties. We can see no reason why any category of resultant costs or benefits, except for the profits due to Qantas as agreed by the Commission, should be excluded for the purpose of considering the welfare effects of the proposed Alliance.

[317] In the result, we consider the Commission was entitled to make an allowance for the fixed costs of the alliance switch as well as the lost revenue from interlining.

Public benefits

[318] By ss 61(6) and 67(3) of the Act, the authorisations sought for both the proposed acquisition and the proposed arrangement are sought on the grounds that they will or will be likely to result in benefits to the public which would or would be likely to outweigh the lessening in competition.

[319] The general principles on which public benefits are assessed are well established:

- Benefits include efficiency gains (s 3A of the Act) and anything of value to the community generally: *Telecom v Commerce Commission* (1991) 4 TCLR 473, 530.
- Only net benefits are included. Any costs incurred in achieving efficiencies must be taken into account. Transfers of wealth which achieve no benefit to society as a whole should be disregarded.
- The benefits must result from the acquisition or arrangement. Benefits which would or would be likely to accrue whether or not the proposed Alliance proceeded should be disregarded.
- Benefits should be quantified if possible but benefits which, by their nature, are incapable of quantification should still be taken into account.

[320] The appellants claimed quantified benefits of between \$211m and \$275m, with a preferred figure of \$218m, would result from the proposed Alliance. They were in the following categories:

- Cost savings
- Tourism
- Engineering and maintenance work
- Improved scheduling
- New direct flights
- Additional freight services
- Online benefits

The appellants claimed other non-quantified benefits, including productive and dynamic efficiencies (which have been considered in the context of detriments), the avoided social cost of public funds, the preservation of New Zealand's national carrier, enhanced global competitiveness and improved governance of Air New Zealand.

[321] The Commission found the quantifiable public benefits of the proposed Alliance to be in the range of \$22.5-56.5m, made up as follows:

- | | |
|------------------------------------|---------------|
| • Cost Savings | 30.0 |
| • Tourism (net benefits) | (13.0) – 16.0 |
| • Engineering and maintenance work | 5.0 – 10.0 |
| • Improved scheduling | 0.50 |

[322] The Commission largely accepted the unquantifiable benefits claimed by the appellants and also recognised environmental benefits which would arise from the reduced number of flights expected under the proposed Alliance. The appellants criticise the findings of the Commission in relation to every category of public

benefit claimed, either because the Commission rejected the claimed benefit or placed an inadequate value on it.

Cost savings

[323] The appellants claimed cost savings would achieve public benefit amounting to \$96 million. They said new services on particular routes would be provided at a lower resource cost under the proposed Alliance than the airlines would be able to achieve without the proposed Alliance. Before the Commission, they did not claim network-wide economies of scale as they recognised these could be off-set by implementation costs.

[324] The Commission concluded that the proposed Alliance would present an opportunity to make cost savings by co-operating to allocate new aircraft services more efficiently. The Commission said this cost saving would represent private benefit to the airline. The Commission reasoned that the public benefit would be the difference between those cost savings and the cost of additional capacity supplied by new entrants. Based on information provided by the appellants and its own analysis, the Commission concluded that on the balance of probabilities likely cost savings would be around \$30 million.

[325] In substantially reducing the appellants' calculation of cost savings, the Commission identified four principal concerns:

- The terms of the proposed arrangement, confirmed by evidence to the Commission, would encourage higher margins and would not necessarily lower costs.
- The cost savings do not allow for the cost of replacement capacity.
- The economic analysis relied on by the appellants to explain the savings was not fully applicable.

- The basis on which cost savings were claimed by the appellant was inconsistent with the claims they made for the purpose of calculating allocative inefficiency.

Each of these findings is contested by the appellants on appeal.

Terms of proposed arrangement

[326] The Commission noted that under the proposed arrangement, the question of which airline would fly a particular sector would depend on which had the highest margins. This suggested that profit margins rather than costs would drive the allocation of capacity under the proposed arrangement. The appellants reject this concern as misplaced because the airline with the higher margin will be the one with the lower cost. That is because there will be no significant product difference and no pricing difference.

[327] This is not a complete answer to the Commission's concerns. It identified ways in which an airline could achieve higher margins without having lower costs, e.g. by exercising greater market power on a route. As developed in submissions, however, the Commission's concern is that the modelling relied on by the appellants to derive their estimates of detriments and benefits assumes that capacity will be allocated on the basis of margin not on the basis of costs. The Commission submits that a cost savings model that does not recognise that these two objectives might diverge will exaggerate cost savings.

[328] We think the Commission is right. The evidence before the Commission made it clear that capacity will be allocated on the basis of margin. That will not necessarily favour the more cost-efficient operator. With fewer competitive disciplines, there is ample scope for increased margins which do not result from cost reductions. An assumption that cost savings will necessarily occur cannot be justified.

Cost of replacement capacity

[329] The Commission said that the appellants should have allowed for the cost of any additional capacity introduced by a new entrant to replace the capacity withdrawn by the proposed Alliance partners. It reasoned that, to the extent new capacity replaces saved capacity, it uses scarce social resources. The cost of that new capacity should therefore be deducted from the savings achieved by the proposed Alliance to determine the net benefit.

[330] The appellants say that, to the extent that new entry is productive (which can be assumed otherwise it would not occur), it would not have any detrimental impact on welfare. In any case, they submit, new capacity would be provided by either a LCC or a fifth freedom carrier which would be likely to have lower costs, either because of the lower cost-base of LCCs or because of the low marginal cost of fifth freedom airlines.

[331] We accept that allowance should be made for the cost of replacement capacity, but only to the extent that the cost is higher than the lower cost achieved by the proposed Alliance as a result of the claimed cost savings. The appellants may be right to say that replacement capacity is likely to be more efficient but that cannot simply be assumed.

The economic analysis

[332] The Commission had misgivings about the appellants' use of the widget factory analogy to explain the cost savings which would follow from the proposed Alliance. The widget market is sometimes used in economics to explain how a product market works. The appellants say the Commission was wrong to reject the analogy. They submit that reducing unit costs through the more efficient deployment of resources creates savings for airlines just as for any other industry.

