

11 October 2013

New Zealand Productivity Commission
PO Box 8036
The Terrace
Wellington 6143

By email: Geoff.Lewis@productivity.govt.nz

Dear Mr Lewis,

Boosting Productivity in the Services Sector

The Commission has invited further submissions on two topics identified for detailed investigation. This submission addresses one of those topics - stimulating services competition – with particular reference to the market for air transport services on regional air routes.

The Commission has noted that several attributes typical of services markets can limit competition. These include high search costs and high switching costs. The Commission aims to identify services markets with those attributes and where government action could empower consumers and stimulate competition.

Our submission is that there is a more fundamental issue which merits the Commission's attention with regard to regional air services, and that is the lack of airline competition. In this case there is simply no ability to switch.

This is potentially an area where government action could empower consumers and stimulate competition (or outcomes similar to a market with competition). In turn the stimulation of competition will provide a significant boost to growth and productivity. The lack of competition on regional air routes can be contrasted with the situation on Auckland-Wellington-Christchurch-Queenstown routes where varying degrees of competition between Air New Zealand (Air NZ) and Jetstar apply.

The importance of regional air connectivity

In a recent article for the Infometrics in-house newsletter¹, the company describes the significance of regional air links:

Air connectivity between geographically dispersed parts of New Zealand provides an economic enabling effect for entrepreneurial activity. In remote parts of the country, that do not have a location advantage, the availability of air travel helps create more efficient access to markets, people, ideas, and capital.

¹ Paterson, B <http://infometrics.co.nz/#news>

Even as the world becomes more digitally connected, there is still, at times, no substitute for face-to-face meetings, particularly in multilateral discussions between various parties. Efficient air connections can improve worker productivity by reducing downtime between meetings and freeing up more time to focus on other important tasks.

Good air linkages can also overcome issues relating to scale, by making it easier for small firms in regional New Zealand to connect with other firms across the country. This can allow geographically-removed firms in different regions to collaborate on projects.

As well as facilitating the movement of workers, regional air services also provide more options for freighting high value-added goods. This is particularly relevant for exporters of perishable goods, such as fresh seafood and cut flowers, where time to market is of the essence.

Finally, it would be remiss to ignore the role of air travel in promoting tourism. Convenient air linkages between smaller regions and cities raise the appeal of more remote locations for weekend getaways or stop-offs on a tour through the country.

Together, all of these enabling functions of air connectivity can help make it more attractive for businesses to locate in a region. In a similar vein, employers in well-connected regions, may find it easier to convince skilled staff to relocate, if staff know they are just a short flight away from friends and family elsewhere.

The economic and social contribution of air transport

NZ Airports has commissioned research into the economic and social contribution of airports. In effect this is a proxy for the contribution of air commerce (passenger and freight) which is enabled in a particular region by its airport. Our consultants Market Economics² have summarised their draft findings as follows:

In New Zealand, airports and air transportation employed over 12,645 people (measured using modified employee counts – MECs). Employment by the airports has increased by 49 per cent since 2000.

The areas surrounding airports are important business locations. Conceptually, these areas have a number of levels starting with the airport (as a business entity) moving to the environs which includes primary, secondary and tertiary activities depending on their relationship with the airport. Primary activities include firms which are located in the airport environs because they tend to co-locate with airports (these firms have a clear relationship with the airport). Secondary activities rely on air transport or access to air transport infrastructure but are not related to airport operations. The final component, tertiary activities, includes firms servicing primary activities, secondary activities as well as firms which are located within the airport environs because the area is a business location and not because of the airport's location.

² Market Economics, *The Economic and Social Contribution of New Zealand Airports*, in preparation, October 2013

Businesses located within the airport environs generate around \$4.6bn or 3.6% of NZ's VA³. More than 90 per cent of this is associated with the airport i.e. supporting the airport activities or using the airport facilities. As expected a large share of this activity is concentrated around the main airports with Auckland and Christchurch capturing 22 per cent and 17 per cent of the economic activity in airport environs. Nationally, the airport environs host some 74,400 employees (MECs); 3.2 per cent of NZ's employment.

