

## Ministry of Transport report on the Application by Air New Zealand and Cathay Pacific for Reauthorisation of their Strategic Alliance

### Purpose

1. This report provides a summary of the Ministry of Transport's (the Ministry's) analysis of the application by Air New Zealand and Cathay Pacific (the applicants) for reauthorisation of the North Asia Alliance Agreement (the alliance).

### Background

#### Alliance and code-share agreements

2. International aviation is a highly regulated industry, governed by thousands of bilateral air services agreements. These agreements set out (among other things) the routes and capacity that airlines can operate between any two countries, and the ownership criteria for the airlines of those countries. As a consequence, airlines are often unable to expand into new markets, and cross-border mergers between airlines are extremely rare and complex.
3. In order to overcome the restrictions imposed in bilateral air services agreements, airlines have developed means of working with one another to expand their global reach. Cooperation between airlines generally takes one of three forms:
  - i. "Interline" arrangements: in which one airline agrees to sell tickets to another airline at a pre-determined price (under a "prorate" agreement"). This is the mechanism through which (for example) Qantas is able to sell its passengers a ticket from Sydney to Nelson, even though it does not operate a service to Nelson. Interlining arrangements are frequent throughout the aviation industry, but interlining tends to occur most frequently between members of the three 'global alliances'<sup>1</sup> – Star, oneworld, and Skyteam.
  - ii. "Codeshare" arrangements: a more formal agreement through which an airline is effectively given the ability to sell seats on flights operated by another airline as if it were operating that flight with its own aircraft. Airlines are generally only able to enter into a code-share agreement when it has been expressly permitted in the relevant bilateral air services arrangements. Code-share agreements are relatively common and rarely raise competition issues. Dozens of code-share agreements have been authorised in New Zealand. A notable example is the code-share arrangement between Air New Zealand and United Airlines (which provides Air New Zealand with access to destinations in the United States beyond California).

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<sup>1</sup> Members of global alliances work together to provide seamless services to consumers on a global level, by cooperating in areas such as scheduling, ticketing, and frequent flier schemes.

- iii. Revenue sharing alliances: an extensive commercial agreement in which two or more airlines agree to cooperate on all aspects of pricing, scheduling and service delivery in a particular market. These arrangements are generally subject to a much higher level of regulatory scrutiny as they have the potential to significantly reduce competition. These alliances are almost exclusively formed between airlines of the same global alliances (or airlines that are not members of any global alliance).
4. The Air New Zealand/Cathay Pacific Alliance is one of four major revenue sharing alliances that have been authorised in New Zealand since 2010<sup>2</sup>. Alliances are becoming increasingly common as a way for airlines to pool resources, share risk, and extend their 'virtual' route networks.
5. Alliances can result in benefits to consumers (for example, better access to connecting flights, and the ability to earn and redeem Airpoints across the networks of both airlines). However, alliances also carry significant risk as they generally result in a lessening of competition, which can lead to higher fares or reduced services.
6. In principle, we have taken the view that alliances are a necessary tool for airlines (particularly those with small and remote home markets, such as Air New Zealand) to overcome restrictions imposed on them by bilateral air services agreements<sup>3</sup>. However, each alliance agreement carries different risks and needs to be carefully scrutinised to ensure that it delivers benefits that counteract any negative impacts that may result from a reduction in competition.

### The Ministry's role

7. The statutory framework applying to alliance and code-share agreements between airlines is set out in Part 9 of the Civil Aviation Act 1990 (the Act). Part 9 provides an alternative mechanism to Part 4 of the Commerce Act 1986.
8. The Minister of Transport is responsible for authorising or declining an application made under the Act. The Ministry is responsible for providing advice to the Minister on whether authorisation would be consistent with the criteria set out in the Act. These criteria and our approach to the analysis are set out below in paragraphs 17 to 25.

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<sup>2</sup> The other alliances authorised since 2010 are between Air New Zealand and Virgin Australia (in 2010, reauthorised in 2013), between Emirates and Qantas (in 2013), and between Air New Zealand and Singapore Airlines (in 2014).

<sup>3</sup> Many bilateral air services agreements in effect require airlines to be majority owned by nationals of their home State. This makes it difficult for airlines to merge or establish joint ventures in the same way that most other businesses can.

### The 2012 application

9. In 2012, Air New Zealand and Cathay Pacific submitted an application for authorisation of a strategic alliance. Under the alliance, the applicants proposed to cooperate on all aspects of pricing and service delivery on their services between Auckland and Hong Kong. The airlines also proposed to enter into a Special Prorate (interline) Agreement, under which Cathay Pacific would sell seats on its connecting services beyond Hong Kong to Air New Zealand at a preferential rate (with Cathay Pacific gaining preferential rates on Air New Zealand's domestic services).
10. At the time the application was submitted, Cathay Pacific was operating between seven and ten services per week between Auckland and Hong Kong. Air New Zealand was operating seven services per week, with five of those services operating beyond Hong Kong to London. Air New Zealand had already decided that it would suspend its Hong Kong-London service, regardless of whether or not the alliance with Cathay Pacific was authorised. For Air New Zealand, the alliance was critical in enabling it to retain as much of its London-bound traffic as possible.
11. When the application was first submitted to us, we were sceptical that it would deliver benefits to consumers. The alliance had a number of unusual characteristics compared to other alliances that had been authorised globally. In particular:
  - Air New Zealand and Cathay Pacific were the only airlines operating on the Auckland-Hong Kong route. This meant that authorisation of the alliance would have eliminated direct competition.
  - Air New Zealand and Cathay Pacific are members of different 'global alliances' (Star and oneworld, respectively). As noted previously, it is unusual for integrated alliances to be formed between members of different global alliances.
12. We were also concerned that the airlines would not be able to gain full benefit from the alliance due to [REDACTED]
13. [REDACTED]

[REDACTED]

[REDACTED]

14. The alliance was authorised for three years (effective from 30 January 2013). We considered this short time limit would minimise the risks to New Zealand in the event that the alliance did not deliver benefits to consumers, while providing the airlines with an opportunity to demonstrate its value.

### **The current (2015) application**

15. On 26 November 2014, the applicants submitted a new application seeking reauthorisation of the alliance beyond its 30 January 2016 expiry date. The conduct for which reauthorisation is being sought is the same as in 2012, and there are no substantial changes to the alliance agreement itself.
16. The applicants initially sought reauthorisation for a further 5 years (i.e. until 30 January 2021). However, they have since amended the alliance agreement and are now seeking reauthorisation for three years and nine months (until 31 October 2019).