[333] The Commission is not, however, suggesting that cost savings will not follow from the proposed Alliance. It is saying that the widget factory analogy is inexact because, unlike the widget factory, aircraft cost and output do not necessarily follow

related linear paths. Different assumptions about schedules (and cost drivers) can substantially change available benefits.

Inconsistency with detriments claim

[334] The fourth issue raised by the Commission and criticised on appeal concerned the inconsistencies between the case for cost savings based on better aircraft utilisation and the appellants' modelling for the purpose of estimating detriments which showed load factors (i.e. the proportion of available seats occupied by passengers) to be lower in the factual than the counterfactual. The Commission took this to show that the schedules used by the appellants to calculate detriments and cost savings (and also scheduling benefits and direct flight benefits) are not reliable.

[335] The appellants say there is no inconsistency between the appellants' estimate of cost savings and their allocative efficiency model when regard is had to the conservative nature of that model. They say it was recognised that the factual outlook was likely to be significantly under-stated by the model when in reality load factors would be higher than in the counterfactual.

[336] We do not find this answer convincing. As the Commission says, the appellants seem to be arguing that for the purposes of calculating cost savings, the aircraft allocation implications of the allocative efficiency model should be disregarded. This adds to the concerns which we have already touched on when discussing allocative efficiencies, as to the relationship between detriments and public benefits. They cannot be validly compared if they have been quantified using different assumptions.

[337] The appellants also criticise as unjustifiably low the Commission's estimate that cost savings are likely to be \$30 million per annum. However, we do not think the Commission can be criticised for adopting conservative assumptions in this context, having regard to the uncertainties over both the feasibility and extent of potential cost savings. The Commission was required to make a judgment based on the information available to it. It has not been shown to have erred.

Tourism

[338] Before the Commission, the appellants claimed the proposed Alliance would increase tourism in New Zealand. It claimed that there would be 60,410 additional tourists each year who would be attracted by:

- The increased promotional effort of the airlines, in particular, of Qantas Holidays;
- The enhanced effectiveness of both airlines' promotion; and
- An enhanced ability to coordinate with Tourism New Zealand.

The resultant public benefit was quantified by the appellants at \$73m per annum.

[339] The number of additional tourists relied on by the appellants is a net figure arrived at after allowing for a decrease in Australian and other foreign tourists deterred by an assumed average increase in airfares of 3.4%. Against this decrease of 24,438 visitors from overseas, the appellants set off 84,848 New Zealand tourists who would be deterred by reduced capacity and increased airfares from travelling abroad but who, it is assumed, would travel within New Zealand instead. The appellants then quantified the benefits by estimating how much the additional tourists would spend, using a computable general equilibrium (CGE) model to estimate the effect of their spending on the rest of the economy.

[340] The Commission analysed the claimed benefits by reference to a series of assumptions and preconditions which underpinned the appellants' case and which the Commission described as, in many cases, highly uncertain but critical to the magnitude and, in some cases to the existence, of positive tourism benefits. The Commission saw most of the assumptions and preconditions as unverifiable and unable to be empirically tested. It is convenient to analyse the Commission's findings by reference to these assumptions.

(1) *That Qantas Holidays can and will promote New Zealand tourism only within the proposed Alliance.*

[341] The Commission accepted that the proposed Alliance would change Qantas' marketing strategy but it rejected the assumption that Qantas would not promote New Zealand tourism in the counterfactual as well. Noting that Qantas sees New Zealand as part of its home market, it suggested that it would be logical for Qantas to promote tourism in order to help fill the increased capacity it planned for Tasman and New Zealand domestic markets. For the Tasman market, the Commission suggested there would be greater incentives to promote New Zealand in the counterfactual than the factual. The Commission questioned the costs and benefits of Qantas not selling Air New Zealand products without the proposed Alliance but accepted, nevertheless, that this is what could occur.

(2) *The proposed Alliance partners in cooperation with national tourism organisations will be effective in increasing tourism.*

[342] The appellants argued before the Commission that Qantas Holidays would be an effective promoter of New Zealand inbound tourism when associated with Air New Zealand and that the proposed Alliance partners together would be more effective and would enhance the effectiveness of official tourism promoters.

[343] These claims were greeted with considerable scepticism by the travel and tourism industry. Some noted that Qantas Holidays is not a specialist in inbound tourism even in Australia and not a specialist in New Zealand at all. They said the claims of Qantas would be more credible if supported by plans by tourism operators. Submissions from travel industry participants also suggested that the appellants' efforts to promote New Zealand could result in a diminished effort by others who would benefit from the promotion – the so-called “free rider” effect.

[344] The Commission, nevertheless, accepted that Qantas Holidays and the airlines acting together had the ability to promote New Zealand effectively. It thought it reasonable to expect that Qantas Holidays could sell 50,000 packages to Australian and other foreign tourists, although these would not necessarily be

additional tourists or tourists who could only be attracted by Qantas Holidays if the proposed Alliance proceeded.

- (3) *That any success Qantas Holidays achieves in selling tours to New Zealand would be to tourists who would not otherwise have come to New Zealand.*

[345] The appellants' case to the Commission was that the 60,000 additional tourists would be additional to those who already visit New Zealand, and would be diverted from other destinations by the promotions of Qantas Holidays and the increased effectiveness of the airlines working with national tourism bodies. Submissions to the Commission suggested that Qantas Holidays would succeed in its strategy (if it succeeded at all) only by attracting tourists away from other providers. They also questioned the relatively large increase in tourist numbers as overly optimistic and questioned whether Qantas Holidays would have the incentive to attract new tourists to the New Zealand market rather than seek to achieve other marketing objectives.

[346] The Commission accepted, however, that the promotional efforts of Qantas Holidays and the airlines could result in tourists coming to New Zealand who otherwise would not have come. The critical issue is the number of tourists in that category.

- (4) *That any success achieved by Qantas Holidays and the airlines will not provoke competitive reactions that would detract from their efforts.*

[347] The appellants submitted there would be no reaction to the promotional efforts of the proposed Alliance because the number of tourists targeted would be too small to attract the attention of rivals and many additional tourists would be visiting Australia as well and would be welcomed by rival state tourism bodies and industries. The Commission doubted that a successful promotional campaign by Qantas Holidays or the proposed Alliance partners would not be challenged. However, it accepted that the proposed Alliance could find a niche and that competitors would have only intermittent success in eroding the targets of the proposed Alliance.

