The Air New Zealand - Qantas decision – what next?

Rory McLeod of the New Zealand Ministry of Economic Development (MED) is responsible for co-ordinating advice to Ministers on competition policy. In late January 2005 he was asked to explore options that would enable Air New Zealand to form strategic alliances with other airlines, like Qantas, and to report back by 1 December 2005. One of the factors he will have to contend with is that the Commerce Act 1986 prohibits mergers and alliances by firms that reduce competition in New Zealand markets – where the wellbeing of consumers resident in New Zealand is the main criterion. The other criterion is whether there are public or social benefits that outweigh consumer costs.

Background

On 23 October 2003, the New Zealand Commerce Commission (NZCC) issued its Final Determination[1] turning down a proposed strategic alliance between Air New Zealand and Qantas, the principal airlines in New Zealand and Australia respectively. The alliance would have involved the acquisition of 22.5 percent of the voting equity in Air New Zealand, which since 2002 had been 83 percent owned by the New Zealand Government. In a media release, NZCC Acting Chair Paula Rebstock said the Commission considered that the proposed alliance would "damage competition and harm consumers and [was] therefore not in the interests of New Zealanders". Within days, the Australian Consumer and Competition Commission (ACCC) issued a similar judgement.

This case was written by consulting economist Ralph Lattimore and Simon Hope from the New Zealand Institute of Economic Research (NZIER) for the Australia and New Zealand School of Government. It has been prepared as a basis for class discussion rather than to illustrate either effective or ineffective handling of a managerial situation. The assistance of Janet Tyson (ANZSOG), Richard Norman (ANZSOG), Janet Whiteside (NZCC), David Stone (consultant) John MacIlree (NZ Ministry of Transport) and Rory McLeod (Ministry of Economic Development) is gratefully acknowledged. Any remaining errors are the responsibility of the authors.

[1] The draft and final determinations of the NZCC, together with background material, can be found on their website www.comcom.govt.nz.

On 13 January 2005, the Australian Productivity Commission issued a report on Australian and New Zealand competition and consumer protection regimes.[2] The report focused on the increasing integration of business activities in the two countries. The Commissioners saw the need for greater harmonisation of the regulatory environments in both countries but they did not recommend changes to the respective commerce acts that would create a single market competition law test.

Early beginnings

Air New Zealand and Qantas both began operations as private airlines over 60 years ago. Governments were involved in the process of converting them into national carriers both to serve the respective domestic markets and to create international links with major markets and tourist destinations.

In April 1940, the forerunner airline to Air New Zealand, Tasman Empire Airways Limited (TEAL) was registered, with holdings by the New Zealand Government (20 percent), Union Airways (19 percent, BOAC [now British Airways] (38 percent and Qantas (23 percent). Ownership control changed in 1953, with TEAL becoming jointly owned by the New Zealand and Australian Governments. In 1961 this was altered again, with the New Zealand Government assuming full control. Four years later, TEAL changed its name to Air New Zealand and continued to operate only international services.

The Qantas shareholding in New Zealand's international airline has frequently changed over the last 65 years and Australian partial financing of Air New Zealand has often been an important source of capital for the development of the airline.

In 1978, Air New Zealand and the nationalised New Zealand domestic carrier, National Airways Corporation[3] merged to form a company offering both international and domestic air services. The Air New Zealand name was retained.

Qantas had similar origins, beginning as a private airline and being nationalised in 1947[4].

As national carriers (holding national bilateral foreign landing rights), Air New Zealand and Qantas now serve both domestic and international markets for their respective countries.

Both national carriers provide politically important air links to the Pacific Island nations. They also provide profitable long-haul services to North America and to Europe with two routes. The Kangaroo Route approaches London via the Middle East or Asia, and the Pacific Route via Los Angeles (mainly).

Both airlines have had direct competition (ex Sydney, Melbourne and Auckland) from, at various times, Pan-Am, Continental, Malaysian, British Airways and United on these routes. Importantly they also had indirect competition from the fast-growing

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[2] See www.pc.gov.au/study/transtasman/index.html

[3] Established by the Government in 1947 following the nationalisation of private sector airlines – see http://www.airnz.co.nz/aboutus/corporateprofile/companyhistory/default.htm,

[4] see http://www.qantas.com.au/infodetail/about/FactFilesNov2002.pdf

Singapore Airlines, Thai and other carriers. The most recent direct competition challenge on the Kangaroo Route has come from Emirates.

Qantas and British Airways now have a comprehensive strategic alliance on the Kangaroo Route, with regard to code sharing, prices, scheduling and other variables.

Currently, Air New Zealand and Qantas essentially have a duopoly on the Pacific Route, because US and other airlines do not choose to compete.

Singapore Airlines has been an important element in this saga for over 25 years.

The airline is well-capitalised with an extensive global network, and expansion plans to match. New Zealand's recent liberal aviation policy (1988) has been quite tolerant of this competition but Australia has been less so. For example, Australia, with its much larger customer pool, has continued to resist permitting Singapore Airlines flying directly from Australian centres to North America.