### **Framework and criteria**

17. Section 88(4) of the Act sets out specific statutory criteria that all provisions of all applications must meet in order to be authorised. We determined in 2012 that the alliance and Code-share agreements satisfied these criteria. We have reviewed the amended application and have confirmed that the current versions of the agreements (which are largely unchanged) also satisfy these specific criteria and are capable of being authorised.
18. The Act does not require the Minister to authorise an application merely because it passes these statutory tests. Rather, it prescribes that the Minister “may from time to time” specifically authorise them. Our interpretation of this provision [REDACTED] is that it implies that the Minister should only authorise the provisions of an agreement if he/she is satisfied that doing so would be in the public interest.
19. Based on this interpretation, our analysis of alliance applications has taken the form of a broad cost/benefit analysis. This consists of:
  - i. consideration of the nature and scale of any benefits to consumers and/or New Zealand as a whole that are likely to occur as a result of the alliance
  - ii. consideration of the nature, scale and likelihood of any possible detriments or risks that may occur to consumers and/or New Zealand as a whole as a result of the alliance
  - iii. consideration of where this proposal sits alongside other code-share and alliance agreements in the New Zealand market

- iv. consideration of the counterfactual (i.e. the likely scenario in the absence of authorisation)
  - v. an overall conclusion drawing together the factors described above.
20. Any conclusions or assertions made in this report should be considered against our assessment of the counterfactual. The applicants each provided confidential submissions outlining their likely course of action in the event that reauthorisation is not granted. Our view on what is likely to occur under the counterfactual is provided in paragraphs 141 to 149 of this report.
21. Benefits accruing to Air New Zealand rather than a foreign entity are considered benefits to New Zealand. Where relevant, we also take account of the impact that authorising or declining an agreement may have on New Zealand's aviation industry and our international connectivity over the long term – both of which are indirectly affected by Air New Zealand's success as a business. However, the fact that the New Zealand government owns 53 percent of Air New Zealand is not a consideration in our analysis.
22. As this application is seeking reauthorisation of an existing alliance (as opposed to authorisation of a new alliance), we have a base of evidence to draw upon. This includes data provided by the applicants (either in their application or in response to requests we have made for additional information), and other data sources including Statistics New Zealand's International Visitor and Migration database.
23. Much of our analysis focuses on assessing whether the potential benefits and risks identified in our assessment of the 2012 application have materialised. In particular, we are looking for:
- i. evidence that the applicants are responding to market conditions when setting fares, capacity, and schedules
  - ii. evidence of connectivity benefits, particularly in the China, India, and South East Asia markets which we deemed to be the markets most likely to benefit from the alliance in 2012
  - iii. evidence that cost savings and efficiencies have been realised and are being passed on to consumers
  - iv. any changes in market conditions that would impact upon either the prospects of market entry or the likely counterfactual scenario.
24. We also need to be satisfied that any benefits that have occurred are attributable to the alliance (i.e. that they would not have occurred if the alliance had not been authorised), and/or could not reasonably be expected to be achieved through other, less anti-competitive means.

### **International comity**

25. The applicants have suggested in their application that international comity represents a separate ground for reauthorising the alliance.
26. In terms of the specific statutory criteria, comity would only become a relevant consideration if we were to conclude that the alliance falls foul of one of the

prohibitions in sub-section 88(4) of the Act. As mentioned in paragraph 18, we do not consider this to be the case.

27. However, a wider international relations (aero-political) perspective is relevant to your public interest consideration.
28. Most international code-share arrangements will require approval in two jurisdictions, each with its own legislation or processes. Consideration of comity should not be interpreted to mean that New Zealand must always accept and adopt the findings of the other regulator or the views of the other jurisdiction. The two regulators will be applying different legislation. The impacts of a proposed alliance may also be different in the two countries.
29. In the case of Hong Kong, there is no equivalent competition legislation.
30. Cathay Pacific is partly owned by the Swire Group and partly by Air China. We do not know what attitude the Hong Kong government has toward the alliance, but there is no evidence to suggest that it is of such importance to the Hong Kong government that a decision to decline reauthorisation would have a material impact on New Zealand's overall relationship with Hong Kong.

### **Market developments since 2012**

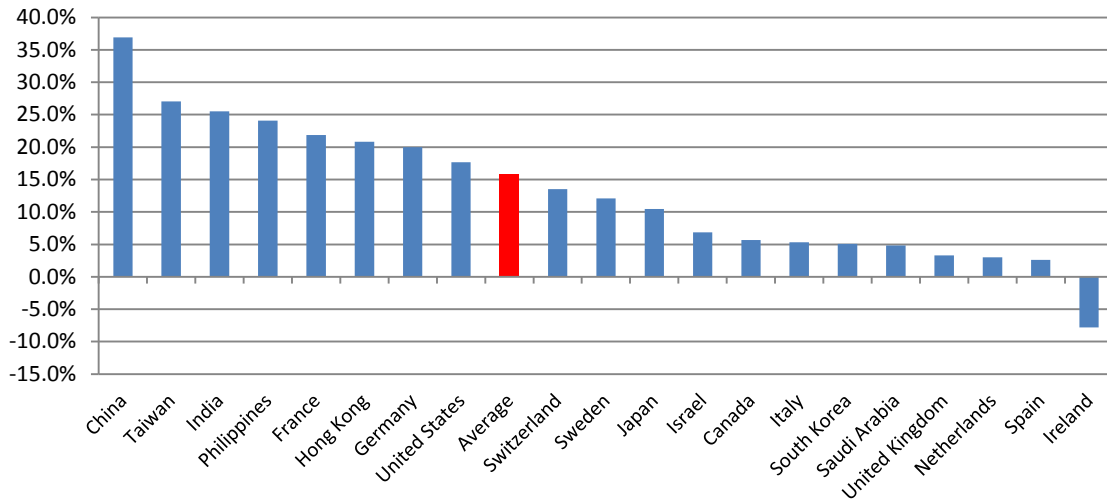
31. This section provides an overview of key industry developments since 2012. Understanding these developments is crucial for our analysis, as it provides a broader context against which to assess our key findings. It also assists in identifying future trends which may influence the decisions the applicants are likely to take both under the status quo and under the counterfactual.