(5) *The tourism industry could and would accommodate the additional business generated by the proposed Alliance.*

[348] The appellants argued that the claimed increase in tourism numbers is a relatively small proportion of total inbound tourism and could be accommodated by existing or planned resources. A contrary view was taken in submissions to the Commission by some opponents of the proposed Alliance. The Commission accepted there would be pressures on resources but expected that investment in new capacity would follow if demand were demonstrated. It sought to deal with this issue by modelling resource costs.

(6) *Price rises and capacity decreases under the proposed Alliance would deter only a moderate number of overseas tourists from travelling to New Zealand.*

[349] The appellants' calculations assumed a higher level of capacity and lower fares than the Commission found to be likely. The Commission undertook its own modelling which indicated that more tourists would be deterred from travelling to New Zealand and more New Zealanders would choose not to travel overseas than projected by the appellants. The comparative figures for year three were:

	Appellants	Commission
New Zealanders	84,848	189,003
Australians	33,229	139,962
Other foreigners	54,485	34,833

(7) *New Zealanders deterred from travelling overseas would spend the money on local tourism.*

[350] The appellants' calculation of benefits assumed that all New Zealanders deterred from travelling overseas would tour in New Zealand instead. The Commission rejected that assumption. It said there was nothing to show that New

Zealanders who chose not to travel overseas would spend the money on domestic tourism ahead of other choices available to them. The Commission assumed 14% would spend the money saved on domestic tourism. That figure reflected New Zealanders' annual expenditure on domestic tourism as a proportion of total annual household expenditure. As a result, the Commission's modelling assumed that 26,460 New Zealanders deterred from travelling overseas in year three of the proposed Alliance would consume New Zealand tourism instead.

[351] The appellants had also assumed that 100% of those Australians deterred from travelling from New Zealand to a non-Australian overseas destination would consume tourism in New Zealand instead. The Commission rejected this assumption also, pointing out that Australian tourists so deterred might find an alternative route to their preferred destination or substitute a completely different holiday destination without the need for a flight from New Zealand. It accepted that some Australians would substitute New Zealand tourism when their preferred destination became too expensive. The Commission assumed 16% (or 1,957) of Australian tourists would be in this category. This percentage reflected the proportion of Australians who choose New Zealand as an overseas tourist destination. This reduces to 138,003 the number of Australians which the Commission assumed would be deterred from travelling to New Zealand in year three.

Conclusion on tourist numbers

[352] The Commission accepted that Qantas Holidays would be successful in attracting additional tourists to New Zealand. It assessed the figure at 28,000 or 80% of the 36,000 increase in non-Australian foreign tourists claimed by the appellants. The reduced number reflected the Commission's uncertainty about many of the assumptions relied on by the appellants. The claimed increase of 14,000 in Australian tourists was disallowed, reflecting the Commission's assessment that Qantas would be more likely to promote vigorously trans-Tasman tourism without the proposed Alliance. The Commission was, nevertheless, prepared to assume that enhanced promotional effectiveness would result in an increase in inbound tourists.

It assessed the figure at 10,622, 80% of the appellants' claim, the reduced figure again reflecting the uncertainties already discussed.

[353] The Commission concluded that 106,954 fewer tourists would use New Zealand tourism facilities in the third year of the proposed Alliance. This figure was calculated as follows:

<i>Gains in tourists</i>		
Qantas Holiday's effect	28,000	
Enhanced promotion	10,622	
New Zealanders foregoing overseas travel	<u>26,460</u>	
Subtotal		65,082
 <i>Losses</i>		
Australians	138,003	
Other foreign tourists	<u>34,833</u>	
Subtotal		172,846
Net reduction		(106,954)

(There are arithmetical errors in this table which is taken from para [1287] of the determination. Total losses are in fact 172,836 and the net reduction in tourist numbers is 107,754.)

Welfare gains from increased local tourism by New Zealanders

[354] In their case to the Commission, the appellants assumed that all New Zealanders deterred from travelling overseas would consume the local product and would spend what they would have spent in overseas markets. The Commission said that would not necessarily be the case. It thought local New Zealand tourists could avoid at least some of the accommodation and transport costs they would have incurred overseas. The Commission concluded that the arguments and evidence put forward by the appellants in support of the quantification of gains to be achieved from local tourism by New Zealanders had not been sustained.

Modelling of tourism benefits

[355] As earlier mentioned, the appellants used computable general equilibrium modelling to quantify tourism benefits. This was for the purpose of estimating the extent to which increased tourism spending as a result of the proposed Alliance would affect the New Zealand economy as a whole. The simpler alternative – a partial equilibrium model – singles out the influence of the proposed Alliance on average expenditure on domestic tourism alone, thereby ignoring any interaction with the rest of the economy. The Commission preferred the latter model because:

- The general equilibrium model was used by the appellants only to model tourism benefits. Other parts of the analysis used a partial equilibrium model.
- The model used by the appellants, although credible and widely used, uses Australian data which may misrepresent some important characteristics of the New Zealand economy. A witness at the conference of the Commission, Dr Ralph Lattimore, said:

“The second problem that’s particularly acute for computable general equilibrium models of the New Zealand economy is that, of the hundreds and thousands of parameters in the model, 99% of them are guestimates. They have never been estimated in a New Zealand market environment.”

- The Commission said it was unable critically to examine the detailed modelling for the purpose of its determination as a result of the late delivery of output files.

[356] Adopting a partial equilibrium model, the Commission calculated the welfare loss of the reduced number of tourists visiting New Zealand would be in the range of \$4m-\$17m, with a preferred figure of \$9m. This assumed economic profits (gross revenue from tourism less the cost of resources used to supply the required services and normal return) would be between 2% and 10% of total expenditure. For the purpose of calculating public benefits derived from New Zealanders substituting other domestic consumption for expenditure on overseas tourism, the Commission assumed, as earlier noted, that 14% of those deterred from travelling overseas would

substitute domestic tourism. The Commission then assumed the remainder would spend 72% of the overseas expenditure saved on domestic expenditure. This calculation excluded expenditure on imports which are 28% of gross national expenditure. Again assuming economic profits in the range of 2-10%, the Commission calculated the benefit of New Zealanders not travelling overseas as between \$4m and \$20m, with a preferred figure of \$10m.