Government assistance to both national carriers has extended beyond joint ownership. For example, in 1992 Australian airline policy was changed making it possible for Qantas to take over Australian Airlines for $400 million,[5] with the Australian Government paying off $700 million in debts left by Australian.[6] The merger positioned Qantas as the principal Australian airline.

The riskiness of airline ownership

One of the most astute international investors, Warren Buffett (affectionately known as "The Oracle of Omaha")[7] is reputed to have once said to his Hathaway Corporation Board that if he ever suggested investing in an airline, the Board should call his psychiatrist!

Most airlines earn relatively low rates of return, as shown below and in *Exhibit 1*.

Table 1 Air New Zealand financial summary

Year to June 30 (NZ $m)

	2003	2002	2001	2000	1999
Revenue	3,617	3,642	4,025	3,656	3,331
Operating Surplus	220	33	25	143	123
Net surplus (deficit) after tax and unusuals	166	-318	83	-600	214

Note: Figure is for continuing operations only.

Source: http://www.airnz.co.nz/aboutus/investorcentre/keystatistics/default.htm

Risk-taking investors favour airline investments. Governments often invested in airlines because they viewed national carriers as *important strategic assets*. This governmental attitude appears to have had multiple dimensions. There was a view that a national carrier was an important part of the national transport infrastructure linking

[5] http://www/qantas.com.au/info/about.history/details17 downloaded on 21/7/05

[6] Personal communication, David Stone.

[7] http://news.bbc.co.uk/1/hi/business/3150257.stm

the country with the rest of the world for both passenger and freight services. This view corresponds to the role of road development internally. Another dimension for small countries related to the prestige value of a national carrier – hence the country's name as part of the Air New Zealand brand. A third dimension was the advertising value of a national carrier operating internationally – the marketing value of the country's name on a Boeing 747 regularly appearing at Los Angeles airport, for example.

The variability of airline earnings has been high because international passenger air routes (markets) were frequently subject to unexpected economic shocks. For example,

- business cycles involve changing demand for the very profitable business class seats,
- the changing popularity of tourist destinations,
- variable fuel costs (associated with exchange rate movements) and
- employee strike actions.

Labour, leasing and interest costs have been so high for full service airlines, with their extensive marketing and ticketing operations, that they could not survive strikes for more than a few weeks.

Even where a national carrier was privately owned and not subsidised or protected by its national government, the level and variability of its earnings has been affected by foreign governments intervening with a foreign carrier competing on the same international air routes. This has occurred, for example, by providing a state-funded capital injection or having bankruptcy protection laws that allowed an unprofitable airline to continue in business. These factors have affected both Air New Zealand and Qantas in the past.

New Zealand (and Australian) international airlines have been particularly vulnerable to these forces by virtue of small domestic market sizes and the distance to major commercial and tourist destinations. The size of the two economies means that the supply of higher risk capital has been very limited relative to the finance requirements of an international airline. Furthermore, many important destinations for New Zealand and Australian travellers are as long as 24 hours flying time away.

Another way of looking at the size issue is to note that the valuable bilateral landing rights granted to national airlines are conditional on the fact that the national airline is owned and controlled from its home country (with the associated small pools of risk capital).

Long distance flights often imply that airlines with the most comfortable and largest aircraft will capture market share: such aircraft also tend to be the most modern and most expensive equipment. Lease markets for aircraft have developed to offset some of these problems, enabling airlines to lower their capital requirements by increasing their leasing costs.

The rise of Low Cost Carriers (LCC)

Over the last twenty years, some of the most profitable airlines have been so-called Low Cost Carriers (LCC) as opposed to full service airlines (FSA) or network carriers. LCCs (like Southwest in the US and Easyjet and Ryanair in Europe) developed highly standardised airline services and low ticket-price options.

The low-cost option appeals to the more elastic or flexible groups of travellers. The advent of LCCs has also stimulated the development of sophisticated yield management or booking systems in which ticket prices quickly respond to changes in consumer demand to maximise the load factor.

LCCs have captured high proportions of market shares from FSAs. Some measures of the relative economic performance of FSAs and LCCs in the US are given in *Exhibit 3*. The success of the LCC format took some time to develop and some of the earliest charter airlines over the Atlantic were often not competitive with FSAs.

There are recent examples of the incursion of the LCC format into Australia and New Zealand. When Ansett Australia collapsed in 1991, its place was rapidly filled by a new LCC, Virgin Blue. Virgin Blue's international counterpart, Pacific Blue, has now entered the trans-Tasman market and has signalled that it may enter the New Zealand domestic market. Air New Zealand introduced its own LCC on the Tasman routes (Freedom Air). Air New Zealand has also completely transformed its New Zealand domestic service to a quasi-LCC format, Air New Zealand Express.

A number of other current issues facing airlines are given in *Exhibit 4*.

