



6 May 2015

Ministry of Transport
PO Box 3175
Wellington, 6140
FAO: Sam Ponniah

Application by Air New Zealand and Air China for authorisation of Strategic Alliance

Introduction

1. Wellington International Airport Limited ("**WIAL**") welcomes this opportunity to submit its views on the application made by Air New Zealand Limited ("**Air NZ**") and Air China Limited ("**Air China**") (together the "**parties**"), seeking authorisation of a proposed strategic alliance ("**Alliance**") (the "**Application**").
2. We note that material parts of the parties' Application are redacted, which has, in places, hindered WIAL's ability to make informed comment on the Application. Notwithstanding this, the Application has a number of significant implications which WIAL seeks to highlight.
3. WIAL supports means to increase air services (and thus volumes of passengers) to and from New Zealand and recognises that international airline alliances can contribute positively to achieving this objective. That is not always automatically the case though and each proposed alliance must be considered on its own facts and in its specific context.
4. In the present case, the key factors for consideration include:
 - (a) The benefits asserted by the parties must be scrutinised to ensure they will in fact accrue, and further that the Alliance is necessary for such benefits to be realised (and not merely desirable for the parties). Benefits asserted by the parties that would occur absent the Alliance are not relevant to the assessment.
 - (b) Whether authorisation of the Alliance is likely to lead to consumer detriment, by restricting capacity relative to the exponential demand growth presently occurring on China to New Zealand routes (and which is forecast to continue throughout the term of the proposed Alliance), and/or by deterring or restricting entry on to the routes covered by the Alliance.
 - (c) The certainty that the net benefits asserted by the parties will evolve over the course of the entire five year term. A shorter period of authorisation may be appropriate if this is not certain.

Framework for assessment of Alliance Application

5. As the Ministry of Transport ("**Ministry**") is aware, approval of the Alliance is at the discretion of the Minister of Transport ("**Minister**"), to be exercised in the public interest. That requires the Minister to weigh the benefits of the Alliance against the potential detriments.¹ In WIAL's view that requires the Minister (and the Ministry for the purposes of forming its recommendation) to:
 - (a) have regard not only to the current impact of the Alliance but also to the future impact of the Alliance - that is, to adopt a forward looking assessment;
 - (b) only have regard to benefits and detriments that arise from the Alliance, and so would not arise absent the Alliance (in which case the parties' Star Alliance code share arrangements would remain in place); and
 - (c) be sufficiently certain that the stated benefits will accrue as a direct consequence of the Alliance, across the entire five year authorisation period, and that these benefits will not be outweighed by any consumer detriments.
6. If the Minister cannot be certain that there are sufficiently certain net benefits in the public interest, then he must decline to grant authorisation (assuming the parties do not amend their Application so as to alter the assessment).
7. This analytical framework should be applied to each Alliance Sector (Auckland-Shanghai and Auckland-Beijing) as well as for air services between New Zealand and China (ie the Alliance Routes as defined in the Application).
8. The effects of the Alliance may extend beyond the routes that it directly relates to. As such, it is appropriate to also consider the Alliance in the broader context of air connectivity between Asia and New Zealand.

Auckland-Shanghai

9. WIAL accepts that with Air China not currently operating on the route, the parties do not presently overlap. However, assessing the effects of the Alliance within the relevant framework, WIAL notes the following indicators of the route's sustainability and future prospects:
 - (a) Air NZ appears to have experienced load factor improvements on the Auckland-Shanghai route over the past four years from 69% in March 2011

¹ Assuming that the Alliance does not trigger certain prohibitions set out in sections 88(3) or (4) of the CAA, as recognised by the Ministry in its briefing to the Minister on the Air New Zealand - Cathay Pacific Alliance (18 October 2012) at paragraphs [15 to 16].



to 77% in March 2015,² while at the same time more than doubling capacity on the route.³