Appellants' submissions

Tourist numbers – price impact

[357] The appellants' first submission is that the Commission's calculations were fundamentally flawed by the price increases it adopted for the purpose of calculating reductions in tourist numbers. It assumed price rises in the range of 5-17%, whereas the appellants had assumed an average price rise of 3.4%. The appellants say this was itself highly conservative; their position is that prices are more likely to fall. The appellants point out that the Commission's calculation of a reduction in Australian visitors is 22% of current visitors from Australia and that result seems unlikely. They say that, although the calculation has a relatively small effect on net tourist numbers, its effect on the calculation of benefits is great because it alters the proportion of overseas to domestic tourists and the former provide a greater public benefit than the latter. The model used by the appellants uses a multiplier of 1.04 for spending by overseas tourists as against 0.52 for domestic tourists.

[358] The differences in tourist numbers calculated by the appellants and the Commission are brought about solely by the fare increases each assumed. The Commission used the same method as the appellants for determining the impact on tourist numbers of price increases and capacity reductions. However, the appellants acknowledged in closing submissions that neither they nor the Commission distinguished in their modelling between tourists and people travelling on business or for other reasons. As a result, both may have over-stated both the number of foreign tourists deterred from visiting New Zealand and New Zealanders deterred from travelling overseas.

Impact of Qantas Holidays

[359] Next, the appellants criticise the Commission's view that Qantas Holidays would not have an increased incentive to promote New Zealand tourism in the Tasman market. The appellants submit that the incentives which Qantas would have to expand the New Zealand tourist market would be weakened in the counterfactual because any initiatives would also benefit Air New Zealand. They point also to the fact that many of the effects of the proposed Alliance on Qantas Holidays will apply equally in the Tasman and non-Tasman markets. The appellants also rely on the limited ability they say Air New Zealand has to market New Zealand tourism in Australia.

[360] Soon after the determination was issued, Qantas Holidays launched a New Zealand tourism promotional campaign aimed at Australians. It launched the "Kiwi Airpass" which "offers flexible, money-saving travel options around New Zealand".

[361] This lends support to the Commission's view that Qantas Holidays would promote New Zealand to Australians as a tourist destination without the proposed Alliance. Whether it would promote New Zealand tourism to the same extent as in the factual, is a different question. The Commission thought it would because Qantas regards New Zealand as part of its home market and increasing tourism business may become an urgent need if the anticipated increase in capacity across the Tasman eventuates.

[362] It has not been shown that judgment was wrong. It was a conclusion the Commission was entitled to reach on the information available to it.

[363] The appellants attack what they describe as the arbitrary reduction of 20% which the Commission made to non-Australian foreign tourists visiting New Zealand to take account of various uncertainties. They say there is no logic in applying a 20% discount for that purpose. We do not agree. It was entirely appropriate that the Commission should make an adjustment to reflect its view that some of the assumptions made could not be verified and may not be realised, and to do so by the conventional means of applying a discount. A discount which is proportionate to the

level of uncertainty cannot be criticised. Having regard to the number and nature of the uncertainties identified by the Commission, we consider the discount was not unreasonable.

Domestic tourism spending

[364] The appellants criticised as unreasonable and unsupported the assumptions made by the Commission for the purpose of calculating domestic expenditure by those deterred from overseas travel. They say the assumption that only 14% of New Zealanders deterred from travelling would substitute domestic tourism, based on the proportion of tourism to gross national expenditure, is spurious. There is no logical connection between the two. The appellants also criticise the assumption that 72% of expenditure would be on domestic consumption and the balance on imports. They say this was arbitrary and overly simplistic and fails to take into account the domestic economic activity associated with imported goods including tax revenue.

[365] The Commission was obviously required to make some assumptions on both issues. The appellants' proposition that all saved expenditure on overseas travel would be expended on domestic tourism was plainly untenable. In the absence of any empirical data as to the spending patterns of deterred overseas travellers, it was not unreasonable, in our view, for the Commission to resort to statistics which provide some rough proxy for the expenditure patterns of consumers.

[366] The issue here is not so much whether the assumptions used by the Commission are sustainable, but whether, in all the circumstances, they were reasonable for the purpose of giving a broad indication of the dollar value of the benefits which are likely to be generated from this source. In the absence of any information to indicate how deterred travellers might actually behave, we can only assess whether the Commission's assumptions come within the range of what those travellers might do. We think they do. We accept, however, that the uncertainties inherent in this part of the Commission's modelling must affect the weight to be given to the final calculation.

Welfare benefits

[367] The appellants criticise the Commission's preference for a partial equilibrium model over the general equilibrium model they used. But they provide no answer to the Commission's major reservations as to the appropriateness of the general equilibrium model, which we consider to be fully justified. In particular, we agree with the Commission that the same type of model should be used for calculating competitive detriments and public benefits. A comparison of the two will plainly be distorted if different types of models are adopted. Both the appellants and the Commission preferred a partial equilibrium model for the purpose of calculating allocative detriments. If a general equilibrium model were to be adopted for the purpose of calculating benefits, an adjustment would have to be made when detriments and benefits were compared.

[368] The appellants also criticise the assumption of fixed employment in the Commission's model. They argue, as they did before the Commission, that the modelling should assume variable employment. The appellants contend that the assumption of fixed employment undervalues tourism benefits and negates short and medium term effects.

[369] The appellants' model assumes that the increase in tourism services is supplied by otherwise unemployed labour. No value is put on the time of these workers when they are not employed. The Commission takes the view that this is not a realistic measure of public benefits, arguing that the appropriate measure is the difference between the value of the highest use of the resource and the value of its next best use. The appellants' argument assumes that the next best use of labour is zero.

[370] The Commission's approach is supported by a Treasury paper which advocates assuming full employment in all cases except when assessing policies relating to unemployment. We agree that this reflects a more realistic view of the tourism market. The assumption of variable employment may be appropriate for valuing employment creation programmes and the like but not to assess benefits in a developed competitive market such as the domestic tourism industry.

[371] Finally, in relation to the quantification of benefits, the appellants criticise the Commission for assuming “near perfect competition” in the New Zealand tourist market and, as a consequence, using extremely low multipliers to calculate the benefit derived from additional tourist spending.

