

# Alert



Number 6 – November 9, 2006

## **ACCC Findings on trans-Tasman “Code-Share”**

As you will have read, the Australian competition watchdog, the ACCC, has proposed to turn down the attempt by Air New Zealand and Qantas to form an anti-competitive agreement on the Tasman.

The ACCC's draft determination is comprehensive, considered and robust, and is succinctly summarised in the attached transcript of an interview with the ACCC Chairman, Graeme Samuel, in an interview with Radio New Zealand on the day of the decision.

This Alert provides an overview of the ACCC's draft determination, and the reaction from airlines.

### **The Australian Decision in Summary**

The ACCC has made a draft decision to reject the Tasman “code-share” on the basis that public benefits are very limited while the public detriments are substantial. In particular, the ACCC said that the “code-share” would lead to higher prices and reduced choice for consumers. It also found that it would lead to higher freight prices.

The ACCC will consider final submissions from applicants and interested parties before completing its decision.

### **The New Zealand Situation**

The New Zealand Government has said that the ACCC decision will have no bearing on its own decision. Strictly speaking, that is proper. Each jurisdiction is independent. But it would be remarkable indeed if the New Zealand Government approved something that an independent and expert competition body in Australia has said emphatically will have substantial detriments to consumers for little public benefit. Indeed New Zealand Treasury warned at a very early stage against allowing any perception that the assessment process in New Zealand was somehow inferior to that in Australia.

The ACCC only focuses on public benefits and detriments in Australia. The impact of the code-share on the New Zealand public will be far worse.

Similarly, the process for considering the application in New Zealand is vulnerable to criticism. New Zealanders do not have the benefit of a decision made by an independent and specialist competition agency, as Macquarie Equities in Australia points out:

*'We also note that aside from the ACCC, the TNA (code share) requires approval from the New Zealand Minister of Transport. Arguably though, **the decision is more a pragmatic political decision** as opposed to the NZCC's (Commerce Commission's) test of "a substantial lessening of competition".' (emphasis added)*

This decision is an opportunity for the New Zealand Government to show that it will protect the New Zealand public rather than "pragmatically" and "politically" pursue protection of an airline of which it owns over 80%.

### **Air New Zealand's Reaction**

The ACCC draft determination appears to have taken Air New Zealand by surprise. The airline has said that it is "astounded and flabbergasted". It was critical of the ACCC, suggesting it does not understand the airline business, despite its extensive investigations and experience with other airline authorisations. A case of criticising the umpire. In response, Graeme Samuel said:

*"I'm perhaps surprised that they were surprised given the significant anti-competitive elements associated with this alliance. I think they must have been aware that our view and the law in Australia takes the position that you need to show substantial public, let me underline the word 'public' benefits flowing from an anti-competitive arrangement before we'll authorise arrangements that we think have significant anti-competitive detriments as far as consumers are concerned."*

In questioning the ACCC draft determination, Air New Zealand repeated well-worn figures and arguments that have not stood up to scrutiny. In particular, Air New Zealand claimed that airline losses on the Tasman are well documented. In fact, there has been no evidence made public to show ongoing losses on the Tasman, and the fundamentals do not suggest that Tasman routes should be unprofitable. Only the ACCC and Ministry of Transport (MOT) have been privy to more detailed financial information about the Tasman, and the ACCC has clearly not been persuaded by what it has seen.

According to media reports, Air New Zealand has also threatened to cut flights and raise fares in response to the ACCC decision. Ironically, both cutting of services and fare increases seem absolute certainties if the "code-share" goes ahead, as the ACCC has now confirmed. The ACCC says that cutting of services is likely to be worse under the code-share than if the code-share is rejected. Indeed, the airlines' own application to the ACCC and Ministry of Transport in New Zealand outlined extensive cutting of flights and complete withdrawal of Air New Zealand on some routes if the code-share is approved.

In another irony, the submissions by airlines to ACCC and MOT claimed that they could not cut services unilaterally – they said that they needed a code-share to do so. Now it appears that Air New Zealand intends to do so if the code-share is declined.

It is quite possible that Air New Zealand will proceed to cut services – that is a matter for them. But it is worth bearing in mind that fares have already increased considerably in 2005 and 2006, even since the application was made for a "code-share". Fuel prices are now falling, and Air New Zealand's financial outlook and share price looks strong. As the Air New Zealand CEO, Rob Fyfe, has now said, the airline has many other irons in the fire at present and the code-share is not a make or break issue for the airline.

Air New Zealand will have to make its decisions about Tasman routes in that context. Obviously, without the “code-share”, Air New Zealand can only make decisions on its own behalf. Qantas and other airlines will be free to decide whether and how to service routes without having to seek Air New Zealand’s agreement.

### **Qantas’ Reaction**

Although clearly not pleased, Qantas has been more circumspect in its response to the draft decision. Its reaction is different to Air New Zealand's claim to be "flabbergasted". Qantas CEO, Geoff Dixon, said the ACCC rejection was expected, based on its knowledge of the ACCC’s history.