### **Demand for travel in the relevant markets has increased significantly**

32. In our 2012 report, we considered the likely impact of the alliance across a range of markets, including China, the rest of Asia, and Europe, in addition to Hong Kong. At the time, many of these markets were in decline. In particular, we noted that visitor arrivals from Europe had fallen from a peak of 549,015 in the year ended July 2006 to 470,915 in the year ended July 2012. Visitor arrivals from Japan and South Korea had also fallen dramatically from their mid-2000's peak.
33. Since 2012, visitor arrivals to New Zealand have grown significantly. In the 2014 calendar year, total visitor arrivals were more than 2.9 million – an increase of 13 percent compared to the 12 months before the Alliance came into effect.
34. The rate of growth has been even higher across the key alliance markets. The figure below shows the overall change in demand for travel to New Zealand from the countries that make up the top 20 sources of passengers travelling on the Auckland–Hong Kong service. These markets collectively accounted for more than 90 percent of inbound passengers on the Hong Kong–Auckland route in the 12 months prior to the alliance coming into effect. In total, the number of passengers travelling to New

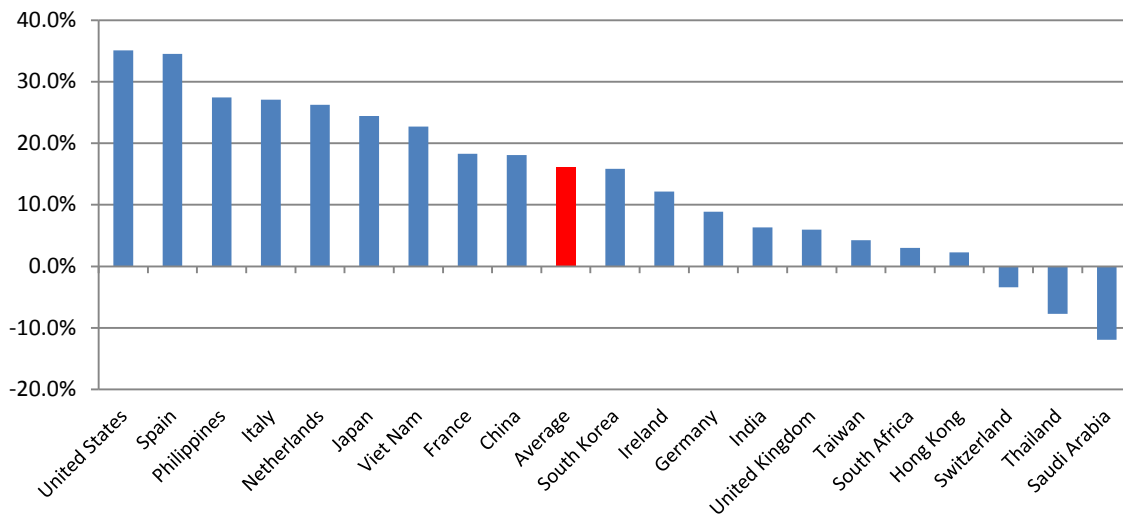
Zealand (on any airline) from these markets has grown by nearly 200,000 since the alliance was authorised<sup>4</sup>.

**Figure 1: Change in demand for travel to New Zealand since the alliance was authorised (from the countries that account for the majority of passengers on the Auckland-Hong Kong route)**



- 35. At the same time, the number of New Zealanders travelling overseas has grown by around 6.2 percent. Once again, this figure is significantly higher (16.1 percent) when looking only at the countries which make up the 20 most common destinations for New Zealanders travelling on the Hong Kong route.

**Figure 2: Change in demand for travel by New Zealanders since the alliance was authorised (for the destinations that account for the majority of passengers travelling on the Auckland-Hong Kong route)**



- 36. The effect of this increase in demand is that Air New Zealand and Cathay Pacific now have a much larger pool of potential passengers from which to draw upon.

**Air New Zealand’s profitability has improved**

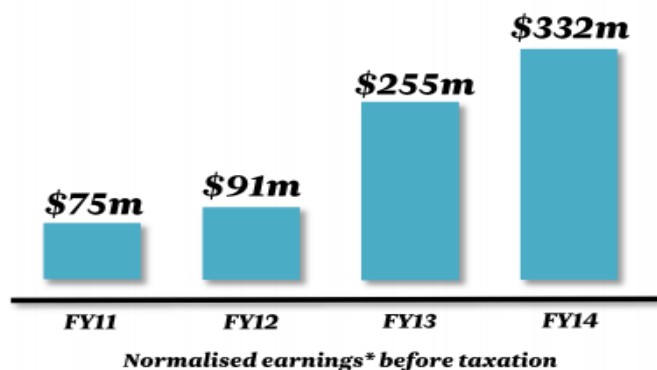
- 37. At the time of the initial application in 2012, Air New Zealand was marginally profitable, generating a relatively low return on equity. This period of low profitability

<sup>4</sup> This methodology includes some markets which represent a small proportion of total alliance traffic, and may not be target markets for Air New Zealand and Cathay Pacific (such as the United States). However, these markets have had very little impact on the average figures quoted above. The weight they carry in our analysis is proportionate to their size.

was not unique to Air New Zealand – it was to a large extent symptomatic of the global airline industry at the time.

38. Since 2012, Air New Zealand's profitability has increased substantially. It is now one of the most profitable airlines of its size in the world. Its return on equity is currently in excess of 15 percent.

Figure 3: Air New Zealand's profitability (source: Air New Zealand)

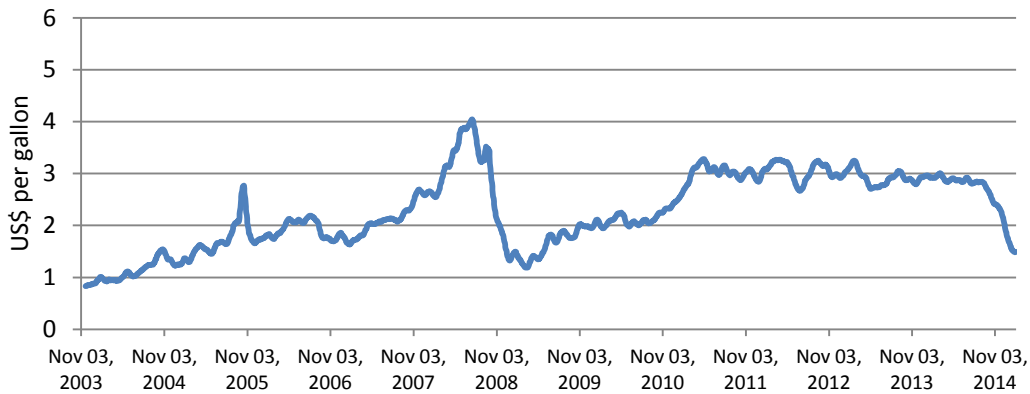


39. While Air New Zealand's financial performance in itself is not a relevant consideration in our analysis, it is relevant to the extent that it influences the course of action Air New Zealand may choose to take, under either the status quo or the counterfactual.