[372] Perfect competition would result in no economic rents. The Commission’s range of multipliers (between 2% and 10%) assumed the tourist industry is competitive and would earn a modest producer surplus. There is no attack on that assumption.

[373] In our view, the Commission’s choice of multipliers cannot be criticised for the purpose of the partial equilibrium model it chose to adopt. The much higher multipliers advocated by the appellants were for the purpose of the general equilibrium model which we have already found the Commission was entitled to reject as unsuitable for the purpose.

Summary

[374] As the Commission observed in its determination, the quantification of tourism benefits involves a number of unverifiable assumptions. There are few certainties. There is no single correct answer. Our task has been to consider whether the approach preferred by the Commission provides a justifiable approximation of those tourism benefits which the Commission attempted to quantify. We think it does. While there is clearly room for differing views on some of the assumptions made and on the methodology adopted, the Commission’s approach has not been shown to be critically in error.

[375] It is to be remembered that even on the appellants’ approach there is a net reduction in overseas visitors to New Zealand as a result of the proposed Alliance. The increased tourist numbers they rely on derive from the assumed increase in domestic tourism by New Zealanders. The substantial public benefit claimed is attributable in large part to the value placed on this expenditure by a model which we are satisfied the Commission was entitled to reject. We are in no doubt that the

appellants' methodology significantly exaggerated, for comparative purposes, the potential benefits to New Zealand from any increase in tourism.

[376] On the other hand, we consider the Commission's figures should be treated with caution. They also rely on unverifiable assumptions, some of which we have already referred to. They are based on price rises which, in the Tasman market at least, are likely to be higher than those which will result after the revised model is corrected for error. These price changes were not disclosed but could be expected to reduce the Commission's calculation of the number of tourists lost. On this account, the Commission's calculation may understate likely benefits from tourism.

[377] The appellants complain that the Commission failed to take into account certain benefits which they made no attempt to quantify, in particular:

- Improvements in Air New Zealand's ability to grow tourism to New Zealand through network enhancement and access to Qantas Holidays IT platform and distribution network; and
- Other changes such as improved capacity management, greater prominence in global reservation systems and improved access by independent wholesalers to improve product.

[378] While these benefits were not quantified by the Commission, we do not think it is correct to say they were not taken into account. The improvements identified by the appellants were advanced as leading to a positive effect on tourist numbers and were reflected in the Commission's assessment of that issue.

Engineering and maintenance contracts

Commission's findings

[379] The appellants claimed benefits of \$35m would arise from Qantas directing more of its sub-contracted external engineering and maintenance work to Air New

Zealand. The appellants said without the proposed Alliance that work would be up to [] of the work available. That would increase [] if the proposed Alliance proceeded. The Commission accepted that the incentives for Qantas to direct work to Air New Zealand would be greater in the factual than the counterfactual but did not accept the difference would be []. It estimated the additional engineering services purchased would be in the range of 20-40% more. It calculated the net benefit on the basis that resource costs would be 50% of revenue. This produced a benefit in year three of between \$5 and 10m.

Appellants' submissions

[380] The appellants criticise the Commission's assumption that Air New Zealand would be able to attract work from Qantas in the counterfactual by cutting prices and would be able to secure other contracts to help replace Qantas work lost. They also take issue with the way in which the Commission calculated the net benefit.

Discussion

[381] In the 2002-2003 year, Qantas directed [] of its external engineering work to Air New Zealand. The appellants said that was exceptional because, due to Ansett's failure, Qantas deployed more aircraft and used its existing fleet more intensively. The need for work to be carried out urgently and at convenient locations assumed prominence over other considerations. Witnesses also told the Commission that some of the work was given to Air New Zealand because Qantas was attempting to build a relationship with it.

[382] However, we were told that in the 2001-2002 year, [] of engineering and maintenance work out-sourced by Qantas went to Air New Zealand. That confirms that Qantas will direct a considerable volume of work to its rival if commercial considerations favour it. In the circumstances, we do not think it was unrealistic for the Commission to assume that Air New Zealand would be able to secure something more than [] of the available work in the counterfactual. Nor, in

our view, was it unrealistic to assume that Air New Zealand would respond to a significant fall-off in work from Qantas by vigorously bidding for replacement work.

[383] The appellants criticise the Commission's assumption of 50% resource costs as "entirely unsubstantiated". They concede that some reasonable resource costs would be involved but say there was no evidence to support the figure of 50%. That is so because the appellants put forward their case on an assumption of zero costs and provided no evidence which would permit an informed finding to be made. They had the onus of establishing the net benefit. They cannot complain about the assumption the Commission was required to make in the absence of evidence which they had the opportunity of adducing.

Improved scheduling

[384] The appellants claimed that improved flight scheduling would result from the proposed Alliance and produce benefits of \$2m. They said there would be improved flight frequency, enhanced connectivity and additional direct services. Travellers would benefit from being able to travel at times they prefer. Savings in waiting time would result which the appellants quantified using a value of \$100 per hour for business travellers and \$20 per hour for leisure travellers.

[385] The Commission accepted that more convenient schedules would result from the proposed Alliance which would benefit passengers, but not to the extent claimed by the appellants. It accepted submissions that it would not be appropriate to calculate benefits based on the full value placed on travel time. It took the view that the time between a person's preferred time of travel and the actual flight time will not be completely wasted. Travellers will find other (albeit sub-optimal) ways to use the time.

[386] The Commission also had reservations about the changes in scheduling relied on by the appellants. On the Wellington to Melbourne route, where savings of almost \$1m were claimed, the appellants relied on a change from two early morning flights and one afternoon flight to one mid-morning and one afternoon flight. The Commission doubted that the loss of one flight and a movement of another to a less

convenient time of day would give rise to significant scheduling benefits for consumers.

[387] The Commission reduced the value of waiting time to 20% of that claimed by the appellants to reflect the alternative uses to which that time would be put. It made no adjustments to reflect its reservations with the changes to scheduling relied on by the appellants in calculating that scheduling benefits should not exceed \$476,000.