Economic Contribution

In addition to the airport and environs, airports enable connections. These connections allow other economic activities such as tourism and international trade. These activities have their own supply chains generating economic activity.

The airports provide crucial economic connections with a long reach that affects a large share of the economy. The total economic contribution of the airport sector can be viewed in different ways depending on which effects are included. The following table summarises the economic contribution (total effect) of the main components.

Summary of Effects			
Component		VA Effect (\$bn)	Jobs Supported (MEC)
Airport Business	Airport businesses	0.4	7,740
Environs (Core and Related)	Related activities	6.4	78,810
Trade (Imports & Exports)	Imports and exports	13.1	150,640
International Tourism	Foreign tourism	13.4	253,920
Domestic Tourism	Domestic	3.5	50,850
Business Travel	Return on investment	2.2	32,690
TOTAL		39.0	574,650
Wider Environs	Less clear relationship	9.9	135,380
TOTAL		48.9	710,030

It is clear that airports make a substantial contribution to NZ's economy. The airport environs are important business concentrations supporting an array of businesses. The above points to three important points:

- ***Tourism activity and international connections*** are critical and the airport network provides a key chain in this link. Around a third of the airports' overall effects arise due to tourism movements.
- ***International trade and business travel*** is the second main source of economic contribution that is facilitated by the connections. These effects are associated with NZ-based business and production activities in contrast to tourism which relies on NZ natural capital. It is anticipated that the

³ The economic activity was estimated using Statistics New Zealand's Annual Enterprise Survey. Value Added figures from the AES were regionalised based on employment with allowance for regional productivity differences. The 25 region MRIO informed the regionalisation process.

overall value of this component will grow in the medium term. These industries often require good international connections.

- ***The wider environs*** account for a quarter of the economic effects of airports pointing to important business location effects.

Social Contribution

At a core level, the airports play an important social role by connecting individuals, families and communities from different locations. In New Zealand these connections are especially important, assisting in reducing the isolation of distance.

The main feature of today's international travel is the relative ease and speed with which people can move around the globe. Reducing travel time unlocks opportunities making it possible to such as those outlined in the following table.

Other Opportunities	
Opportunity	Description
Social Connectivity	<ul style="list-style-type: none"> • Airports enable different type of travel. For example, visiting families, friends and relatives. A third of departures (New Zealanders travelling abroad) is classified as VFR travellers. • Migration is supported. During the last year (year ending August 2013), unadjusted figures showed that there were 90,300 permanent and long-time (PLT) migration arrivals to NZ.
Sport events	A number of sport competitions are now between franchises in different countries. This translates into more games between different teams increase exposure to different regions lifting the profile of destinations and potentially legacy effects (improvements in stadium infrastructure, road infrastructure when hosting large events)
Artists and performers	International artists can include NZ in their performance schedule giving residents an opportunity to view international artists and performers. Similarly, NZ artists can now perform on the international stage.
Cultural Exchanges	Air transportation offers viable, low risk, alternatives to sea transportation. This means that valuable cultural artefacts and art pieces can be transported around the world giving a wide audience the access to culturally valuable artefacts.
International Education	A recent study for Education New Zealand indicates the economic value of international students at over \$2.6bn direct expenditure. However, in addition the economic value of this sector it generates an array of wider social effects such as developing an student alumni, bringing foreign cultures to NZ shores, and contributing towards the competitiveness of NZ education institutions, this creates spill-over benefits NZ residents accessing the world class services.
Unlocking research opportunities	The United States Antarctic Service (USAS) is an organisation of the United States government which has presence in Antarctica. Part of this service is delivered via Christchurch and the Christchurch International Airport. The body's goals are "...to expand fundamental knowledge of the region, to foster research on global and regional problems of current scientific importance, and to use the region as a platform or base from which to support research. A 2007 economic impact study put the Contribution of Antarctic Related Activities to Canterbury and NZ at \$155m.
Community wellbeing	In 2008 there were at least 41 helicopters and 13 fixed-wing aircraft providing ambulance services throughout New Zealand. Of the 41 helicopters, 18 are 'dedicated' emergency helicopters. The annual budget of the air rescue service is estimated at \$40m across NZ. Indications are that the potential 'community value' of the fixed wing service is estimated at over \$2.8bn.
Royal NZ Air Force	The RNZAF delivers a wide range of services. This RNZAF's budget of \$410m is larger than the combined expenditure of the civilian airports. The RNZAF delivers important services including Maritime Search and Rescue (MSAR), transporting government officials (thereby supporting democracy) and providing relief work during disaster periods. In addition, the RNZAF provides surveillance assisting the Ministry of Primary industries to protect the NZ Exclusive Economic Zone. The EEZ has been valued at over \$4bn ₂₀₀₉