International aviation policy and the nine freedoms

The New Zealand and Australian government's involvement in airline ownership mirrored that of most other governments around the world since the Second World War. Even where governments did not choose to hold shares in their national carrier, they regulated landing rights for local and foreign airlines. These regulations were, and still are, usually developed by governments exchanging rights on a bilateral basis.[8] This contrasts to some extent with the multilateral framework (World Trade Organisation) often used to regulate international trade in goods and services (except aviation).

International agreements in aviation services have been highly proscriptive compared to other trade policies. They were based upon granting certain so-called "freedoms of the air" to foreign carriers. The freedoms range from one (no access to foreign markets, just over-flying rights) to nine (greatest access).[9] Two levels of freedoms have been especially relevant in this case study. The eighth freedom (in combination with lower freedoms) is the right of a foreign carrier to land in New Zealand, discharge and pick up passengers, fly to other airports in New Zealand, and then fly to another destination overseas. This freedom enables a foreign carrier to compete on international routes into and out of New Zealand and, importantly, to compete on air routes within New Zealand. Ninth freedom rights permit similar competitive forces

[8] New Zealand has recently exchanged rights on a plurilateral basis with a number of our key partners, including Singapore and the USA – see http://www.maliat.govt.nz/.

[9] An outline of these freedoms is given in Exhibit 2.

within a country market. For example, Qantas has eighth and ninth freedom rights in New Zealand. These rights were seldom granted, historically, with the result that domestic carriers were often virtual monopolies charging monopoly prices.

Fifth freedom rights are rights granted to a foreign airline to land at a New Zealand airport, discharge and pick up passengers, and fly to a third country. Emirates, Thai, Garuda, Lan Chile, Singapore Airlines and Air China have such trans-Tasman rights and some other carriers have such rights in New Zealand at present.

Both Australia and New Zealand have granted fifth freedom rights that allow a significant number of third countries full access to the Tasman. As noted, Australia has not granted fifth freedom rights to Singapore Airlines to enable it to pick up passengers in Australia en route to North America, and this has limited potential competitive pressure on the Pacific route.

Single Aviation Market and "open skies"

Over the last twenty years, there have been moves by governments to liberalise international air service agreements (grant more rights on a reciprocal basis). The aim has been to raise the number and quality of air connections in attempts to keep aviation markets competitive. New Zealand has been at the forefront of such air service policy changes.[10] Australia has only one "open skies" agreement – with New Zealand.

In 1996, the two countries agreed to establish a Single Aviation Market (SAM) for Australia and New Zealand. This arrangement automatically provided eighth and ninth freedom rights in both countries to SAM airlines. There are restrictions, however, which limit competition. SAM airlines have to meet the technical operational requirements of both countries. They must be at least 50 percent owned by Australian and/or New Zealand nationals and have boards of directors who are comprised of at least two thirds Australian and/or New Zealand nationals. SAM airlines must also have their operational base and head office in one of the two countries.

Since 1996, Air New Zealand, Ansett, Qantas, Norfolk Jet Express, Asian Express and Pacific Blue have qualified as SAM airlines. Clearly, third-country international carriers with fifth freedom rights to Australia and/or New Zealand (Singapore, British Airways, Japan Airlines, United, Korean and others) are not SAM airlines.

The re-privatisation of Air New Zealand

During the major government reform period of the mid to late 1980s, Air New Zealand became one of a number of large government-held assets that were sold to private owners. The government announced the sale of 100 percent of Air New Zealand in late December 1988, with the buyer being a consortium headed by Brierley Investments Ltd (BIL). The holdings amongst the consortium were:

- BIL – 65 percent with 30 percent being on-sold to the New Zealand public, staff and institutional investors

[10] [See http://www.executive.govt.nz/96-99/minister/williamson/air_trans/ for the most recent New Zealand International Air Transport Policy statement]

- Qantas – 19.9 percent
- Japan Airlines – 7.5 percent
- American Airlines – 7.5 percent

The New Zealand Government took a "Kiwi" share, to ensure that the majority shareholding remained in the hands of New Zealanders (via key veto rights).

The sale of Air New Zealand was accompanied by changes in domestic air route policy which enabled the Australian airline, Ansett, to establish a subsidiary in New Zealand and compete with Air New Zealand (*Exhibit 5)*. This competition resulted in, among other things, airbridges being introduced at major airports for the comfort of domestic passengers.

Ansett New Zealand had difficulties making profits as a full service airline competing with Air New Zealand – as had a number of other airlines in the past. In the late 1990s it was decided to sell the airline. Ansett New Zealand was purchased by a group of New Zealand investors and it continued as a major domestic competitor, Tasman Pacific Airlines. Tasman Pacific was a franchised operation using the Qantas brand. After a short period, Tasman Pacific went into receivership on 21 April 2001 and was replaced domestically by a subsidiary of Qantas Australia, Jet Connect, which also traded under the Qantas brand.

The re-privatisation of Air New Zealand, with accompanying aviation policy changes, forced the airline to manage the inherent risks of airline ownership to a greater degree. (Previously the New Zealand Government, as owner, had assumed many of these risks). Entry into the Australian market was an opportunity that needed to be explored by Air New Zealand for a number of reasons. Australia was a larger market for domestic travel that Air New Zealand could exploit with a low-cost carrier, and it could channel Australian passengers to its international services.