[388] The appellants criticise the reduced value put by the Commission on waiting time and the concerns it had about the scheduling assumptions relied on by the appellants. In our view, the Commission was entitled to reduce the value of waiting time to take account of alternative uses to which time would be put. We note also that, because of the relatively high hourly rates used by the appellants, even the discounted figures used by the Commission are not out of line with the full value attributed to travel time in reports referred to by the Commission in its draft determination.

[389] We consider the reservations about scheduling expressed by the Commission are merited. However, it is unnecessary to explore that issue any further as they were not reflected in the figure finally adopted by the Commission.

Direct flights

[390] The appellants claimed the proposed Alliance would introduce four new direct trans-Tasman flights which would result in time-savings for passengers, to a total value of \$9m. The Commission disallowed this claim altogether. It reasoned that, if the routes are profitable, a service would be introduced by one of the appellants or Virgin Blue even if the proposed Alliance did not proceed.

[391] The Commission's position would appear to have been vindicated by the post-determination introduction by Qantas of a direct flight from Auckland to Adelaide, a route which accounted for 70% of the claimed benefit. The appellants claim, nevertheless, that the sum of \$2.7m attributable to the other three routes should be allowed. They continue to assert that the incentives to provide a new

direct service are different for the proposed Alliance than for each airline acting independently.

[392] Whether or not that is so, we see no reason to differ from the Commission's assessment. The appellants have not shown the Commission to have erred in rejecting the claim. The uncertainties which caused it to do so – among them, whether the proposed routes would be profitable and, if not, whether they could only be operated by the proposed Alliance - remain, and we have been offered no basis on which to resolve them in favour of the appellants.

Increased freight services

[393] The appellants claimed improved freight services under the proposed Alliance would produce a public benefit of \$2.5m. These were expected to arise from additional freight capacity of 5.3%, resulting from new services and improved scheduling. Cost savings were also projected through the use of common facilities and systems and through the possibility of operating joint freighter services.

[394] The Commission decided that no freight benefits had been established. It was not persuaded that the additional capacity projected on some routes would occur and, if it were introduced, it foresaw the possibility of reduced competition under the proposed Alliance increasing freight rates. As with the issue of direct flights, the Commission also suggested that if new freight services would be profitable under the proposed Alliance, they could be offered now, either by the appellants or others; in other words, the benefits claimed would not result from the proposed Alliance. The Commission also noted that the appellants proposed providing the additional freight services only for so long as the market supported it.

[395] Some of the additional capacity would utilise existing capacity already possessed by Qantas. The Commission thought this capacity was also available to be used in the counterfactual. Finally, the Commission rejected as inappropriate the basis on which benefits had been calculated; half of the projected additional revenue was claimed as a welfare gain.

[396] The appellants complain that the Commission had not previously indicated that their claim had not been accepted. They say the Commission's analysis relies, in large part, on its finding of the substantial lessening of competition in the freight market which they do not accept. Thirdly, they point out that the Commission's finding that a proposed "back-of-the-clock" operation would not be viable, failed to take into account that Qantas currently operates such a service.

[397] The Commission points to the terms of the draft determination as showing clearly that the claimed freight benefits were not accepted. We accept that the terms of the draft determination should have left the appellants in no doubt that they had not discharged the burden of substantiating the claimed benefits. In our opinion, the Commission's reasons for finding that they had failed to do so are fully supportable. Fundamentally, the appellants failed to show that the additional capacity (assuming it was realised and sustained) would result from the proposed Alliance. There has been nothing put to us to rebut the Commission's view that any profitable opportunities to add capacity could be exploited now. Further "back-of-the-clock" services are in this category.

Online services

Commission's findings

[398] The appellants submitted to the Commission that benefits of \$21-33m would accrue as a result of the additional online services which would become available as a result of the proposed Alliance. These benefits will be achieved on journeys which link the services of each appellant. Currently, such a journey entails interlining – the issue by one airline of a ticket coupon for carriage by another airline – or the issue by each carrier of separate tickets. Interlining permits baggage to be transferred between carriers but passengers are required to check in for each flight. The advantages of online services include a single check-in and boarding pass for the entire journey, shorter transit time and a less stressful and more convenient journey. The appellants submitted that reduced airfares also result.

[399] In their initial submission to the Commission, the appellants did not seek to quantify the benefits. They said there was no reliable way of evaluating them. Subsequently, Professor Willig and Ms Guerin-Calvert presented papers to the Commission which drew on research they had carried out on Tasman routes. They found the difference between average interline and online fares on a sample of twenty routes was 21%. This was in line with earlier estimates based on United States studies. Professor Willig and Ms Guerin-Calvert also found that a switch from an interline service to an online service would shorten travel time by an average of 9.9%. They calculated there would be 855 new online services offered by the proposed Alliance on Tasman routes. They identified the benefits of the new online flight options as including:

- Improved connections between coordination of flights;
- Lower fares;
- The ability to purchase a single ticket for the entire journey;
- A seamless travel experience equivalent to travelling on a single airline.

In calculating benefits in the range of \$21-33m, Professor Willig and Ms Guerin-Calvert quantified the time and convenience benefits of online itineraries at 10-20% of the fare price and assumed that New Zealanders' share of total online benefits would be 50%.

[400] The Commission accepted that the proposed Alliance could potentially offer online benefits but did not accept Professor Willig and Ms Guerin-Calvert's analysis or their estimates of online benefits. Among the Commission's reservations were:

- Doubts that the sample used to estimate the difference between online and interline fares was representative;
- The inclusion of some unlikely itineraries for those for whom time-saving and convenience was important;

- The likelihood that part of the gain to consumers would be a transfer from the airlines rather than a welfare gain;
- The absence of any allowance for the cost of providing online services;
- The use of current prices rather than those which would occur under the proposed Alliance.

[401] The Commission said the Willig/Guerin-Calvert analysis did not show how many people would benefit from the introduction of an online service on some routes or what the social cost of their current inconvenience is. The Commission referred to evidence that the appellants already negotiated with many airlines worldwide, including competitors, to create interline fares. According to the evidence, Air New Zealand currently offers interline fares between at least 414 city pairs combining Air New Zealand and Qantas flights.

Appellants' submissions

[402] The appellants reject the Commission's criticisms of the Willig/Guerin-Calvert studies. They say the routes chosen were representative and those which would be unlikely to achieve time-savings (a small minority) do not distort the overall result.