Regional Importance

The modelling suggests that the airports are important to the local economies and this importance stems from the size of the airports (as businesses) and the nature of airports' facilitated effects. Airports are important in the local context because:

- *They tend to be (medium to) **large businesses** with strong local value chains,*
- *The airport environs are **important business concentrations**. The firms located in the airport environs support either airport or the associated operations thereby assisting the airport system to operate without interruption. This smooth operation is needed to ensure that the wider and facilitated effects are maximised and that firms using the system can be confident that it will deliver. Some firms in the airport environs rely on air transport as a key business input. These firms' offshore (or outside of the region) connections generate and support business activities locally and need to be protected and enhanced by having an efficient airport system.*

The airport and airport environs can be seen as the origin of the facilitated effects but the effect of these two components is small when compared to the total facilitated effects. The 'total airport' effect is often hidden and removed from the airport. The facilitated effects are around four times larger than the effects associated with the airport and environs. In some cases the regional facilitated effects can be up to ten times greater than the airport effect. This pattern is evident across all the airports but as expected, in the smaller regions where airports do not provide high connectivity (tourist movements, imports or exports) the facilitated effects are smaller.

Importantly, the facilitated effects occur in the wider economy so airports have little direct influence over those effects. By delivering high quality services the airport can enhance the growth potential of their regions, in turn creating addition demand for air travel. This means that future proofing airports will be critically important. Such future proofing relates to the way airports operate as well as the protecting their immediate environs (land resource, flight paths etc.) and unlocking latent development opportunities in their local economies. This will be critical because:

- *The presence of an airport can be a critical factor in attracting inward investment,*
- *Firms within the airport environs may wish to expand their operations,*
- *Growing exports is a key objective (outlined in central government's Business Growth Agenda) and airports clearly influence and support import and export trade.*

- *Efficient airport services enhances economic competitiveness by reducing transaction costs for companies involved in international trade,*
- *Airports play a critical role in making tourism possible.*

Airports provide a critical service linking regions with business opportunities in other regions.

The most important role of airports is related to the connectivity they underpin. At the core, these connections are about moving freight and people between points. These connections provide the mobility enabling interactions between businesses, individuals, cultures and communities. Allowing businesses and entrepreneurs to connect allow them to share ideas, link production processes to generate wealth and therefore lift the standard of living.

Going forward, airports will be expected to be more than simple infrastructure providers. Airports will be expected to contribute to the transportation value chain by driving down costs, reducing time spent in the transport system while making an acceptable return to shareholders.

The detailed justification for these conclusions, including regional breakdowns, is available in the full report by Market Economics.

Effects of competition

In support of the Commission's view that competitive markets are important drivers of productivity we note the analyses of Hazeldine (2007)⁴ and Keshav (2008)⁵ which illustrate the significant scale of fare reductions achieved on contestable routes compared with monopoly routes.

Hazeldine analysed prices for 1001 flights observed in 2004 and 2005 on eight New Zealand and twenty one Trans-Tasman routes. He found that for the New Zealand sample, the fare difference between monopoly and duopoly routes was 29%.

Keshav looked at price data for New Zealand domestic flights in 2006 and 2007 (a period of competition between Qantas and Air NZ) and found:

The average price analysis revealed that fares on monopoly routes are on average up to 20% higher than on a symmetric duopoly, a finding which implies that greater competition does lead to lower average fares. It is also found that routes on which Qantas operate have fares up to 22% lower than routes on which Air New Zealand has a monopoly. Hence if the proposed alliance of Air New Zealand and Qantas was given approval by the authorities, there would have been substantial lessening of competition on domestic New Zealand routes.

