

# AIR NEW ZEALAND/AIR CHINA ALLIANCE APPLICATION: PRELIMINARY ADVICE AND DRAFT CABINET PAPER

<b>Reason for this briefing</b>	To provide you with our preliminary advice on the application for authorisation of an alliance between Air New Zealand and Air China. We have also attached a draft Cabinet paper, so that your colleagues can note your likely decision.
<b>Action required</b>	Indicate if you wish to discuss our advice at the officials meeting on Monday, 3 August.  Advise if you have any comments on the attached draft Cabinet paper.  Agree that we may discuss our preliminary view with the applicants.
<b>Deadline</b>	3 August 2015
<b>Reason for Deadline</b>	To enable a discussion on this issue at the officials meeting on Monday, 3 August 2015.

## Contact for telephone discussion (if required)

Name	Position	Telephone		First Contact
		Direct Line	After Hours	
Sam Ponniah	Adviser			✓
Sonya van de Geer	Principal Adviser			
Glen-Marie Burns	Manager, Aviation & Security			

## MINISTER'S COMMENTS:

<b>Date:</b>	28 July 2015	<b>Briefing Number:</b>	OC03197
<b>Attention:</b>	Hon Simon Bridges (Minister of Transport)	<b>Security level:</b>	In-Confidence

## Minister of Transport's office actions

- |  |  |   |
|--|--|---|
| <input type="checkbox"/> <i>Noted</i>        | <input type="checkbox"/> <i>Seen</i>                 | <input type="checkbox"/> <i>Approved</i>            |
| <input type="checkbox"/> <i>Needs change</i> | <input type="checkbox"/> <i>Referred to</i>          |   |
| <input type="checkbox"/> <i>Withdrawn</i>    | <input type="checkbox"/> <i>Not seen by Minister</i> | <input type="checkbox"/> <i>Overtaken by events</i> |

## Purpose of report

1. This briefing provides you with a summary of our analysis of the application by Air New Zealand and Air China (the applicants) for authorisation of a strategic alliance (the alliance). We have attached a draft report at Annex I with our more detailed analysis of the application.
2. You will not be able to make your final decision or formally authorise the arrangements because the applicants have not submitted two of the implementing agreements<sup>1</sup>.

However, we are providing you with our preliminary advice now in order to reduce the chance of delays that may prevent Air China from launching its proposed service between Beijing and Auckland in December 2015.

3. If you agree with our preliminary advice, we seek your:
  - 3.1. comment on the attached draft Cabinet paper (Annex II refers) which notes your likely decision to the Cabinet Economic Growth and Infrastructure Committee
  - 3.2. agreement for officials to discuss our preliminary view with the applicants.

## Background

4. In March 2015, Air New Zealand and Air China submitted an application under section 88 of the Civil Aviation Act 1990 (the Act) seeking authorisation of a strategic alliance. Under the proposed alliance, the applicants intend to code-share<sup>2</sup> and coordinate capacity and pricing and share their revenues on direct services between New Zealand and China. This includes Air New Zealand's current daily service between Auckland and Shanghai and a proposed new daily service by Air China between Auckland and Beijing.
5. The applicants intend to code-share and coordinate pricing, but not share revenue, on domestic services in New Zealand and China that connect to an international service between both countries.
6. The applicants have indicated that they are seeking authorisation for five years.

### *Current level of cooperation*

7. Air New Zealand and Air China are members of the Star Alliance<sup>3</sup> and already cooperate on frequent flyer programs and airport lounge access.
8. The applicants are also parties to a code-share agreement under which:
  - Air China code-shares on Air New Zealand's Auckland-Shanghai service and seven trans-Tasman services.
  - Air New Zealand code-shares on four of Air China's Australia-China services and three domestic services in China.

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<sup>1</sup> Agreements which support the Alliance Agreement

<sup>2</sup> Code-sharing allows airlines to sell seats on each other's flights and agree on how schedules and fares are set.

<sup>3</sup> Global airline alliances (Star Alliance, SkyTeam and Oneworld) aim to facilitate cooperation between member countries through interlining, code-sharing, reciprocal frequent flyer schemes and joint baggage handling to provide customers with a more seamless travelling experience.