The re-privatisation of Qantas and trans-Tasman competition

The re-privatisation of Qantas occurred later than for Air New Zealand and difficulties arose, in part, as a result of the lack of policy co-ordination of these trans-Tasman policy changes. Air New Zealand was pushing for greater access to Australia over the period 1988 to 1995 while the Australian government was trying to maximise the price it would attract by selling Qantas. In 1992, British Airways was sold a stake in Qantas and in 1995 Qantas was fully privatised.

Air New Zealand had attempted to expand in the 1990s by acquiring seventh freedom rights in Australia. In somewhat controversial circumstances, this application was denied. With its preferred entry strategy blocked by the Australian Government, Air New Zealand pursued what appeared to be the next best option by buying into Ansett Australia. The outcome would be disastrous.

In September 1996 Air New Zealand increased its stake in the Australasian market by announcing an agreement which would see it acquire 50 percent of Ansett Holdings Limited Group[11] for around NZ$540[12] million. In October of that year the deal was finalised.

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[11] Ansett Holdings owned 100% of Ansett Australia and 49% of Ansett International

[12] NZ$ = approximately US$0.68c in 1996 and in 2000.

This purchase provided a feeder service from around Australia to Air New Zealand international services out of Sydney and elsewhere to New Zealand, North America and other international destinations, and, importantly, allowed Air New Zealand to offer Northern Hemisphere tourists travel to New Zealand and Australia.

However, Ansett was a high cost airline with a number of outstanding technical and staffing issues.

The Single Aviation Market arrangement came into effect on 1 November 1996. In 1997 Qantas sold its 19.9 percent share in Air New Zealand to American institutional investors.

In February 2000, after some competition with Singapore Airlines, Air New Zealand announced the purchase, for NZ$744 million, of the 50 percent of Ansett Australia that it did not already own.

Developments since 2000

In 2000, Singapore Airlines increased its stake in Air New Zealand, purchasing 8.3 percent of the shares and getting New Zealand government approval to acquire up to 25 percent of the national carrier. Also in that year, BIL announced its intention to sell its shares in Air New Zealand to Singapore Airlines and by August of that year, Singapore Airlines had acquired the maximum possible holding of 25 percent in Air New Zealand.[13]

In November 2000, the Open Skies Agreement gave treaty (more formal) status to the SAM arrangements signed four years earlier. The agreement allowed New Zealand and Australian airlines to operate in the Tasman, and further afield to third countries, without restriction. Previously, beyond (fifth freedom) services were restricted.[14]

The agreement also covered freight transportation, with both countries being able to operate dedicated freight services using seventh freedom rights. The agreement allowed them to operate from any international airport in New Zealand and Australia to third countries.

The situation developed further in 2001, when, as already noted, Tasman Pacific's operation in New Zealand, trading as Qantas New Zealand, went into receivership requiring large increases in domestic capacity by Air New Zealand to meet demand.

Only a month later, Qantas looked to once again acquire a significant shareholding in Air New Zealand through a purchase of holdings by BIL and Singapore Airlines. One of the outcomes was a recommendation by the New Zealand Government to

[13] NZ Government policy (but not legislation) precludes any one foreign airline owning more than 25% of a New Zealand international airline. Government approval for foreign shareholding is required in part to protect the foreign landing rights of the national carrier. In the case of New Zealand, where the air services arrangements are not open, the Minister of the Transport under the Civil Aviation Act allocates these rights. Air New Zealand is the de facto recipient of these national traffic rights ("freedoms").

[14] http://www.ministers.dotars.gov.au/ja/releases/2000/november/a182_2000.htm [see also http://www.executive.govt.nz/speech.cfm?speechralph=33059&SR=0 and http://www.beehive.govt.nz/ViewDocument.cfm?DocumentID=14662]

recapitalise Air New Zealand, via a placement of shares to Singapore Airlines, and additional capital-raising. Because of the government's policy on foreign airline ownership, a transaction that could potentially have lifted ownership by Singapore Airlines from the previous 25 percent up to 49 percent, would have required significant regulatory clearance. However, as it happened, Singapore Airlines pulled out of the race by announcing it was unwilling to pay the share price being offered.

By June-July 2001, Ansett Australia was making losses of around A$1.3 million per day. There were two proposals to salvage Ansett. Air New Zealand offered to sell Ansett to Qantas for a dollar, but Qantas was unwilling to take over Ansett's debt and so declined. The Australian Government was asked if it would indemnify Ansett while an attempt was made to restructure it into a LCC, but declined. Losses as a result of Ansett hit Air New Zealand's overall position hard. Air New Zealand was making a net annual loss of NZ$1.425 billion. Ansett Australia was placed into voluntary administration.