Qantas has considerable experience with the ACCC and has been the beneficiary of favourable decisions in other applications. In particular, the ACCC authorised Qantas’ ongoing agreement with British Airways in February 2005, due to public benefits combined with higher levels of competition between Australia and the UK. It also authorised an agreement between Qantas and Orangestar in September 2006. In short, Qantas has been able to secure authorisations that are considered by ACCC to be benign or favourable to consumers. The Tasman “code-share” is not in that category.

### **SUMMARY OF ACCC DRAFT DETERMINATION ON THE “CODE-SHARE”**

#### **“Intense Competition” on the Tasman??**

The two airlines claimed that the Tasman was “intensely competitive”, something which opponents questioned early on. The ACCC found that:

- Qantas and Air New Zealand have maintained a combined market share close to or above 80% since the Australian Competition Tribunal’s decision in 2004.
- Capacity growth has declined – only Air New Zealand has discernibly increased seat capacity since 2004.
- Most routes have only a few airlines and Qantas and Air New Zealand are the only operators on 18 out of 27 Tasman routes.
- Emirates and Virgin Blue have not expanded in the way expected by the Australian Competition Tribunal in 2004 and are unlikely to do so. There are genuine barriers to expansion for Virgin and Emirates.
- In particular, there is now evidence that Emirates faces significant regulatory barriers to expansion on the Tasman.
- Time sensitive travellers are particularly exposed to lack of competition.
- Some routes, such as those into Wellington are even more exposed to lack of competition than most.
- Competitors such as Emirates and Virgin Blue have not expanded their route schedule or frequency and remain inferior to Qantas and Air New Zealand.
- In particular, Emirates, Virgin and other airlines carry a very small proportion of time sensitive business/convention travellers.

### **Empty Planes?**

There have been many loose claims about empty planes that could only confuse those not familiar with the airline sector. Those claims were questioned and challenged by opponents of the code-share from the very beginning.

The ACCC found that load factors of Qantas and Air New Zealand on the Tasman are within the range of other routes and other airlines. The claims about “empty planes” should be put to bed as misleading.

### **Public Benefits?**

The ACCC said that there are only limited public benefits arising from the proposed “code-share”. The ACCC identified the following limited benefits:

- Limited cost savings to the airlines – the ACCC said that savings would be significantly lower than the airlines claimed and that they do not appear to arise from greater efficiency, so much as from fewer services. They also said that the small benefit accruing to the airlines would not be passed through to consumers in the form of lower airfares (in fact the ACCC’s analysis suggested that airfares would rise).
- Schedule spread (less wingtip flying) – the ACCC said that this benefit was marginal.
- Connectivity and flexibility – the ACCC said that this benefit was marginal.
- Frequent flyer options – the ACCC said that these benefits were limited.

The ACCC did not accept a number of other “benefits” claimed by the airlines. In particular, it did not accept arguments about “international competitiveness” or “national interest” as a benefit. Nor did it accept arguments about likelihood of “new routes”.

### **Public Detriments**

In contrast to limited public benefits, the ACCC found substantial public detriments. In particular the ACCC predicted the following if the “code-share” proceeded:

- Higher fares, particularly for time sensitive passengers (which generally include business travellers and leisure passengers on shorter trips).
- Reduced choice for customers.
- Higher air freight rates.

The ACCC said in conclusion:

*“The ACCC is not convinced, on the available evidence, that the limited benefits from the TNA would outweigh the large anti-competitive detriment that is likely to result from the cessation of competitive hostilities between Qantas and Air New Zealand.”*

**The “Counterfactual” – What will happen if there is no code-share?**

After considering submissions, the ACCC concluded the following if the “code-share” does not proceed:

- Qantas and Air New Zealand would continue to operate separately on the Tasman.
- A more limited arrangement between Qantas and Air New Zealand is not likely, and nor is a commercial arrangement with other airlines.
- Both airlines would review their operations. They may review the type of aircraft flying on some routes and may decide to reduce services on some routes (subject to two comments below):
  - Reductions in capacity will be less than if the code-share were to proceed.
  - Service reductions are most likely to be on routes where competition is minimal (including competition between Qantas and Air New Zealand) and on routes where there are less network connections.

**Final Decisions and Appeals**

The ACCC is a draft determination. A final determination is not likely until at least late 2006 or early 2007. However, the ACCC has made it clear that unless there is new information or evidence of significant errors, it is unlikely to change its position. In fact, comments made by Air New Zealand since the draft determination was released appear to confirm the ACCC’s analysis.

The ACCC draft report is well researched and thorough. It leaves little to the imagination. It has also carefully examined the position taken by the Australian Competition Tribunal in 2004 when the ACT overturned the last ACCC decision on appeal. It would appear that this decision, if made final, is not highly vulnerable to appeal.

Nonetheless, the risk to the public will continue until airlines formally withdraw their applications or the New Zealand Government rejects the anti-competitive arrangement.