- (b) Substantial growth in the number of Chinese visitors to New Zealand, increasing from approximately 259,000 in 2014 through to 455,000 in 2019 is forecast.⁴ This is consistent with forecasts of total Chinese tourist departures increasing from 98 million annually in 2013 to 200 million by 2020.⁵
 - (c) In the face of this forecast growth, China Eastern Airlines has recently announced it will expand its seasonal service on the Auckland-Shanghai route (operated from December 2014 to March 2015) to a four flights per week year-round service from September 2015.
 - (d) Air China is a substantial, growth focussed airline, with a hub at Shanghai Airport. It has a total fleet of 523 aircraft (including 86 wide bodied aircraft), which is expected to continue to grow to 581 aircraft by the end of 2015. Air China has also expressed an intention to "*expand its route network through...using the Sixth Freedom Rights to adjust or increase the frequency of some Asia-Pacific routes to connect with Europe and the U.S. services.*"⁶
10. Against this background, we expect that the benefits of the Alliance asserted by the parties, which include helping to support the sustainability of Air NZ's existing Auckland-Shanghai route, will be rigorously assessed by the Minister.
11. Potential consumer detriment that the Ministry should consider in its assessment includes:
- (a) The effects of a potential reduction in operators on this route, compared with the counterfactual (ie absent the Alliance). This could arise if Air China would enter the route absent the Alliance; and/or by the Alliance deterring entry by another potential airline, for example, China Southern Airlines.
 - (b) The potential for the Alliance to restrict capacity compared with the counterfactual, in particular to restrict capacity below the levels which the market would support in a fully competitive environment. This is particularly important given the forecast exponential growth in demand - even if the Alliance increases capacity year-on-year, the CAGR is currently 26% on the Auckland-Shanghai route and so there is a real risk that capacity increases will not match demand growth, especially over a five year period. In those circumstances prices would almost inevitably increase.

² Source: Stats NZ Migration Data, Sabre ADI

³ On a 12 month moving capacity basis from 97,969 in March 2011 to 241,054 in March 2015 (Source: Sabre ADI).

⁴ Ministry of Business, Innovation and Employment *New Zealand Tourism Sector Outlook* (2014).

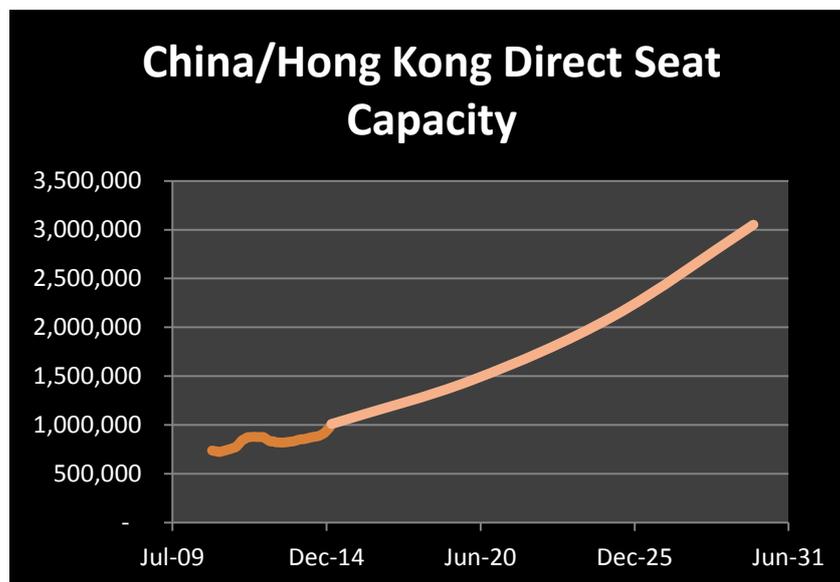
⁵ CLSA "Chinese outbound travel a multi-decade growth trend" (2015) <https://www.clsa.com/about-clsa/media-centre/2015-media-releases/chinese-outbound-travel-a-multi-decade-growth-trend.php>.

⁶ See <http://www.wcarn.com/news/39/39129.html>.