In the current environment the consumer benefits on the domestic trunk routes where Air NZ and Jetstar are both active are readily apparent. For example:

⁴ Hazeldine, T. (2007), *Pricing, Competition and Policy in Australasian Air Travel Markets*.

Sourced from <http://www.business.otago.ac.nz/econ/seminars/Abstracts/Hazeldine.pdf> 11 October 2013

⁵ Keshav, P (2008) *Pricing and Competition in the New Zealand Air Travel Market*,

Sourced from <http://www.airways.ch/files/2008/0808/001/part2.htm#42> 9 October 2013

- Consumers have a choice between a 'full service' model – Air NZ – which offers lounge facilities, kiosk check-in and enhanced in-flight service on some flights (as well as 'seat only' options) versus Jetstar which promotes itself as a 'low cost' carrier without airline lounges and with potentially longer queuing times
- Both carriers are introducing wider choice and innovative services – for example Air NZ has introduced late night low fare options (the 'Nightrider') while Jetstar has just announced options which bundle Qantas air points with food vouchers and increased flexibility to change flights without penalty, as well as promoting a 'Friday Fare Frenzy' featuring \$25 one-way fares.

Unsurprisingly, as any traveller to regional centres can attest, a far more limited range of options and fares is available on Air NZ's monopoly routes.

Competition law

In its earlier report (July 2013) The Commission noted that competition policy is based on the notion that well-functioning competitive markets are an important driver and determinant of overall economic performance and the choices and benefits available to consumers. We agree with the identification of competition as one of the most important drivers of productivity, and we draw the Commission's attention to the apparent failure of existing competition law to protect or promote consumer interests and the public benefit in the regional air transport market.

While a proposed merger between Air NZ and Qantas was analysed by the NZ Commerce Commission in 2003 and found not to produce public benefits that outweighed the lessening of competition⁶, complaints by Origin Pacific of anti-competitive behaviour by Air NZ which had similar detrimental effects for consumers were found by the Commerce Commission⁷ to be "a competitive response to a rival in the marketplace" and "unlikely to have been materially different from what might have occurred in a competitive market".

The outcome has been that there is no competition at the airline level (i.e. scheduled passenger flights using pressurised aircraft) on regional routes, to the considerable detriment of regional economic growth and productivity.

It therefore seems to NZ Airports that the current Commerce Act provisions relating to predatory or anti-competitive behaviour are not effective in this market, and/or that there are characteristics of the market that render sustainable competition difficult.

With regard to the market, Paterson⁸ commented:

The issue as to whether these regional connections are offered by airlines in the first place comes down to profitability and the price an airline can charge per air kilometer.

⁶ Qantas-Air New Zealand Final Determination, October 2003, <http://www.comcom.govt.nz/business-competition/anti-competitive-practices/anti-competitive-practices-authorisations-register/airnewzealandqantas/>

⁷ See Attachment 1 and 2

⁸ Paterson, B <http://infometrics.co.nz/#news>

Although from a consumer's perspective having competition is vital for keeping air prices low, Air New Zealand's incumbent advantage in regional centres means that it is in a dominant competitive position. The relatively low scale of regional flights makes it uneconomic for new entrants to build a comprehensive regional network. As a result, Air NZ has been left in the stronger position of being able to sell tickets to people flying on both regional and main routes, while Jetstar needs to generate its profits from passengers flying between main-trunk airports.

A case for transparency

In its July 2013 Interim Report the Commission considered the value of transparency in promoting competition, and possible roles for the government or other agencies to facilitate greater competition.

Auckland, Wellington and Christchurch Airports have some experience with the information disclosure regime in Part 4 of the Commerce Act which brings comprehensive transparency to airport charges, service quality and investment. When that regulatory regime is fully implemented there will be annual summaries and analyses by the Commerce Commission which will assist interested parties to assess whether the objectives of the regime are being achieved. In essence the goal is to ensure that suppliers of goods and services (in this case the major airports) have similar incentives and pressures to suppliers operating in competitive markets. The information disclosure regime for airports, even in its formative years, is proving effective and appropriate.