The crisis position of Air New Zealand was followed by a move to recapitalise the airline via intervention from the New Zealand Government. This saw a two-phased loan and equity investment of NZ$885 million. This move took the government's stake in the airline to 83 percent - and a subsequent reduction in shareholdings by BIL and Singapore Airlines to 5.2 percent and 4.3 percent respectively. The recapitalisation was complete in early 2002.[15]

As noted above, Virgin Blue, a subsidiary of the UK airline, Virgin, gained access to the Australian market and more than filled the vacuum left by the closure of Ansett. Virgin Blue also announced its intention to set up a subsidiary of its own, Pacific Blue, to begin operations across the Tasman and on other international routes.

Proposed alliance, Air New Zealand/Qantas

In 2002, Air New Zealand and Qantas proposed a strategic alliance in which Qantas would buy 22.5 percent of Air New Zealand's shares in return for seats on the Air New Zealand Board of Directors. The proposal also went further. It was designed to allow Qantas and Air New Zealand to rationalise their flight schedules in a co-operative fashion on domestic routes in New Zealand and on international routes they currently both fly. The proposal involved an asymmetric profit-sharing arrangement whereby Qantas would take around 20 percent of the profits of Air New Zealand flights. It has been estimated that this profit-sharing arrangement would result in a significant financial transfer from Air New Zealand to Qantas.[16] Air New Zealand has a very high[17] market share of New Zealand domestic flights and seats and a high[18] market share on trans-Tasman flight routes[19] so the proposal would have at least some upward effect on consumer prices.

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[15] Relevant papers are available at http://www.treasury.govt.nz/release/airnz/

[16] Hazledine, Tim (2004), *Application of the Benefit Test to the Air New Zealand/Qantas Case.* N.Z. Economic Papers 38(2), pp. 279-298.

[17] Numerical values of these shares remain confidential in competition authority hearings but they are known to be very high by international standards? Market shares of 70-80 percent are common for large New Zealand companies. Typically, monopolists in larger countries have markets shares around 40 percent.

[18] As above

[19] See http://www.btre.gov.au/statistics/aviation/international.aspx for statistics

On 9 December 2002, the New Zealand Commerce Commission (NZCC) received two interdependent applications for authorisation from Air New Zealand and Qantas. The first application, made by Qantas under section 67(1) of the Commerce Act, related to a proposed “share price agreement” whereby Qantas would acquire 22.5 percent of the voting equity in Air New Zealand. The second by Air New Zealand and Qantas, made under section 58 of the Commerce Act, related to the proposed implementation of a “strategic alliance arrangement” between the two airlines.

The two airlines adopted a similar approach in Australia with applications to the NZCC’s counterpart, the Australian Competition and Consumer Commission (ACCC).

Both competition authorities declined to give clearance to the proposal under their respective Acts, after lengthy analysis and discussion with the airlines and other related market participants (including airport owners and travel agents). The NZCC[20] and the ACCC argued that the proposed alliance would substantially reduce competition in the markets to an unacceptable level (according to the law). In the New Zealand case, the NZCC found that this “net detriment”, as it is technically called, would not likely be outweighed by public benefits in increased tourism, improved Air New Zealand international competitiveness, increased aircraft engineering activity in New Zealand and improved airline services.

Qantas and Air New Zealand appealed both decisions in 2004. The New Zealand High Court dismissed the appeal against the NZCC. Both airlines announced they would not appeal the appeal to an even higher authority.[21] It was a different story in Australia. The Australian appeal authority, the Australian Competition Tribunal subsequently upheld the airlines appeal in Australia. However, since approval was not obtained in both jurisdictions, the proposal cannot proceed.

Factors argued to the New Zealand authorities

Both parties to these proceedings used a considerable amount of economic analysis in their arguments and reportedly spent around $50 million on legal and expert advice.[22] The frameworks they used were also largely common. For example, a standard benefit/cost approach was used – though it is called a benefit/detriment approach in proceeding like this. Parties also used a similar economic model to estimate the degree to which prices might rise and costs decline under the proposed alliance – the Cournot oligopoly model.

The standard procedure adopted in these cases of proposed mergers and acquisitions is provided on the NZCC website www.comcom.govt.nz. It involves firstly an assessment of the structure and current performance of the markets involved, an assessment of how the proposal would likely alter the markets and an assessment of the benefits and detriments to New Zealanders that would result.

[20] The draft and final determinations of the NZCC, together with background material, can be found on their website www.comcom.govt.nz.

[21] Judgment (No 6) of Rodney Hansen J and Kerrin M Vautier CMG Lay Member, High Court of NZ, Auckland Registry, 17 September 2004. CIV 2003 404 6590.

[22] Hazeldine, op cit.

The exercise is a pure economic efficiency argument – changes in the distribution of income and wealth are ignored. Furthermore, every attempt was made to quantify benefits and detriments. The parties made quantitative assessments of the detriments associated with higher ticket prices and the associated reduction in demand and the value of increased engineering services and tourism numbers. No attempt was made to quantify the improved status of Air New Zealand as national carrier nor was there an attempt to quantify the improved international competitiveness that might result from the proposal.

Your task

With this background your task is now to weigh up the pros and cons of actions that the New Zealand government might take. Should they let the status quo prevail or not, as outlined at the beginning of the case study.