Evaluating direct air traffic between NZ-China, including NZ-Hong Kong, the CAGR for passenger growth over the last five years has been 9.5%. The capacity growth rate has been 7.7%.⁷ Using the more conservative of these two measures, Figure 1 below illustrates the future levels of capacity which could be supported assuming these rates of growth are maintained.

Figure 1: Potential capacity growth NZ - China



The 7.7% rate of annual capacity growth would produce 1.46 million seats of capacity by March 2020, a 45% increase on the 1.01 million seats flown to the year ended March 2015. While it would be anticipated that rates of growth will eventually slow as the market matures, high historic growth rates and expectations for these trends to continue for the foreseeable future present a compelling growth opportunity for New Zealand. In this context the Ministry should carefully consider the potential for the Alliance to limit the potential growth of this market.

- (c) Whether the Alliance has the potential to cause China Eastern to reconsider its decision to commence a permanent year-round service on the route and/or to hamper or restrict its permanent operation of the route.

Auckland-Beijing

- 12. WIAL agrees that the creation of a new direct Auckland-Beijing route is a consumer benefit and is likely to expand the overall number of air services (and passengers carried) to and from New Zealand. The primary consideration for the Ministry should therefore be whether the Alliance is necessary to achieve that benefit - that is, would the benefit accrue absent the Alliance?

⁷ Source: Sabre ADI



13. Factors which WIAL considers the Ministry should rigorously test in carrying out its assessment include:
- (a) The extent to which circumstances have changed since Air NZ exited the Auckland-Beijing route in June 2012. At the time of withdrawal, Air NZ noted that its long-haul routes were underperforming due to increased fuel costs and fewer international travellers. However, since then:
 - (i) Aviation fuel prices have fallen dramatically and are forecast to remain low for the foreseeable future.⁸ Specifically, the price of jet fuel as at 24 April 2015 is 39% lower than it was at the same time in 2014.⁹
 - (ii) Air NZ's profitability has increased dramatically. Air NZ reported normalised earnings of \$75m for the year ended June 2011. In stark contrast, its normalised earnings for its 2014 financial year were \$332m, a 343% increase.¹⁰
 - (iii) Air NZ has introduced Boeing 787-900 aircraft into its fleet, which it operates on its Auckland-Shanghai route and which, as part of the Alliance, Air China proposes to operate on the Auckland-Beijing route. These aircraft offer up to 20% fuel efficiency gains compared with, for example, the Boeing 777-200 aircraft Air NZ operated on its Auckland-Beijing route.
 - (iv) As above at paragraph 10(b) Chinese demand, in particular, has continued to increase and, more generally, demand for international air travel has increased.
 - (b) Whether the evidence indicates that in the counterfactual, ie absent the alliance, that Air China would in any event commence operating the route. Air China has a hub at Beijing Capital Airport and, as noted above, is seeking growth opportunities.
 - (c) Whether Air China and/or this particular route is different to other routes commenced by Chinese carriers between China and New Zealand. By way of comparison, China Southern Airlines has been able to make a success of its Auckland-Guangzhou route without any alliance arrangements, growing it from average load factors of 61% to 66% in its first six months of operation to close to 80% in the first two years, while increasing capacity significantly at the same time.
 - (d) As noted above at paragraph 5(b), Air NZ and Air China are already both Star Alliance members. Here too, the Ministry should consider whether any

⁸ On this point Air NZ has recently stated, " Costs have come down significantly from a fuel perspective of late and if that lasts long term, it changes the dynamics of a number of routes that we look at and the cost structures associated with that" NZ Herald, "China Business: Joint venture takes to the air", 30 April 2015 (available at http://www.nzherald.co.nz/business/news/article.cfm?c_id=3&objectid=11440327).

⁹ <https://www.iata.org/publications/economics/fuel-monitor/Pages/price-analysis.aspx>

¹⁰ <http://www.airnewzealand.co.nz/investor-centre-presentations>



benefits would arise absent the Alliance on account of the fact that the parties will still be able to code share on each other's flights, access domestic networks in each country and, among other things, their respective customers can earn frequent flyer points on one another's flights.