[403] The Commission's concern is not, however, that the routes were unrepresentative. It is that the fares used to calculate the assumed price benefits of an online service are not representative. Professor Willig and Ms Guerin-Calvert used differences in advertised business class fares for their study. The concern of the Commission, with which we concur, is that business class fares may not reflect what happens with other classes of fares or on average.

[404] The appellants confirm that Qantas and Air New Zealand currently have an interline agreement but say this does not mean that the non-price benefits of online travel are available or that consumers in fact pay prices comparable to online fares. In response to the Commission's claim that the estimates relied on are current prices

and not those which would apply in the factual, the appellants submit that even if prices were higher (which they do not accept), they would not alter the online savings as a proportion of total expenditure. In this respect, they say online savings are independent of price changes due to competitive effects.

[405] However, we think the Commission is right to say that the appropriate comparison would be between online services offered at factual prices with benefits achievable from interline services at counterfactual prices. We accept, too, the Commission's submission that account should also have been taken of additional online services which would become available in the counterfactual as Qantas and Virgin Blue increase their presence in New Zealand.

[406] On the other hand, we do not think the absence of information on passenger numbers materially affects the Willig/Guerin-Calvert analysis, although we note that it is not clear how many, if any, passengers actually flew interline on the routes surveyed. Nor do we share the Commission's doubts that any demonstrated benefit is a genuine welfare benefit and may merely be a transfer from airlines to consumers. We also accept the appellants' submission that the omission to allow for the costs, if any, of providing online services is not material to the claim.

[407] The benefits in time and convenience of online services were quantified by the appellants at between 10% and 20% of the fare price. This was based on an American study of benefits to online passengers following an airline merger. The Commission points out, however, that the study relied on merely assumed that demand would shift out as a result of online service without making any attempt to estimate the extent of that shift. The resultant benefits are assumed, not actual.

[408] The way in which non-price benefits have been calculated contrasts with the way in which such an advantage was estimated for the purpose of calculating the benefits of improved scheduling. Benefits in that category were calculated by applying an hourly rate to actual time saved. We think a similar approach was required for the purpose of providing a more reliable estimate of non-price online benefits.

[409] In our view, the concerns we have identified raise substantial doubts as to the overall accuracy of the claim. They affect key elements of the appellants' case – whether and to what extent the savings result from the proposed Alliance (or could be achieved anyway); the reliability of the fare data relied on; whether the basis for quantifying time-savings and convenience benefits is appropriate.

[410] We accept that the appellants have demonstrated that substantial online benefits would accrue from the proposed Alliance. It is a benefit which should be given considerable weight in the final analysis, but it is not one which can safely be expressed in monetary terms.

Other benefits

[411] The Commission accepted that there were unquantifiable benefits in four categories:

- Air New Zealand's governance would improve because of an increased reliance on private funds;
- To the extent that the proposed Alliance could secure Air New Zealand's existence, its status as New Zealand's national carrier would be preserved;
- Air New Zealand's global competitiveness would be enhanced; and
- The reduction in flight numbers would decrease the likelihood of air traffic congestion and reduce pollution, visual disamenity and adverse environmental effects.

The last of these was raised by the Commission itself.

Balancing detriments and benefits

Introduction

[412] As earlier discussed (paras [32] – [33]), having found there was likely to be or deemed to be a substantial lessening of competition in the relevant markets as a result of the proposed Alliance, the Commission was required to decide whether the likely benefit to the public from the proposal was such that authorisation should nevertheless be permitted. Unless the Commission was satisfied that such a benefit existed, it was bound to decline authorisation.

[413] The Commission was required therefore to consider whether the public benefit it had accepted would flow from the proposed Alliance would outweigh the detriments to efficiency it had found. For all detriments and some categories of public benefit it had suggested a likely range and a preferred figure for year three. It referred to the following table in its determination which summarised its findings on annual changes in net welfare for New Zealand as a result of the proposed Alliance.

TABLE 3: Summary of Annual Net Public Benefits (\$m) (Year 3)

Item	Range	Most likely
Detriments		
• allocative inefficiency and transfers	(110) – (83)	(90)
• productive inefficiency	(91) – (18)	(55)
• dynamic inefficiency*	[()]	(50)
Sub-total	[()]	(195)
Benefits		
• tourism	(18) – (4)	(11)
• domestic spending by NZers deterred from overseas travel	5 – 20	13
• cost savings	30	30
• engineering & maintenance	5 – 10	8
• scheduling	0.5	0.5
• new freight services, direct flights, online benefits and miscellaneous	0	0
Sub-total	22.5 – 56.5	40.5
TOTAL NET BENEFITS/(DETRIMENTS)	[()]	(154.5)

*The Commission’s estimate is an intermediate point in a range partly bound by an estimate derived from confidential information. Consequently, the range cannot be disclosed for the purposes of balancing public benefits and detriments.

Note: The Commission’s figure for allocative inefficiency of \$90m was replaced at the hearing by a figure of \$126.4m – see Table 2.

[414] The Commission went on to say at para [1395] that on the basis of its analysis, it concluded on the balance of probabilities that the detriments from the proposed Alliance substantially outweigh the benefits. The Commission said this is true both in the time period considered (year three), and in the prior period, and as a continuing trend.

[415] The appellants were critical of the Commission's failure to give consideration in the course of the balancing exercise to unquantified benefits. Based on the way in which the Commission explained its thinking in this area, this criticism seems justified. It may be the Commission thought it unnecessary to discuss unquantified benefits because its quantified detriments so clearly outweighed its quantified benefits. But this is to assume that a benefit (or a detriment) should be accorded less weight simply because it has not been quantified. That approach would be wrong. As our discussion has already shown, there may be categories of detriments and benefits which, for one reason or another, cannot be readily expressed in monetary terms. That is no reason to exclude them from the balancing process, as the Commission itself had much earlier in its determination (at para [899]) acknowledged.

[416] At the same time, it may be necessary to reduce the weight to be given to some categories of quantified detriments and benefits if there are doubts about the reliability of the calculation or when the quantification process is necessarily abstract in nature. The balancing process is not to be seen as a purely arithmetical exercise. It should be leavened with a healthy regard for any shortcomings in the way in which detriments and benefits have been quantified.