## Framework for your decision

9. The Act provides for an exemption from the Commerce Act 1986 for cooperative arrangements between international airlines. The Act provides statutory authority for you to authorise cooperative arrangements of this nature. No Cabinet decision is required.
10. Under the Act, the Minister of Transport must determine whether the provisions of the alliance agreements meet the statutory criteria in Section 88 of the Act to be capable of authorisation.
11. There is also a public interest component to your decision. You are not required to authorise an arrangement merely because it meets all of the statutory tests.
12. In order to advise you on the public interest impacts of the alliance, we have undertaken a comprehensive analysis of the alliance consisting of:
  - consideration of the counterfactual scenario (i.e. what is likely to occur if authorisation is declined)
  - consideration of the likelihood that the benefits claimed by the airlines will eventuate both with and without the alliance
  - consideration of the likely risks or detriments that authorisation would entail for New Zealand as a whole
  - consideration of where this proposed alliance sits alongside other code-share and alliance agreements in the New Zealand market
  - an overall conclusion drawing together the factors described above.
13. The Act does not provide you with any powers to impose time limits, minimum capacity requirements or any other stipulation on an authorisation.
14. Below is a summary of our analysis to date on the likely impacts of the alliance. We have not been able to complete our analysis as we have yet to receive two implementing agreements for the alliance.

. These agreements are referenced in paragraphs 56 to 59.

## Market definition

15. The main markets of focus for the proposed alliance are Shanghai (population of approximately 24 million people) and Beijing (population of approximately 20 million people) and the passengers travelling between New Zealand and each of these cities. These markets are predominantly inbound markets with New Zealand residents making up only a small proportion of passengers who travel between New Zealand and China (22 percent of passengers in 2014). As a result, much of our analysis has focused on the inbound markets.
16. The proposed alliance is much narrower in scope than other alliances that have previously been authorised, such as the Qantas/Emirates and Air New Zealand/Singapore Airlines alliances. Air New Zealand is not intending to cooperate with Air China on its international services beyond Shanghai. Passengers from third countries make up a smaller proportion of traffic between New Zealand and China (for example, during the year ended February 2015, around [redacted] of passengers on Air New Zealand's Auckland-Shanghai service were travelling directly between New Zealand and China).

17. The New Zealand-China market sees competition between one-stop carriers like Qantas, Cathay Pacific, Singapore Airlines and Malaysia Airlines and the following airlines offering direct services:
- China Southern operates two daily services between Auckland and Guangzhou
  - Air New Zealand operates daily services between Auckland and Shanghai
  - China Eastern will operate four weekly services between Auckland and Shanghai from September 2015.

### **Assessment of the counterfactual – the scenario if you decline authorisation**

*In the absence of an alliance, Air New Zealand is likely to*

*We expect Air China, or another airline, to commence a service from Beijing in one to three years*

20.

21. In our view, the market opportunity for a direct service between Beijing and Auckland is simply too large for airlines to ignore. Despite the absence of a direct service, there are almost as many visitors to New Zealand each year from Beijing as from Shanghai. Air China is by far the most likely airline to operate a Beijing-Auckland service, as it is the largest international airline operating from Beijing. In the event that Air China did not operate a service to Auckland, it is likely that another airline eventually would.

### **Likely benefits to arise if the alliance is authorised**

22. The alliance provides Air New Zealand with a local partner  
The alliance would provide Air New Zealand with more favourable code-share access on Air China's network beyond Shanghai. The alliance would also provide more effective sales and distribution channels for Air New Zealand's marketing activity. Air New Zealand contracts with agents in China, following 8 years of operation. In contrast, Air China has sales units in the country.

23.

China Eastern only operated during the summer of 2014/15 but carried around percent of Chinese arrivals to New Zealand for the 12-month period ending February 2015.

Air New Zealand carried percent of Chinese arrivals over the same period.

Air New

Zealand seems to price its services competitively and in some cases on par with lower-cost indirect competitors like China Southern. This highlights the challenges that Air New Zealand faces in attracting Chinese passengers onto its services.

*Without an alliance, Air China is less likely to immediately commence a direct service to New Zealand*

24. The alliance provides Air China with a low risk business case to commence an Auckland-Beijing service immediately. While we expect a direct service would be likely in the counterfactual, the alliance provides certainty that the service would soon commence and with daily frequency.

25. In particular, the alliance incentivises Air New Zealand to feed passengers travelling on Air China's Auckland-Beijing service onto Air New Zealand's domestic and international network. Without a revenue-sharing arrangement for the Auckland-Beijing service, Air New Zealand would be better off ticketing passengers through its Auckland-Shanghai service even if they were travelling to or from Beijing.

*New Zealand is likely to become a more attractive destination for Chinese residents under the alliance*

26. The alliance provides incentives for Air China to market New Zealand as a destination to its customer base. Provided that tourism infrastructure continues to keep pace with growth in arrivals from China, the alliance would provide benefits for the industry.