Proposal

NZ Airports submits that the role of competition in regional air services should be considered in further detail by the Productivity Commission as part of this inquiry. The potential benefits are very significant, and existing regulatory tools in tandem with the characteristics of the regional air market have proven not to be adequate to protect the public interest and promote productivity.

We will be happy to discuss this issue further with the Commission.

Yours sincerely

Kevin Ward
Chief Executive,
NZ Airports

Attachment 1

Origin calls for investigation into Air NZ pricing

By [Liam Dann](#) @liamdann

Origin Pacific says Air New Zealand is muscling in on routes. Picture / Wanganui Chronicle.

Regional airline Origin Pacific will ask the Commerce Commission to investigate Air New Zealand for predatory pricing.

The Nelson-based carrier yesterday described Air NZ as "the Telecom of the skies" and claimed it was the subject of ongoing action by the Government-owned national carrier "aimed at regaining its monopoly status on domestic routes".

Air NZ began new services in April on two Origin Pacific routes – Nelson to Hamilton and Nelson to Palmerston North.

Origin is unhappy that it is chartering aircraft to fly those routes.

"Air NZ is complaining about unfair competition on the transtasman route and seeking support for code-sharing, yet at the same time it goes to the expense of leasing planes to take on its only real competitor in regional services," said Origin spokesman Brendon Burns.

Origin Pacific will also ask the commission to look at Air NZ's pricing on three routes.

Last week, Air NZ announced special fares on the Wellington–Blenheim, Auckland–Nelson and Nelson–Christchurch routes, all of which are serviced by Origin Pacific.

"This is the pattern," Burns said. "Air NZ attempts to squeeze out the competition on routes where there is an alternative, but you pay through the nose if you live in Whangarei or Invercargill, or any of the other centres not served by Origin Pacific."

Origin Pacific will file a formal application with the commission in the next fortnight.

Air NZ said it was disappointed by the move, describing it as a waste of time. The company's short-haul airlines general manager, Norm Thompson, said it had been developing its domestic service for three years in response to demand. Some of that demand was actually driven by Origin Pacific's decision to cut back services on many routes.

He said Air NZ was a supporter of Origin and was one of the creditors that wrote off substantial debts when it nearly went bankrupt in 2004.

This is the second time Origin has taken Air NZ to the commission. In 2003, it claimed that the larger airline was being anti-competitive by announcing a Hamilton-Christchurch service eight days after Origin Pacific unveiled its plans for the route.

After more than two years looking into the case, the commission eventually disagreed.

"Frankly, it's quite disappointing to see Origin Pacific indicating it wants to waste more of everyone's time," Thompson said.

Origin Pacific flies services to Auckland, Hamilton, Napier, New Plymouth, Wanganui, Palmerston North, Wellington, Blenheim, Christchurch and Nelson.

It is starting a new service from Tauranga to Christchurch on June 28.

By [Liam Dann](#) @liamdann
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The New Zealand Herald

Commission says Air NZ not restricting competition

The Commerce Commission has found Air New Zealand was merely showing a competitive response when it introduced direct flights between Christchurch and Hamilton, following plans by Origin Pacific Airways to do the same.

Origin Pacific had complained to the Commission that Air New Zealand took advantage of its market power to stifle competition by starting the direct flights.

Origin Pacific announced plans on September 1, 2003, to start a direct service between Christchurch and Hamilton -- which would have been the first direct flights between the cities offered by any airlines.

But on September 9, 2003, Air New Zealand announced its own non-stop flights between Christchurch and Hamilton.

Origin Pacific then cancelled its plans to operate the service, claiming it could not viably fly the route alongside Air New Zealand.

Origin Pacific alleged Air New Zealand's behaviour was an abuse of market power and a breach of section 36 the Commerce Act.

Section 36 of the Commerce Act prohibits entities with a substantial degree of market power from taking advantage of that position to prevent or deter competitive conduct by others.

But after investigating the Commission found Air New Zealand's move was a competitive response to a market rival.

" Air New Zealand's behaviour is unlikely to have been materially different from what might have occurred in a competitive market," the Commission said in a statement.

– NZPA