14. Like with the Auckland-Shanghai route it will be important to assess the extent to which the Alliance could have the effect of restricting capacity on a route likely to encounter strong demand growth, either because it removes the prospect of entry by the most likely entrant (Air NZ) or by deterring a potential third party entrant.

Assessment of the Alliance in the broader NZ to China and Asia context

15. The parties acknowledge that there has been a substantial increase in the number of flight frequencies between China, Australia and New Zealand over the past six years.¹¹ WIAL disagrees with the parties' approach of relying heavily on indirect services in its assessment of China-New Zealand air traffic, as for a substantial proportion of passengers these are imperfect substitutes for direct routes.¹² In any event, there has been substantial growth in direct services between New Zealand and China, due, in particular, to the introduction of new carriers and routes, including:
 - (a) The entry of China Southern in 2011, operating the Guangzhou-Auckland route. Entry was initially three services per week, but increased to a daily service in 2012. For the NZ summer 2014 season, China Southern moved to twice-daily frequencies on the route, operated by a Boeing 787-800 and a Boeing 777-300 (offering greater capacity than the Boeing 787-800 and Airbus A330 aircraft previously operated).
 - (b) The entry of China Airlines in 2011, operating the Auckland to Taipei route (with a stop in Australia). Capacity has increased significantly from an initial three services per week in 2011 to eight services per week for summer 2014, and seasonal services to Christchurch.
 - (c) China Eastern commenced operating the Shanghai-Auckland route in late 2014 (four services per week),¹³ which will become a year round service later this year.
16. The airline industry is notoriously dynamic, making it difficult to anticipate what the market will look like in the future.¹⁴ This is particularly the case for air services between New Zealand and China where the market is in flux, with entry and expansion occurring to meet increased demand. Careful consideration should be given to the potential for the Alliance to disrupt the competitive process and to deprive consumers of the benefits of that competition over the five year horizon. It also means the Ministry must consider how certain it can be that the benefits

¹¹ Parties' Application, paras [5.3] to [5.5].

¹² See for example the discussion of the High Court on this point in the context of flights between New Zealand and Asia in *Air New Zealand v Commerce Commission* (2004) 11 TCLR 347 at [153].

¹³ See <http://www.aucklandairport.co.nz/Corporate/NewsAndMedia/AllMediaReleases/Inaugural-China-Eastern-Airlines-seasonal-flight-arrives-at-Auckland-Airport.aspx>

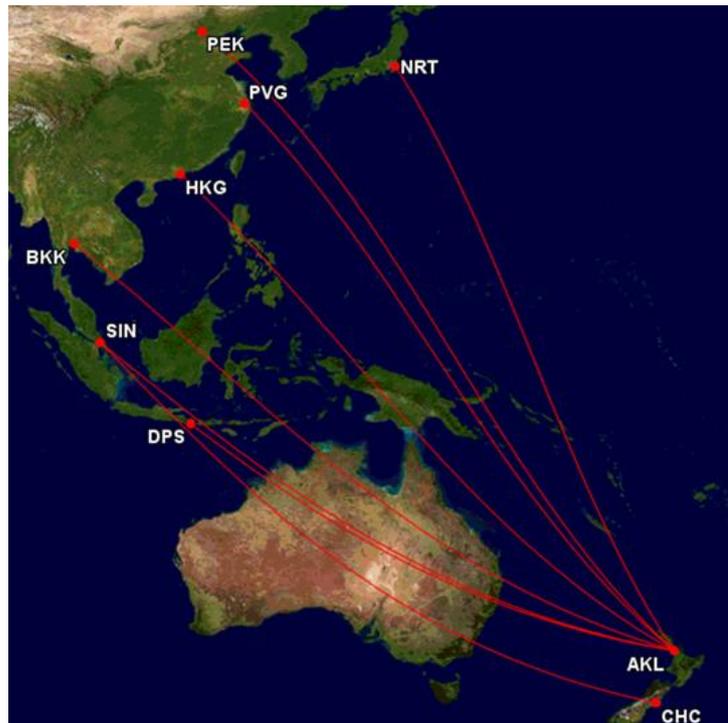
¹⁴ As noted in Ministry of Transport, Briefing to the Minister of Transport, Air New Zealand - Cathay Pacific Alliance, 18 October 2012, paragraph 25.



asserted by the parties will accrue over a five year period in those changing market circumstances, as well as how certain it can be that any such benefits will continue to outweigh potential consumer detriment.