Exhibit 1

Airline financial statistics

2004 Financial Year

Company	Year end	Sales (USD) $M	Net income USD ($M)
Full service airlines			
Air New Zealand	June	$2,209	$105
Continental Airlines	December	$8,870	$38
Japan Airlines Corp	March	$18,286	-$839
Lufthansa AG	December	$20,029	-$12,351
UAL	December	$13,724	-$2,809
Delta Airlines	December	$13,303	-$773
All Nippon	March	$11,526	$234
Aer Lingus	December	$1,194	-$124
Air Canada	December	$6,463	-$1,442
US Airways	December	$5,312	-$174
Northwest Airlines	December	$9,510	$248
British Airways	March	$13,933	$240
Virgin Express	December	$260	-
Swiss International Airlines	December	$3,226	-$553
Qantas	June	$7,832	$448
Singapore Airlines	March	$5,796	$504
American Airlines	December	$17,440	-$1,228
Air France	March	$15,018	$113
Alitalia	December	$5,405	-$652
Low cost carriers			
Ryan Air	March	$1,322	$254
JetBlue	December	$998	$104
AirTran	December	$918	$101
WestJet	December	$664	$47
American West	December	$2,255	$57

Source: www.hoovers.com

Exhibit 2 Air Freedoms

Traditionally, an airline needs the approval of the governments of the various countries involved before it can fly in or out of a country or even across another country without landing. Prior to World War II, this did not present too many difficulties since the range of commercial planes was limited and air transport networks were in their infancy and nationally oriented. In 1944, an International Convention was held in Chicago to establish the framework for all future bilateral and multilateral agreements for the use of international air spaces. Five freedom rights were designed, but a multilateral agreement went only as far as the first two freedoms (right to overfly and right to make a technical stop).

Freedoms are not automatically granted to an airline as a right; they are privileges that have to be negotiated. All other freedoms have to be negotiated by bilateral agreements, such as the 1946 agreement between the United States and the UK, which permitted limited "fifth freedom" rights. The 1944 Convention has been extended since then, and there are currently nine different freedoms (see above picture):

- **First Freedom**. The right to fly from a home country over another country (A) en-route to another (B) without landing. Also called the transit freedom.
- **Second Freedom**. The right for a flight from a home country to land in another country (A) for purposes other than carrying passengers, such as refueling, maintenance or emergencies. The final destination is country B.
- **Third Freedom**. The right to carry passengers from a home country to another country (A) for purpose of commercial services.
- **Fourth Freedom**. The right to fly from another country (A) to a home country for purpose of commercial services.

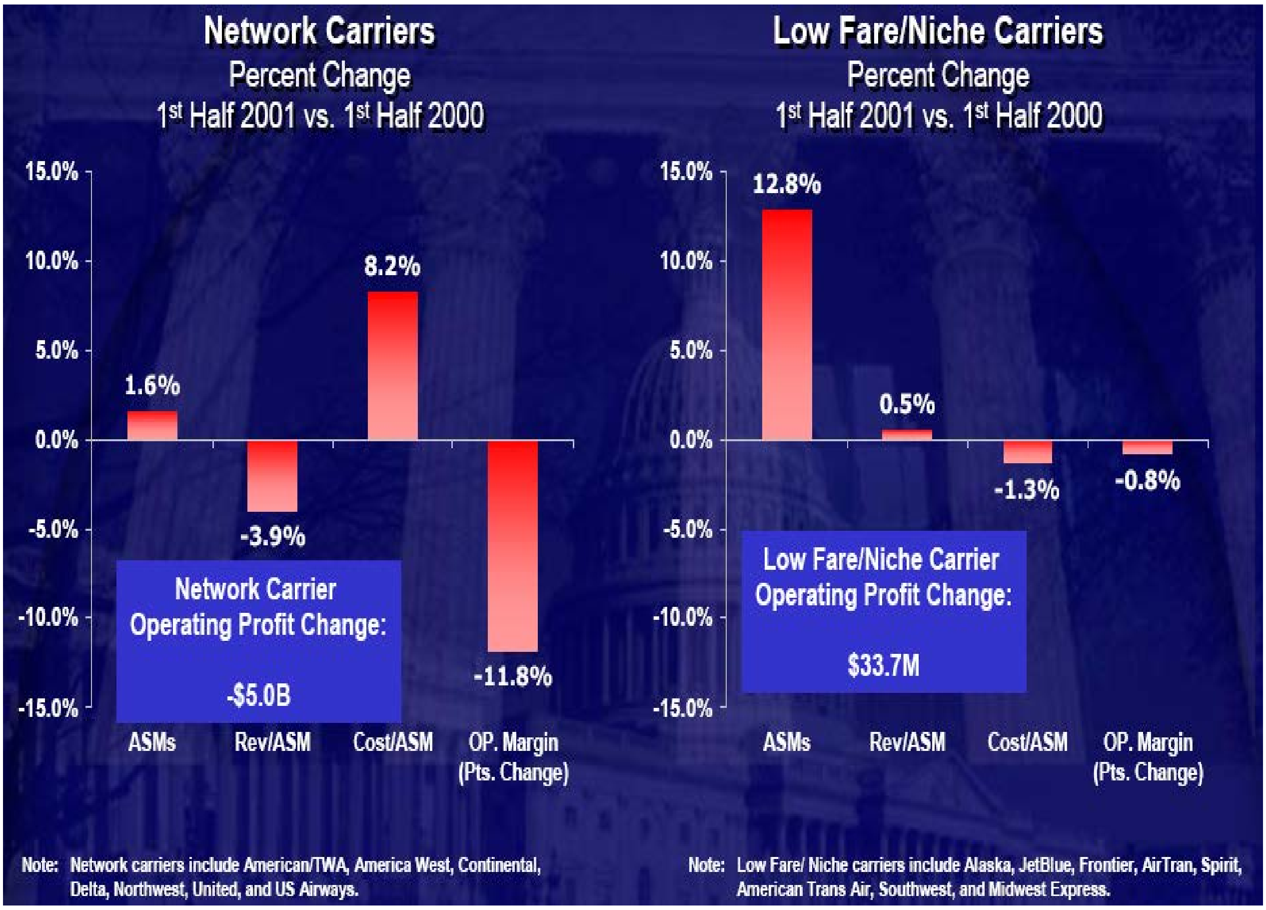
Third and Fourth Freedoms are the basis for direct commercial services, providing the rights to load and unload passengers, mail and freight in another country.