### Fuel prices have plummeted

40. In 2012, both applicants cited the impact of high fuel prices on the profitability of their services. At US\$3 per gallon, fuel can account for more than 40 percent of operating costs on long-haul routes. In total, Air New Zealand spends more than \$1.1 billion annually on fuel.
41. Since October 2014, the price of jet fuel has reduced by more than 30 percent. The impact of this has been softened slightly by a weaker exchange rate and hedging<sup>5</sup>, but it still represents a significant reduction in costs. If lower fuel prices are sustained, it will have a major impact on the profitability of the Auckland-Hong Kong route for both airlines.



**Figure 4: Jet fuel spot prices**

42.

### Air New Zealand has pursued new relationships with other airlines based in Asia

43. In 2014, the Minister of Transport authorised a comprehensive strategic alliance between Air New Zealand and Singapore Airlines, for a period of four years. Under this alliance, Air New Zealand has commenced a daily service between Auckland and Singapore.
44. Under the alliance with Singapore Airlines, Air New Zealand has already entered into code-sharing arrangements covering a number of markets beyond Singapore. Over time, it plans to put its code onto Singapore Airlines flights to Europe, South East Asia, India, and South Africa<sup>6</sup>. Many of these markets are also relevant to the alliance with Cathay Pacific.

<sup>6</sup> In some cases, Air New Zealand is currently unable to code-share with Singapore Airlines under the terms of our bilateral air services agreements. The Ministry of Transport is currently working to amend these air services agreements where possible.

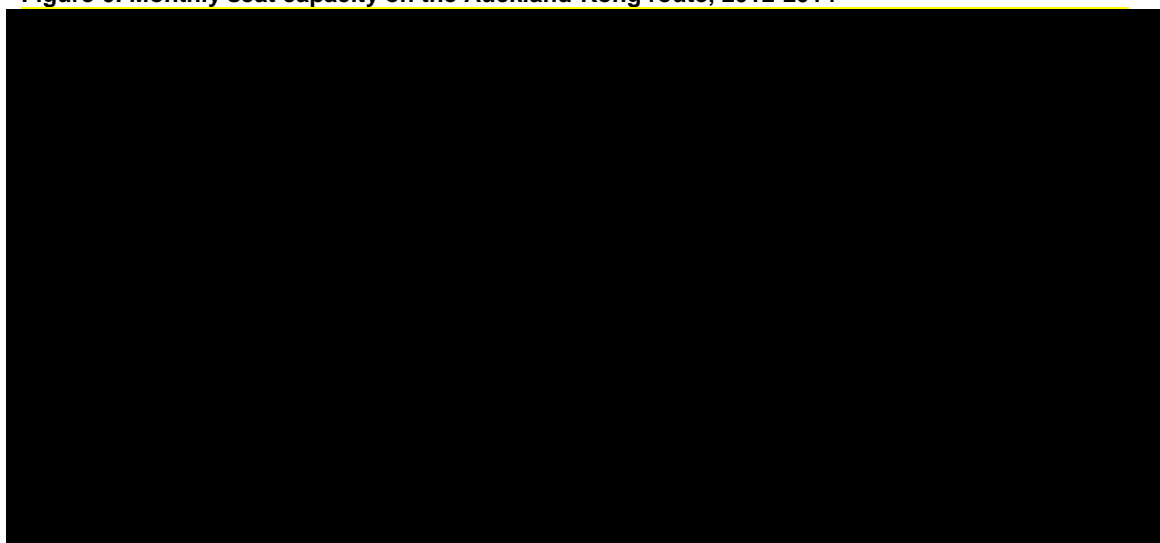
45. As discussed further in paragraph 93, there are a number of barriers which effectively prevent Air New Zealand from entering into code-sharing arrangements with Cathay Pacific. This means that in most cases, Air New Zealand will be able to obtain better access to these markets and at lower prices through its code-share with Singapore Airlines, rather than the Special Prorate Agreement it has negotiated with Cathay Pacific. This applies particularly to markets in South East Asia and India, and to a lesser extent, Europe. It does not apply to North Asia (China, Japan, South Korea and Taiwan), [REDACTED]
46. Separately, Air New Zealand has signalled its intent to enter into a strategic alliance with Air China<sup>7</sup>. Subject to regulatory approval, this alliance would result in Air New Zealand continuing to operate its daily Auckland-Shanghai service, and Air China operating a new daily Auckland-Beijing service. The two airlines would share revenue on both services in accordance with an agreed formula.
47. This alliance would result in Air New Zealand code-sharing on a number of Air China's domestic services from both Shanghai Pudong airport and Beijing Capital International Airport. While connecting services are not expected to be the focus of that alliance, it will provide alternative options which may reduce the number of Air New Zealand passengers travelling through Hong Kong (particularly passengers travelling to/from cities north of Shanghai and Beijing).

## Key findings from our analysis


### Total capacity has reduced and the peak summer season has been shortened

48. Total seat capacity on the Auckland-Hong Kong route has reduced by [REDACTED] over the duration of the alliance, from [REDACTED] in the 12 months before the alliance came into effect to [REDACTED] in the 12 months to November 2014.

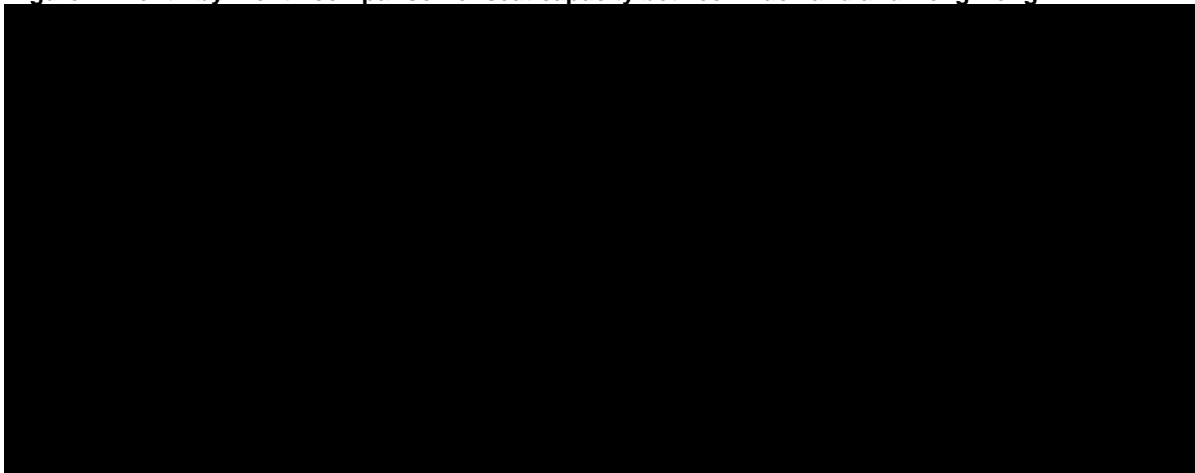
Figure 6: Monthly seat capacity on the Auckland-Kong route, 2012-2014



<sup>7</sup> <http://www.airnewzealand.co.nz/press-release-2014-air-new-zealand-and-air-china-agree-strategic-alliance>

49. This appears to be the result of two factors:
- i. Cathay Pacific introducing premium economy class onto its aircraft (thereby reducing the total seating capacity of its aircraft). This decision was a network-wide decision for Cathay Pacific and would have occurred regardless of the alliance.
  - ii. 