27. The alliance also provides some benefits for consumers given the further alignment of both applicants' frequent flyer programs. Consumers, in particular business travellers, would have the ability to earn and redeem frequent flyer points

. While we have considered these benefits as modest in past alliance applications, the alliance between Air New Zealand and Air China is an exception given the size of the Chinese market. Effectively, Air New Zealand operated services from Shanghai are made available to Air China's strong frequent flyer customer base.

*China is likely to interpret authorisation of the alliance as a positive development in its overall bilateral relationship with New Zealand*

28. China is an important bilateral partner for New Zealand. China is our second largest tourist market, behind Australia, with visitor arrivals forecast to double in the next five years. China is also our number one export destination for goods and services, with annual exports to China reaching \$11.3 billion in September 2014.<sup>4</sup>

29. Air New Zealand and Air China's intention to enter into this alliance was announced during President Xi's State visit to New Zealand in November 2014. Prime Minister Key and President Xi were present at the announcement.

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<sup>4</sup> Data from Statistics New Zealand.

30. In Australia, an alliance between China Eastern and Qantas was similarly announced during a State visit. Following a draft determination in Australia to decline authorisation of that Alliance, the Chinese Ambassador wrote to the Australian Competition and Consumer Commission (ACCC) to state that he saw the arrangements to be in the long-term interests of both Australia and China. He expressed his hope that the ACCC could bear in mind the interests of the overall relationship and make a fair and reasonable decision. We could expect the Chinese government to take a similar position with regard to this alliance.
31. Given the importance of the bilateral relationship with China, authorisation of the alliance would provide benefits to the national interest in maintaining and strengthening that relationship.

*Increased competition and capacity in the cargo market*

32. Air freight accounts for around 16 percent<sup>5</sup> of total trade between New Zealand and China by value and tends to comprise high value, perishable goods.
33. The alliance does not include cooperation in relation to cargo carried on the bellyhold of either airlines' passenger services.
34. As a result, the alliance provides for increased competition and capacity in the freight market. In particular, the alliance provides for additional cargo capacity between Auckland and Beijing over and above what we would expect in the counterfactual.

**Potential risks associated with authorising the alliance**

*The Air New Zealand/Air China alliance overlaps with the Air New Zealand/Cathay Pacific alliance*

35. The Air New Zealand/Air China alliance allows Air New Zealand and Air China to jointly set fares on routes between New Zealand and China, Air New Zealand has a pre-existing alliance with Hong Kong-based Cathay Pacific<sup>6</sup>.
36. likely that the fares Air New Zealand sets on connecting services through its alliances with Cathay Pacific and Air China are aligned. This risks higher prices for consumers travelling between New Zealand and other cities in China via Shanghai, Beijing and Hong Kong.
37. Indirect competition from airlines providing one-stop services between New Zealand and China is likely to partially mitigate this risk by constraining the ability of Air New Zealand, Air China and Cathay Pacific to artificially raise fares.

*The alliance may constrain growth and competitive pricing on the Auckland-Beijing route*

38. The 'big three' state-owned Chinese carriers (China Southern, China Eastern and Air China) have all pursued aggressive growth strategies over the last decade, capitalizing on growing demand for international air travel among Chinese residents. In New Zealand, both China Southern (from three times a week to twice daily in under three years) and China Eastern (from a daily seasonal service to a year round four times weekly service in under a year) have commenced and grown their services at unprecedented rates.

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<sup>5</sup> Data from Statistics New Zealand.

<sup>6</sup> Air New Zealand's alliance with Cathay Pacific will expire on 31 January 2016 unless it is reauthorised. We have separately provided you with advice recommending that you reauthorise that alliance for an additional three years and nine months (until 30 October 2019).

39. If Air China were to enter the Beijing market on its own, we would expect it to employ a similar growth strategy to that of the other Chinese carriers.
40. Although Air New Zealand is currently in a high-growth phase, it is likely to take a more conservative and managed approach to growth than Air China. Under the alliance, Air New Zealand may object to Air China adding too many seats too quickly, as too much growth could reduce yields and result in losses that Air New Zealand would be exposed to.
41. We consider it likely that, under an alliance with Air New Zealand, Air China would face less incentive to pursue an aggressive growth strategy. This would reduce the prospect of lower fares being offered to travellers. It is possible that competition from a range of one-stop carriers in the market could mitigate this risk by prompting the applicants to pursue more ambitious growth.

## **Submissions**

### *The majority of stakeholders supported authorisation of the alliance*

42. A number of aviation and tourism related organisations have provided submissions on the proposed alliance. The majority of stakeholders have been broadly positive about the value the alliance would provide to New Zealand, highlighting the potential tourism benefits and referring to the New Zealand-China market as relatively competitive. A few stakeholders referred to the need to test the impact of the alliance around the country and commented on the overall composition of routes between New Zealand and Asia. These submitters' concerns are set out below.