17. If the Alliance is authorised, as indicated below in Figure 2, 73% of Asia - NZ traffic will be subject to Air NZ alliances (both formal alliances and code share arrangements). A full 65% of Asia - NZ traffic will be subject to Air NZ strategic alliances (eg with Cathay Pacific, Singapore Airlines and Air China), arguably the most extensive form of collaboration between potential competitors short of a structural acquisition.

Figure 2: Air NZ alliance/code share routes - NZ to Asia



18. WIAL therefore submits that the potential effects of a further Air NZ alliance on future air connectivity between Asia and New Zealand should be considered. Such effects could include potentially deterring other carriers from entering routes between New Zealand and Asia, on account of the current network of alliances across the key Asian routes and also due to a (not unreasonable) estimation of further alliances being formed by Air NZ on candidate routes.
19. Building atop the existing market share of NZ – Asia capacity already enjoyed by Air NZ via its existing alliances and relationships, the proposed Alliance will serve to lessen the commercial opportunity New Zealand’s travel markets present to potential new entrants. This statement holds when new services on existing routes to NZ via Auckland or Christchurch are considered, or potential new routes. A dominant share of capacity to the country, coupled with an 80 – 100% capacity share of domestic



connecting capacity, presents a significant barrier to entry for foreign airlines considering the potential for new service introduction.

Conclusions

20. The addition of a new direct service strengthening New Zealand's connectivity to China is clearly very beneficial and is welcomed by WIAL. However, it does not necessarily follow that the Alliance itself provides public benefits. In particular, the proposed Alliance involves two key routes to/from New Zealand that are expected to continue to enjoy demand growth and contribute to New Zealand's international tourism and trade. Therefore, the future effects of the Alliance, particularly around capacity and pricing, need to be examined with great care to identify the relevant benefits and detriments.
21. If the benefits would accrue absent the Alliance, under the parties' existing code share arrangements, or if they could be achieved through a lesser form of cooperation (which may mitigate the risk of potential detriment), then they are not benefits of the Alliance and cannot properly be taken account of in the assessment.
22. In WIAL's view the Ministry should consider the benefits of authorisation in the context of record airline profitability, a rapidly expanding market for travel to and from China and a counterfactual which is potentially able to deliver many, if not all, of the stated benefits put forward by the parties.
23. It is prudent for the Ministry to weigh this counterfactual against the potential detriments of the Alliance, namely (i) the restriction of capacity that might arise from the Alliance and (ii) the barriers to capacity expansion and new route development (both by the applicants and third party operators).
24. A further key question is whether the Ministry can be sufficiently certain that the asserted benefits will continue to outweigh any potential detriment over the course of the five year term. If, against a backdrop of high demand growth and recent and prospective entry on to routes between China and New Zealand, all of which means the markets are very much in flux, the Ministry cannot be sufficiently certain in its assessment, then a shorter period of authorisation will be appropriate (as was the case in the initial authorisation of the Air NZ/Virgin and Air NZ/Cathay Pacific alliances), so that the parties can demonstrate the stated benefits will outweigh any potential detriment. A term of two or three years (four to six IATA seasons) would suffice for the parties to build the Auckland-Beijing route and, more generally, to demonstrate the Alliance's benefits.
25. WIAL would be pleased to discuss this submission further with the Ministry.

Yours sincerely



Steve Sanderson
CHIEF EXECUTIVE OFFICER