- **Fifth Freedom**. This freedom enables airlines to carry passengers from a home country to another intermediate country (A), and then fly on to third country (B) with the right to pick passengers in the intermediate country. Also referred to as "beyond right". This freedom divided into two categories: Intermediate Fifth Freedom Type is the right to carry from the third country to second country. Beyond Fifth Freedom Type is the right to carries from second country to the third country.

- **Sixth Freedom**. Not formally part of the original 1944 convention, it refers to the right to carry passengers between two countries (A and B) through an airport in the home country. With the hubbing function of most air transport networks, this freedom has become more common, notably in Europe (London, Amsterdam).
- **Seventh Freedom**. Covers the right to operate a passenger services between two countries (A and B) outside the home country.
- **Eighth Freedom**. Also referred to as "cabotage" privileges. It involves the right to move passengers on a route from a home country to a destination country (A) that uses more than one stop along which passengers may be loaded and unloaded.
- **Ninth Freedom**. Also referred to as "full cabotage" or "open-skies" privileges. It involves the right of a home country to move passengers within another country (A).

Source: Http://www.people.hofstra.edu/geotrans/eng.ch3en/conc3en/arifreedom.html downloaded on 23/03/05

Exhibit 3: Critical indices underlying the industry's operating performance, United States



Source: http://spacestation.mit.edu/airlines/conferences/DC-2002/documents/16-DC2002-Swelbar.pdf

Exhibit 4: Current issues with airlines

- "The woe afflicting the North American airline industry spread to three low-cost carriers yesterday (27th October 2004) with AirTran, WestJet and American West all reporting quarterly losses" – *Financial Times, p.24, 28 October 2004*
- "Low cost carriers are joining the big "legacy" airlines – American Airlines, United Airlines and others – in claiming a hard time making those fuel payment, the latest headache for an airline industry that has been struggling to regain profitability since the 9/11 terrorist attacks" – *Newsday, 29 October 2004.*
- Air Canada is trying to "beat the low cost carriers at their own game" but "the lower cost structure and new business model will only fly if the deferral government loosens regulations on the airline industry…" – *Financial Post, 16 November 2004.*

"The demand for low-cost travel has so far shown no signs of abating, and airlines are still expanding to match it. According to figures from the Association of European Airlines (AEA) total capacity grew by around 20% in 2003 as the travel market revived." – Economist Intelligence Unit – *Country Monitor Europe, 29 November 2004*

- The market share for low cost carriers in Europe is still some way behind that of their US counterparts.
- Low cost airlines only really introduced in Europe after liberalization of the domestic airline market was completed in 1997 – with Ryanair and easyJet mimicking American budget airlines such as Southwest and ValuJet. They have orders out for around 207 new planes. Europe has around 50 low cost carriers with an estimated share of short haul bookings of around 25%.
- *In the United States, since 2000 low cost airlines have expanded capacity by 44%. They currently have orders out for 400 planes, whereas the old network carriers only have orders for 150.* Most of the expansion has come from JetBlue, Frontier and AirTran; Southwest, which accounts for half of the sector is somewhat less bullish at present in its expansion than it has been, although it is still returning to a growth path of 10% per year. It is the fourth largest American airline by passenger numbers. They are revenue restricted though through their inability to raise prices too far, and the impact of fuel price hikes. *It is estimated that low cost competition exists on 70% of American routes. Their market share has grown to around 30% nationally. – The Economist, "Turbulent Skies", July 8th 2004.*
- US carriers trying to minimize cost per available seat mile or CASM. American Airlines now spends about 9.4 cents for each seat on every mile it flies, down from 11.7 cents a year ago, but far high than low cost competitors like Southwest (7.6 cents), ATA (6.9 cents) and JetBlue (6.4 cents). – *"Airlines struggle with paths to profit", http://msnbc.msn.com/id/3679292/*

Exhibit 5 – Domestic air services reforms in New Zealand

The New Zealand Aviation Industry has undergone significant changes over the past few years. Domestic air services have been progressively deregulated leading to increased competition and rationalisation of services.