[417] We pass now to consider the final and ultimately determinative issue of whether the Commission has been shown to have erred in finding that the appellants had not satisfied it that the proposed Alliance would result in such a benefit to the public that it should be permitted. For this purpose we must review the balancing exercise carried out by the Commission, substituting our own findings where we have found the Commission to have erred in its treatment of detriments and benefits.

Detriments

[418] We have found the appellants to have shown that there were two important errors in the modelling which the Commission used to quantify allocative detriments. We also found that the figure of (\$11.7m) calculated by the Commission for the Auckland-Asia market should be disregarded. We concluded that the amended figure of (\$126.4m) put forward by the Commission at the hearing

overstates the level of welfare losses from allocative inefficiencies. As the process by which the figure of (\$90m) used for the purpose of the determination was reached was similarly flawed, it cannot be relied on either.

[419] At the same time, we are unable to accept the appellants' final calculation of welfare loss of (\$2.1m). In respect of the two key markets, this relies in large part on the assumed change in the level of marginal costs for the airlines in the proposed Alliance – an assumption which we consider is unsupported by the evidence. The figure is even less than the (\$23m) which the appellants argued for before the Commission. Further, and importantly, there is a risk that the appellants' final figure includes certain cost savings that were claimed as a public benefit. In order to avoid the risk of double-counting and to recognise that the appellants' calculation also relies on an imperfect modelling process, we will for the purpose of this balancing exercise adopt a figure for allocative inefficiency of (\$32m). This may be compared with the appellants' (untested) calculation of (\$21m) for the Tasman and New Zealand domestic markets using weighted average costs.

[420] We accept that, on the available evidence, the Commission was entitled to find that some loss in productive efficiency would probably result from the proposed Alliance – from both X-inefficiency and rent-seeking behaviour. But, again, we have misgivings about the way in which this loss was quantified. For the reasons given in our earlier analysis, we consider that the estimate of (\$55m) should be significantly discounted.

[421] Of the figure of (\$50m) which the Commission settled on as quantifying the annual dynamic efficiency loss resulting from the Alliance, some [()] reflected specific transition costs associated with the formation of the proposed Alliance. Although doubting that these costs are appropriately categorised as examples of dynamic inefficiency, we accept they should be taken into account as part of the weighing process. The balance of the (\$50m) figure adopted by the Commission relies on a method of quantification which the Court has previously accepted and which we have found to be generally supportable. However, we reiterate that the weight to be attached to that component of the welfare loss should recognise and take account of the necessarily abstract nature of the estimating exercise.

Public benefits

[422] Generally, we have upheld the Commission's approach to the quantification of public benefits. We have accepted as defensible:

- a) Cost savings of \$30m.
- b) Tourism net benefits ranging from (\$13m) to \$16m, with a preferred net figure for the balancing exercise of \$2m. This benefit is arrived at after setting off losses from a projected reduction in foreign tourists against gains from increased domestic spending by New Zealanders deterred from travellers overseas. While generally upholding the Commission's approach, we have drawn attention to the uncertain nature of the assumptions on which it was based and the likelihood that, because price rises may not be as high as the Commission assumed, benefits could be understated. In the event, the figure of \$2m used by the Commission should be taken as being at the lower end of the scale of likely benefits from this source.
- c) Engineering and maintenance work of between \$5m and \$10m, with an intermediate figure of \$8m.
- d) Improved scheduling benefits of \$0.5m.

[423] Of the benefits claimed by the appellants – for direct flights, increased freight services and online services – we have accepted that the Commission was entitled to reject the claims put forward by the appellants. In the case of online services, however, the appellants established that a substantial benefit was likely to arise, which should be given considerable weight in the final analysis, but which could not be safely quantified.

[424] In summary then, we take into account the following benefits as quantified by the Commission:

Cost savings	\$30.0m
Tourist benefits	\$2.0m
Engineering and maintenance work	\$8.0m
Improved scheduling	\$0.5m
Total	\$40.5m

[425] The unquantifiable benefits are for online services and those listed in para [411] above.

Discussion

[426] The question we must now address is whether the appellants have shown the Commission was in error in finding that it was not satisfied the proposed Alliance would result in a net welfare benefit to New Zealand. For the purpose of our analysis, that requires the appellants to satisfy us that benefits from the proposal outweigh efficiency detriments flowing from the reduction in competition found.

[427] We have accepted that the Commission was entitled to find that allocative, productive and dynamic inefficiencies would be likely to result from the proposed Alliance. We have rejected the quantification of losses it attributed to allocative inefficiencies and expressed reservations about the figure it put on productive inefficiencies. But we are satisfied that the Commission was entitled to find that substantial detriments are likely to arise in both categories and have been fairly quantified in the case of dynamic inefficiencies.

[428] Quantified public benefits are modest. Those arising from increased tourism may be somewhat understated but the Commission's figure has not been shown to be wrong. Cost savings are taken into account subject, as explained in para [419], to their being allowed for in quantifying allocative inefficiencies to avoid any risk of double-counting. On this basis, quantified public benefits are significantly less than quantified detriments, even after giving due weight to the reservations we have expressed as to the losses arising in each category of efficiency.

[429] Are unquantified benefits sufficient to tip the balance to such an extent that would lead us to find that the Commission's assessment was wrong? In our judgment they do not. We have acknowledged that the enhanced online services which would result from the proposed Alliance will significantly improve the airline services available to the public of New Zealand. And it was generally accepted that a value should be attached to the positive flow-on effects for Air New Zealand's international competitiveness, its status as New Zealand's national carrier and its governance. At the same time, we do not accept (and were not asked to accept) that Air New Zealand would not continue to improve its performance, to compete internationally and domestically and to maintain its position as New Zealand's national carrier in the absence of the proposed Alliance. The additional benefit is in the extent to which the proposed Alliance would enhance these outcomes.

[430] These unquantified benefits are undoubtedly material but, in our judgment, fail by a significant margin to outweigh quantified net detriments (i.e. after allowing for quantified public benefits). It follows that the appellants have not shown the Commission to have erred in concluding that the likely public benefits of the proposed Alliance would not outweigh the likely efficiency detriments.

Result

[431] The appeal is dismissed.

Delivered at 3.30 p.m. on 17 September 2004.

Rodney Hansen J

Kerrin M Vautier CMG