### *Concerns on the impact of the alliance around New Zealand*

43. Christchurch Airport, Wellington Airport, the New Zealand Airports Association and the Tourism Industry Association have commented on the need to ensure the benefits of the alliance are spread around the country.
44. The benefits of the alliance are generally weighted towards Auckland, reflecting Air New Zealand's single hub strategy of directing as many passengers as possible through Auckland.
45. However, we would expect any impact on the likelihood of direct services to other airports to be minimal, at least in the short to medium term. The key reason for this is that Air China is a member of the Star Alliance and if it were to operate on its own, it would still have relatively good access to Air New Zealand's domestic network (as Air New Zealand has an incentive to provide favourable interline rates to other Star Alliance airlines).
46. In our view, it is unlikely that Air China would consider operating a service to Christchurch until it has firmly established itself in the Auckland market, regardless of whether the alliance is authorised. The alliance could become a barrier for the commencement of direct services to Christchurch in the longer term if demand for travel to the South Island continues to grow.

### *Concerns with Air New Zealand's alliance strategy*

47. Christchurch Airport and Wellington Airport have expressed concerns that alliances in general are reducing the incentives for airlines to operate new direct services between New Zealand and Asia, in particular to cities other than Auckland.
48. We agree to some extent that Air New Zealand's alliances limit the incentives for its partners to operate to cities outside of Auckland. However, we are confident that none of the alliances that have been authorised in New Zealand to date have resulted in an airline operating to Auckland when it would have otherwise operated to Christchurch.

## **Preliminary recommendation**

*Our preliminary recommendation is that you authorise the alliance to 31 March 2021*

49. In our view, the sum total of the benefits associated with the alliance outweighs the risks we have identified.
50. If the alliance was authorised, we would expect to see:
- stimulation of demand following Air China commencing the Auckland-Beijing service, including opportunities to deploy more capacity on that service
  - increases in passenger numbers between New Zealand and China above predicted levels of growth
  - increased trade between New Zealand and China as exporters take advantage of the capacity offered by the new Auckland-Beijing service.
51. The applicants have applied for authorisation to 31 March 2021 and we consider this an appropriate length of time to enable us to revisit the alliance and reassess its impacts on consumers and competition. We are confident that this term will mitigate any risk that the applicants will engage in anti-competitive behaviour, including the risks identified in paragraphs 35 to 41. This term will also provide the applicants with sufficient time and confidence to invest in integrating and expanding their operations.

### *Testing the impact of the alliance*

52. We consider that the risks of the alliance are mitigated by the current dynamics of the market and a time-bound authorisation that incentivises the applicants to behave competitively. The New Zealand-China market is likely to evolve rapidly over the next five years and if the alliance were authorised, we would assess the impact of the alliance in the following areas as part of any future application for reauthorisation.
- Whether there is strong competition in the market, in the form of competitive pricing, between Air China and Cathay Pacific for passengers travelling between New Zealand and China
  - Whether fares on alliance services are lower, on average, including for passengers connecting to other cities in China
  - Whether there is an increased likelihood that the alliance will commence new direct routes between New Zealand and China, particularly to/from airports outside of Auckland (the applicants have not identified this as a benefit of the alliance but it is plausible that a new direct route could be viable in the next five years).

### **Quality assurance – our analysis has been peer reviewed by Webb Henderson**

53. We engaged Webb Henderson to peer-review our analysis to ensure that it is robust and has taken account of all relevant factors. Webb Henderson provided a similar peer review for the Ministry's analysis of the Air New Zealand/Cathay Pacific alliance application for reauthorisation.

54. Webb Henderson's report is attached at Annex III to this briefing. It concludes that "

55. The report noted several areas where our analysis could be improved. Where appropriate, we have addressed these suggestions in our analysis.

**Our final advice is subject to an analysis of the alliance's revenue share and code-share agreements that have yet to be submitted**

56. The applicants submitted their application for authorisation ahead of concluding several agreements that would implement the alliance. They sought to commence the regulatory approval process early to allow sufficient lead-in time to sell and market the new Auckland-Beijing service.

57. The application included the main Strategic Alliance Agreement. However, we have yet to receive the following implementing agreements to inform our analysis of the application:

57.1. A revenue share agreement that sets out how the applicants intend to divide the revenue they earn on alliance services between New Zealand and China (Auckland-Shanghai and Auckland-Beijing). We will need to assess the revenue share agreement to ensure it does not shift the balance of benefits for the public interest.