**Figure 7: Month-by-month comparison of seat capacity between Auckland and Hong Kong**



50. When recommending authorisation of the alliance in 2012, we did not necessarily expect that it would result in an increase in capacity. In particular, we acknowledged that it would be unreasonable to expect the alliance to replace all of the capacity that would be lost following Air New Zealand's decision to suspend its Hong Kong-London service. Rather, we anticipated that the alliance might allow capacity to be more or less maintained. However, we did not anticipate that market conditions would be as favourable as they have been, with strong demand in both directions across nearly all of the relevant markets and more recently, low fuel prices.
51. In response to our concerns, the applicants provided further information on the decision to reduce the length of Cathay Pacific's additional seasonal services. They note that this decision was made prior to the alliance, and suggest that it cannot be attributed to the alliance. While we do not dispute the timing of the decision, we note that airlines can and often do adjust their schedules at relatively short notice to respond to changing market conditions. In fact, Cathay Pacific recently announced that it intends to upgauge to a larger aircraft and operate an additional 13,500 seats over the upcoming summer season<sup>9</sup>.
52. Capacity planning is a core component of any alliance. The alliance governance structure includes a commercial board which is required to meet at least four times

<sup>8</sup> Refer to paragraph 5.17 of the Application

<sup>9</sup> <http://www.stuff.co.nz/travel/news/68446795/cathay-pacific-adds-13500-seats-between-auckland-and-hong-kong>

annually to discuss issues including network and capacity planning. The applicants have therefore had numerous opportunities over more than two years to review their capacity on the Auckland-Hong Kong route.

### Load factors have increased

53. Despite the reduction in capacity, the number of passengers travelling on alliance services has remained relatively steady; increasing slightly from 395,589 passengers in the 12 months prior to the alliance coming into effect to 397,011 in the year ended November 2014. As a consequence, load factors (the proportion of seats sold) on alliance services have increased by [REDACTED] percentage points; from [REDACTED] percent to [REDACTED] percent.
54. There is no clear answer as to what an acceptable load factor for an airline is, as it is influenced by yields and the specific characteristics of each route. Load factors within the 75-85 percent range are considered fairly typical across the industry as a whole (the global average in 2012 was 79.1 percent). As shown in the figure below, load factors on alliance services have [REDACTED]

Figure 8: Load factors on Alliance services, 2012-2014



55. The applicants argue in their application that improved load factors are a benefit of the alliance, and evidence that they are utilising their aircraft more efficiently. High load factors can be a benefit of alliances, as it allows airlines to spread their fixed costs over a greater number of passengers, thus creating scope for fares to be reduced. However, high load factors can also be evidence that airlines may be restricting supply in order to improve profit margins.
56. While load factors had previously been [REDACTED]  
[REDACTED] In this case, the increased load factors appear to have been influenced at least in part by [REDACTED]

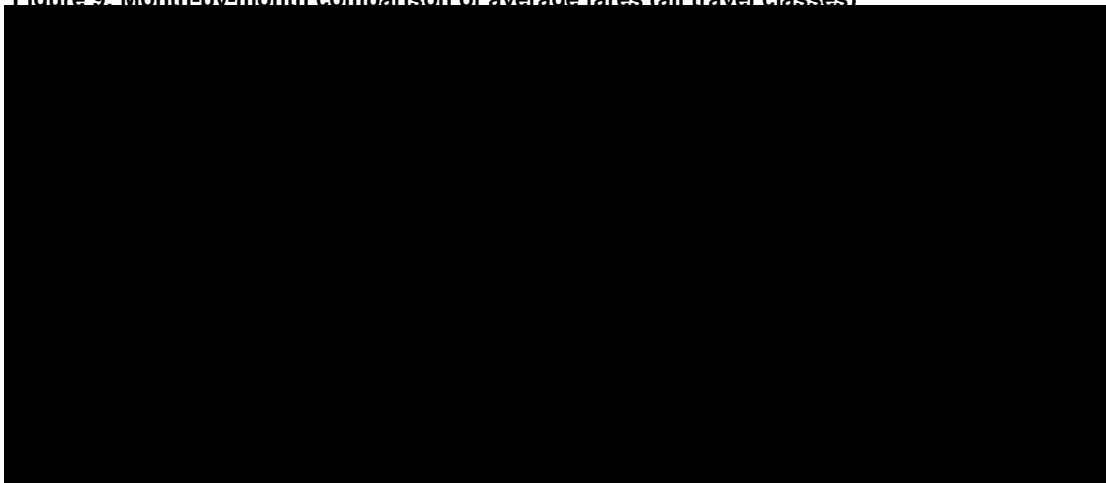
### The impact of the alliance on fares between Auckland and Hong Kong is unclear

57. The application states that total passenger revenue [REDACTED] over the first 12 months of the alliance. When adjusting for the small increase in the total

number of passengers carried, this equates to [REDACTED]  
[REDACTED]

58. However, data supplied by the applicants confirms that [REDACTED]  
[REDACTED]
59. This data is skewed to some extent by the fact that the airlines are selling a higher proportion of premium economy class fares (so some of the increase in revenue is due to passengers choosing to purchase a higher quality product). By travel class, economy class fares have [REDACTED] since the alliance came into effect; premium economy fares have [REDACTED] and business class fares have [REDACTED]
60. As the applicants have since pointed out, this analysis is a fairly simplistic way of measuring changes in fares, as it does not take into account the impact of inflation or fluctuations in the exchange rate. The applicants have noted that inflation in Hong Kong was 9 percent over the period of the alliance (compared to just 2.4 percent in New Zealand). Analysis they commissioned from Dr Michael Tretheway suggests that real average annual fares sold in Hong Kong have [REDACTED], while real average fares sold in New Zealand have [REDACTED]
61. In New Zealand, international air fares have typically tracked well below the consumer price index. In real terms, the cost of international air transport has been declining for decades. In Hong Kong, inflation has been at or near its current rate since the beginning of 2011 [REDACTED]

Figure 9: Month-by-month comparison of average fares (all travel classes)



62. Taking the above into account, we believe there is insufficient evidence to come to a conclusive view about the impact the alliance has had on fares. We have not attempted to calculate a true and dependable assessment of the impact of the alliance

on fares. To do so would require significant external expertise and access to data that is not readily available to us.