Legislative Framework

From 1951 to 1983 a "quantitative" air services licensing regime applied whereby an independent Air Services Licensing Authority approved entry into the air transport and aerial work industries, and also controlled expansion of areas and routes, aircraft capacity and fleet size and pricing. ASLA was required to consider whether or not proposed services were in the "public interest" and existing operators had rights of objection leading to an adversarial environment. Farmers dissatisfaction with licensing of aerial spraying and topdressing in the 1970's led to the advent of farmers aerial cooperatives utilising "split invoicing" (for aircraft, pilot and loader) to circumvent the definition of an air service under the Air Services Licensing Act 1951. Another notable attempt at circumvention to establish a main trunk air transport service relied on the exemption of Aero Clubs from licensing, but was declared illegal by the High Court before the service could commence.

In 1980 the Government instructed the Ministry of Transport to undertake a review of domestic air services. Government policy was announced in the White Paper "Domestic Air Services Policy of New Zealand" in November 1982 and was implemented in the Air Services Licensing Act 1983.

The 1983 legislation introduced a "qualitative" regime in which the principal consideration of ASLA was operator competence. ASLA was required to issue a license if it was satisfied that the proposed service was likely to be "safe and reliable". Once entry to the industry was gained, the operator was required only to notify ASLA of changes to the aircraft fleet, areas or routes served and the management of the service. Thus operators had considerable flexibility to respond to market demand without the necessity for prior approval. Pricing approval was also dispensed with in 1983 and industry specific "predatory pricing" protection was later replaced by the provisions of the Commerce Act 1986.

The immediate effects of the new legislation were a significant increase in the number of aerial work operators as pilots employed by the large topdressing companies sought their own licenses, in several cases assisted by their employers. In the air transport sector, there was not a significant change in the number of commuter airlines, however those airlines utilised the freedom of the legislation to vary routes and capacity, and price discounting became more prevalent particularly on routes where Air New Zealand faced direct competition from commuter airlines.

Overseas Investment

In June 1986 the Air Services Licensing Act 1983 was amended to remove specific restrictions on overseas investment in domestic air services. Policy guidelines were issued to the Overseas Investment Commission (OIC) that up to 50 percent investment by foreign airlines was acceptable, thus the subsequent application by Ansett Transport Industries Pty Ltd to hold 50 percent of the shares in Bilmans Management Ltd (Ansett New Zealand) was approved. Ansett New Zealand replaced Newmans Airlines in the tourist market in 1987 and its entry into direct main trunk competition with Air New Zealand in July 1987 stimulated significant improvements in service quality and further price discounting. A chart of average airfare movement is attached.

In February 1988, the Government approved a temporary increase in Ansett Australia's shareholding in Ansett New Zealand to 100 percent, provided a return to 50 percent occurred within two years if a suitable New Zealand shareholder could be found. However in September 1988, the Government decided to remove the previous 50 percent limit on investment by foreign airlines and the OIC may now approve up to 100 percent investment by any foreign airline in domestic air services.

Rationalisation of services

During 1991, the major domestic airline, Air New Zealand, rationalised it's provincial services, by withdrawing the long-serving F27 "Friendship" aircraft from provincial routes in favour of commercial alliances with two commuter airlines, Air Nelson Ltd and Eagle Airways Ltd, in which it acquired a 50% shareholding. These airlines replaced the Friendship services with smaller Bandierante, Metro and Saab aircraft under the Air New Zealand "Link" brand. In 1996, the 100% owned subsidiary Mt Cook Airlines joined the other "Link" airlines with it's new ATR-72 aircraft and Air New Zealand acquired 100% of Air Nelson, which now predominantly operates Saab 340 aircraft.

Similarly, Ansett New Zealand sought feeder traffic by entering into alliances with other commuter airlines in the North and South Islands under the "Tranzair" identity, although without ownership considerations. In 1996 the Tranzair airlines were renamed "Ansett New Zealand Regional.

Review and Repeal of Legislation

A review of the Air Services Licensing Act 1983 was undertaken by the Ministry during 1989. The outcome of the review was that any future entry or exit controls on the aviation industry should be *safety related* and that there was no longer any justification for economic regulation. The Air Services Licensing Act 1983 was repealed on 1 September 1990 by the Civil Aviation Act 1990.

Operators continue to have complete commercial freedom to determine areas, routes, fleets, capacity and pricing, without Government intervention and any entry certification or approval by the Civil Aviation Authority (CAA) is entirely related to operational and airworthiness requirements.

New Zealand Ministry of Transport, 1999