57.2. A code-share agreement that sets out the details of how the applicants will cooperate in offering services to passengers who have purchased tickets through the other airline. We will need to assess the code-share agreement to ensure it meets the statutory criteria in the Civil Aviation Act to be capable of authorisation.

58. We recommend that you do not make your final decision until we have reviewed the two agreements and confirmed that they do not present any significant risks. Provided we do not identify any significant risks, our final recommendation will be that you authorise the alliance to 31 March 2021.

59. When we have received the  
agreements, we will update you on whether we have identified any risks and our expected timeframe for providing you with our final advice.

**Next steps**

*We have prepared a noting paper for you to take to the Cabinet Economic Growth and Infrastructure Committee (EGI)*

60. We have attached a draft Cabinet paper at Annex II that provides a summary of our analysis of the alliance. The draft Cabinet paper reflects the key points set out in this briefing and our detailed report at Annex I.

61. If you agree with our analysis, we recommend that you provide any feedback you may have on the attached draft Cabinet paper. After you have provided your feedback, we will consult with other government departments (Treasury, the Ministry of Foreign Affairs and Trade, and the Department for Prime Minister and Cabinet) and provide you with a final version to lodge with the Cabinet Office.

62. We can provide you with a final Cabinet paper for lodging on 13 August to be discussed at EGI on 19 August 2015.

63. Discussing the alliance at EGI on 19 August has two benefits:
- 63.1. EGI will be discussing the Air New Zealand/Cathay Pacific alliance at this meeting where you will be notifying them of your intention to reauthorise that alliance. Discussing the Air New Zealand/Air China alliance at the same meeting may offer a more efficient use of time.
  - 63.2. Discussing your likely decision with EGI earlier will help to reduce any delays in the regulatory process that might prevent the applicants from launching the new Auckland-Beijing service in December 2015.
64. There is a small risk that you will have to return to EGI after you have received the revenue share and code-share agreements. If these agreements contain significant risks that cause you to revise your decision, EGI may expect to be updated on the application.

*You may wish to delay discussing the alliance at EGI*

65. If you do not wish to discuss the alliance with your Cabinet colleagues until you are certain about your decision, you could delay providing an update to EGI until we have reviewed the remaining alliance agreements.
66. The risk associated with this option is the delay it would create for the applicants. The applicants require a decision by the end of September 2015 to allow them sufficient lead in time to market and sell the new Auckland-Beijing service, which is tentatively scheduled to commence in December 2015.

*Updating the applicants*

67. If you agree with our recommendation, we propose to discuss our preliminary view with the applicants. We would inform them that at this stage, subject to receiving and considering the two implementing agreements, we are inclined to recommend authorising the alliance. This would allow them to proceed with any planning and applications that may be required in order to launch the new Beijing-Auckland service on time. We will note during our discussions with the applicants that our advice and your decision will be subject to us confirming that the revenue share and code-share agreements do not present any significant risks.

## Recommendations

68. The recommendations are that you:

- (a) **note** that we consider authorisation of the alliance for a five year term to be in the public interest
- (b) **note** that we are unable to provide you with a final recommendation until we:
- assess whether the alliance code-share agreement meets the statutory criteria in the Civil Aviation Act 1990
  - assess whether the alliance revenue share agreement presents any significant risks for the public interest
- (c)
- (d) **indicate** if you wish to discuss our advice at the officials meeting on Monday, 3 August 2015 Yes/No
- (e) EITHER
- advise** if you have any comments on the attached draft cabinet paper, which can be tabled at the Cabinet Economic Growth and Infrastructure Committee on 19 August (recommended option) Yes/No
- OR
- direct** officials to provide you with updated advice and a draft cabinet paper after the applicants submit the remaining alliance agreements Yes/No
- (f) **agree** for officials to discuss our preliminary view with the applicants. Yes/No

Sam Ponniah  
Adviser

Glen-Marie Burns  
Manager, Aviation & Security

**MINISTER'S SIGNATURE:**

**DATE:**

**ANNEX I – DRAFT REPORT: ANALYSIS OF THE  
APPLICATION BY AIR NEW ZEALAND AND AIR CHINA  
FOR AUTHORISATION OF A STRATEGIC ALLIANCE**

**ANNEX II – DRAFT CABINET PAPER: AUTHORISATION  
OF A STRATEGIC ALLIANCE BETWEEN AIR CHINA AND  
AIR NEW ZEALAND**

**ANNEX III – PEER REVIEW REPORT: REVIEW OF DRAFT  
AIR NEW ZEALAND-AIR CHINA DECISION**