### There is some evidence of pricing behaviour that is unlikely to occur in a competitive market

63. We have undertaken a basic analysis of prices charged by a range of airlines on their respective websites for travel to Hong Kong and mainland China. While we acknowledge that this analysis is fairly basic and based upon a small sample size, it does reveal some potentially concerning pricing strategies.
64. Figures 10 and 11 below show the best available fares offered by different airlines at two different dates. All tickets quoted by Air New Zealand and Cathay Pacific are for travel to or via Hong Kong, while prices for other airlines are based on travel via their respective hubs.

**Figure 10: Analysis of tickets booked on airline websites – cheapest available fares for travel in the first two weeks of April 2015, when booked in December 2014**

	Auckland-Hong Kong	Wellington-Hong Kong	Auckland-Shanghai	Auckland-Chengdu	Auckland-Xi'an	Auckland-Nanjing	Wellington-Qingdao
Air New Zealand	\$1,839	\$1,839	\$1,729	\$1,895	\$1,895	\$1,895	\$1,895
Cathay Pacific	\$1,835	\$1,831	\$1,702	\$1,702	\$1,702	\$1,702	\$1,697
Singapore Airlines	\$1,932	\$1,933	\$1,932	\$1,921	N/A	N/A	N/A
Qantas	\$1,378	\$1,374	\$1,359	\$1,632	\$1,656	\$1,502	\$1,495
Malaysia Airlines	\$1,288	N/A	\$1,278	\$1,078	N/A	N/A	N/A

**Figure 11: Cheapest available fares for travel in the last two weeks of June 2015, when booked in February 2015**

	Auckland-Hong Kong	Auckland-Beijing	Auckland-Changsha	Auckland-Kunming	Auckland-Xiamen	Christchurch-Hong Kong	Christchurch-Beijing
Air New Zealand	\$1,845	\$1,845	\$1,845	\$1,845	\$1,845	\$1,839	\$1,845
Cathay Pacific	\$1,817	\$1,127	\$1,127	\$1,127	\$1,127	\$1,833	\$1,327
Singapore Airlines	\$1,932	\$1,932			\$1,921		
Qantas	\$1,369	\$1,648	\$1,602	\$1,712	\$1,602	\$1,359	\$8,769
Malaysia Airlines	\$1,153	\$1,366	N/A	\$1,268	\$1,318	N/A	N/A

65. Of particular note is that tickets between Auckland and Hong Kong are often more expensive than fares between Auckland and mainland China via Hong Kong. The most extreme example of this is Cathay Pacific selling a return ticket from Auckland to Hong Kong for \$1,838, while at the same time selling a return ticket to Beijing (involving the same flight to Hong Kong plus a three hour connecting flight from Hong Kong to Beijing) for \$1,127. This suggests that there is strong demand (or a shortage of supply) for non-stop services to Hong Kong, and the applicants are pricing that service accordingly. It also confirms that competition to other markets beyond Hong Kong is not constraining prices for travel to Hong Kong.
66. The applicants have suggested that this is 'a simple fare comparison performed at a certain point in time, providing a very small sample, which is totally inadequate to

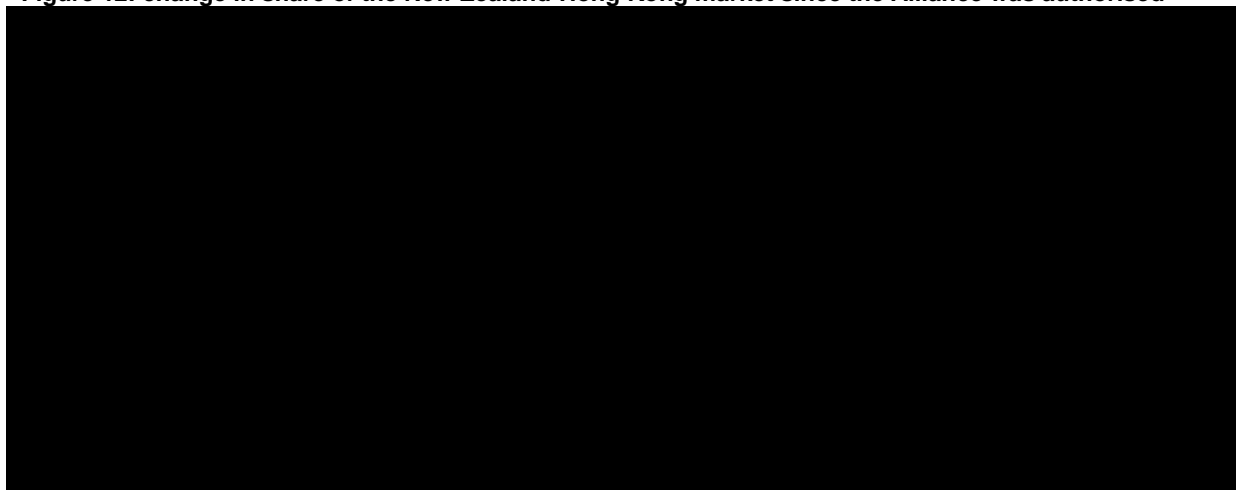
draw serious conclusions'. They also imply that it may have been due to a one-off Cathay Pacific sale on fares to China.

67. Notwithstanding the shortcomings of this analysis, we note that this was just one of numerous examples we found using website comparisons. Such examples are not difficult to find, and indeed the majority of flights to Beijing booked with Cathay Pacific are still priced lower than flights to Hong Kong. We are comfortable that the example shown above is not an anomaly.
68. It is also notable that Cathay Pacific flights involving a connecting service behind or beyond Hong Kong are generally considerably cheaper than comparable flights booked with Air New Zealand. It is also considerably cheaper for services with connecting flights on both ends of the route (refer to the Wellington-Qingdao and Wellington-Nanjing examples above). This implies that [REDACTED]. In our view, this highlights the limitations of interlining, compared to the more in-depth code-sharing arrangements seen in other alliances where the two airlines do not have incentives to apply a mark up to connecting flights sold to the other party.

### The Alliance has lost market-share in the New Zealand-Hong Kong market

69. The applicants note that one-stop carriers, in particular those operating through Australia, have a 'significant and increasing share for travellers between New Zealand and Hong Kong'. This is confirmed in our analysis of Statistics New Zealand data, which shows that Air New Zealand and Cathay Pacific's combined share of the visitor arrivals from Hong Kong has [REDACTED]

Figure 12: change in share of the New Zealand-Hong Kong market since the Alliance was authorised



70. The applicants suggest that the fact they have lost market share is evidence of increased competition in the market. They refer to the large number of airlines offering one-stop services between New Zealand and Hong Kong, and provide examples of airlines that have increased their capacity to either New Zealand or Hong Kong since the alliance was authorised.

71. There is limited evidence to suggest that the drop in market share is due to a strong competitive reaction from other carriers responding to the alliance. Total capacity between the East Coast of Australia and Hong Kong has reduced<sup>10</sup>, and is constrained by the fact that Cathay Pacific is currently utilising its full entitlement of services under the air services agreement between Hong Kong and Australia. In addition, many of the airlines the applicants cite as providing indirect competition in the New Zealand-Hong Kong market have negligible market shares. For example, [REDACTED]
72. The applicants have also suggested that the loss in market share may be a result of Qantas offering marginal pricing in order to attract more passengers travelling on indirect services between New Zealand and Hong Kong. This strategy is not uncommon and it would not be surprising if Qantas was employing this tactic. However, there is no evidence to suggest that this is a recent development that was triggered by the alliance.
73. In our view, the fact that the applicants have lost market share while increasing fares and reducing capacity is evidence that the attractiveness of the alliance to consumers has reduced, relative to other airlines. This appears to justify the concerns stated in our 2012 report to then Minister of Transport Hon Gerry Brownlee, which noted that *'it is likely that the removal of direct competition on the Auckland-Hong Kong route ... would result in higher fares on the direct service and an increase in the proportion of passengers travelling on indirect alternatives'*.
74. However, the reduction in market share also indicates that the applicants may not hold significant market power, as price-sensitive passengers are reacting to increases in price by seeking other options. Therefore, we would expect any further attempts to increase fares on the Auckland-Hong Kong route to result in a further reduction in market share. This is likely to place some constraint on fares.
75. The reduction in market share may not necessarily be a concern to the applicants, provided there is still strong demand for higher-yielding passengers who are prepared to pay a premium for a direct service.

### **The Alliance has gained market share in some key markets**

76. The table below shows the change in Air New Zealand and Cathay Pacific's combined market share across key markets over the course of the alliance. From this data we have excluded passengers we have identified as travelling through Hong Kong for the purposes of connecting to Air New Zealand's Hong Kong-London service. Passengers travelling on this service for the purposes of travelling to or from Hong Kong have been included in the data. We believe this methodology is the best way to capture the fact that some, but not all of the capacity on the Auckland-Hong Kong-London route was dedicated to serving the New Zealand-Hong Kong market.

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<sup>10</sup> As noted by the Applicants, Qantas has increased its capacity between Brisbane and Hong Kong. However, Virgin Atlantic has ceased operating between Sydney to Hong Kong resulting in an overall reduction in capacity between the East Coast of Australia and Hong Kong.



77. This data indicates that the alliance ha [REDACTED]

**Table 1: Change in Air New Zealand/Cathay Pacific market share from pre-alliance (Feb 12 to Jan 13) to the last 12 months (Jan 14 to Dec 14)**

	Total passengers carried (Air NZ + Cathay Pacific)		Share of market		% change in market share	% change in demand
	Pre-alliance	Last 12 months	Pre-alliance	Last 12 months		
China	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Taiwan <sup>11</sup>	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Korea	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Japan	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
United Kingdom	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Germany	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
France	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Philippines	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
India	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]

### There is limited evidence that the alliance has improved connectivity with new or poorly served markets

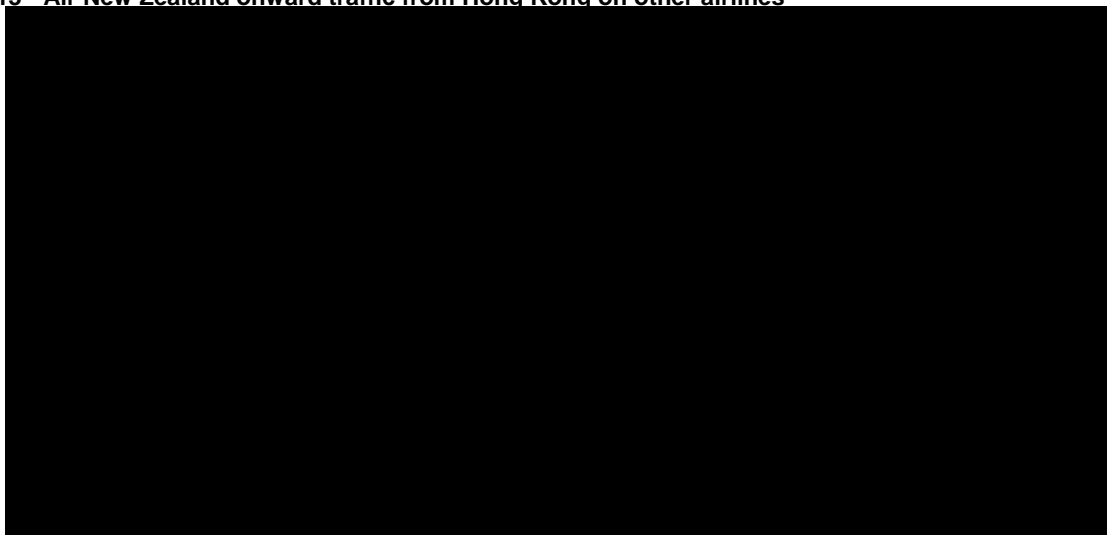
78. The majority of passengers travelling on alliance services between Hong Kong and Auckland are connecting passengers. [REDACTED] travellers on the Hong Kong – Auckland route are actually Hong Kong residents travelling to New Zealand, or New Zealand residents travelling to Hong Kong.
79. The alliance has provided Air New Zealand with access to favourable interline rates for services beyond Hong Kong that are operated by Cathay Pacific and Dragonair<sup>12</sup>. Without the alliance, Cathay Pacific would have little incentive to offer more attractive rates to Air New Zealand while they are competing head-to-head on the Auckland-Hong Kong route.
80. Data provided by the applicants confirms that the average rate that Air New Zealand pays for flights beyond Hong Kong on Cathay Pacific/Dragonair has [REDACTED] by around [REDACTED]. The number of destinations and booking classes to Air New Zealand has also increased substantially. There is little doubt that from Air New Zealand's perspective, this is a substantial benefit of the alliance. However, it is unclear whether these benefits are being passed on to consumers. The applicants have provided some data on connecting fares, but it is not clear how this has been calculated or whether it is a true representation of point to point fares (as it only covers a limited number of self selected city-pairs).

<sup>11</sup> The reduction in market share in Taiwan is likely to be a consequence of China Airlines commencing direct services to New Zealand via Australia.

<sup>12</sup> Dragonair is a wholly-owned subsidiary of Cathay Pacific, which focuses on short-haul flights within Asia.

81. As the graph below shows, prior to the alliance, [REDACTED] of Air New Zealand passengers connecting to a flight beyond Hong Kong on another airline were booked with airlines other than Cathay Pacific or Dragonair. Towards the end of 2014, this figure [REDACTED]. As would be expected under an alliance, Air New Zealand is now more reliant on the networks of Cathay Pacific and Dragonair to provide feed for its services between Auckland and Hong Kong.

Figure 13 - Air New Zealand onward traffic from Hong Kong on other airlines



82. While this demonstrates a large shift in the airlines Air New Zealand is working with to provide onwards connectivity, there has been less change in the destinations of those passengers.
83. In the last 12 months, [REDACTED] of Air New Zealand passengers travelling beyond Hong Kong were travelling to 10 cities – [REDACTED]. In the 12 months before the alliance came into effect, these same cities accounted for [REDACTED] of passengers travelling beyond Hong Kong (excluding those travelling on Air New Zealand's London service). There are multiple airlines operating to all of these destinations from Hong Kong.
84. This demonstrates that from the consumer's point of view, the biggest change has been in the airline they travel with beyond Hong Kong, rather than the destination. It also suggests that Air New Zealand would likely be able to retain a large proportion of passengers travelling to these destinations even if it were unable to obtain the same level of access to Cathay Pacific services.
85. The markets beyond Hong Kong where Air New Zealand has achieved the strongest growth over the course of the alliance include [REDACTED]. In these markets, the growth appears to have been a result of more passengers travelling on Cathay Pacific/Dragonair flights. The exception is [REDACTED].

86. With the exception of [REDACTED]. As a result, we would expect Air New Zealand to route a large proportion of these passengers over Singapore, rather than Hong Kong in the future.
87. Strong growth has also occurred in a number of secondary cities throughout China, including Xi'an, Chongqing, Chengdu, Qingdao, Wuhan, Tianjin, and Dalian (See Appendix I for a map of China). These markets are of particular interest, as we considered improved connectivity to secondary cities in China to be one of the primary benefits of the alliance. In the 12 months before the alliance entered into effect, Air New Zealand sold tickets to [REDACTED] passengers travelling to secondary cities in China (i.e. cities other than Beijing, Shanghai, and Guangzhou). In the year ended September 2014, this had increased to [REDACTED] passengers. This accounts for [REDACTED] percent of Air New Zealand's passengers connecting to destinations beyond Hong Kong.
88. In most of these markets, there are other options in terms of airlines Air New Zealand could interline with. This is especially true of the Northern regions in China where Air New Zealand is not utilising Cathay Pacific and Dragonair as strongly as it is other airlines. Cathay Pacific and Dragonair have stronger networks in the southern and eastern parts of China which Air New Zealand has been able to better leverage. The only airport in China served *only* by Cathay Pacific or Dragonair from Hong Kong is Qingdao, in Eastern China.
89. Appendix II provides a more detailed analysis of the impact the alliance has had on Air New Zealand's interline traffic to different cities throughout China.
90. The applicants refer to the QSI (Quality Service Index) analysis conducted by Dr Michael Tretheway as evidence of the connectivity and scheduling benefits of the alliance. This analysis found that the QSI score for Air New Zealand services rises by [REDACTED], and Cathay Pacific services by [REDACTED], as a result of the alliance.
91. In general, we are sceptical of the value of QSI analysis as a means of measuring the potential benefits of an alliance. While we have not seen the detailed methodology of Dr Tretheway's analysis, our understanding is that it does not take account of the competitive impacts of the alliance. If the alliance results in higher fares or reduced capacity, or it deters other airlines from competing in the market, any other benefits will be quickly eroded.
92. Overall, we are not convinced that the alliance has resulted in significant connectivity benefits. Had connectivity (i.e. fares and schedules) improved significantly, we would have expected far greater volumes of passengers travelling to new markets or markets that were previously poorly served. We accept that the alliance may have resulted in improved schedules and possibly lower fares to some markets, but these appear to primarily be markets that are either well served already (such as Europe), or markets that are being targeted by other alliances involving Air New Zealand.

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<sup>14</sup> Markets that are considered to be primary drivers of traffic for the Air New Zealand/Singapore Airlines Alliance.

### There are significant barriers preventing the connectivity benefits from being fully realised

93. The alliance will continue to face some significant regulatory and market barriers which are likely to prevent the airlines from fully realising its potential connectivity benefits. These barriers include:

i. New Zealand's air services agreements with Hong Kong and China, [REDACTED]

ii. The Star Alliance procedures, [REDACTED]

iii. The commercial terms of Air New Zealand's alliance with Singapore Airlines, [REDACTED]

94. The combined effect of these three factors is that [REDACTED]

### There are a range of alternative options for Air New Zealand to expand its presence in China and North Asia

95. In recommending that the Minister authorise the alliance in 2012, an important consideration was the strategic importance of maintaining an Air New Zealand presence in a key Asian hub. In particular, we noted that:

*"Hong Kong is Air New Zealand's main gateway for servicing Chinese markets other than Shanghai. Air New Zealand argues that indirect access to these cities is an important step towards building markets for direct flights, and Hong Kong is a key gateway that is critical to Air New Zealand's plans to operate to a wider range of destinations in China in the future. Air New Zealand argues that Shanghai is not*

<sup>15</sup> Singapore, New Zealand, the United Kingdom, Germany, India, Indonesia, Malaysia, Thailand, Vietnam, the Philippines, South Africa, France, Italy, the Netherlands, and Switzerland.

*suitable for generating connecting traffic, as its services to Shanghai arrive at Pudong airport, while the majority of domestic services depart from Hongqiao airport”.*

96. Hong Kong has clearly retained its status as a key international gateway. However, in light of recent market developments and a broader analysis of alternative options, we are not convinced that the alliance with Cathay Pacific is the *only* option for Air New Zealand to expand its presence in China and North Asia. There are a range of alternatives that Air New Zealand could explore, all of which are likely to raise fewer competition concerns.

97. In particular, Air New Zealand’s proposed alliance with Air China could provide connectivity to northern and eastern China that is at least comparable to and could well exceed what Cathay Pacific can provide. While it is true that in general the majority of domestic services from Shanghai depart from Hongqiao airport, Air China is an exception to this. Air China operates just six domestic services from Hongqiao airport, compared to 16 from Pudong airport. Under this alliance, Air New Zealand could conceivably also have access to Air China’s domestic flights from Beijing, from which it operates to 87 domestic destinations. Air New Zealand would also be able to code-share on these services as they are not affected by the restriction on third-country code-sharing in our air services agreements with China and Hong Kong.

98.

However, it is likely that at least a portion of Air New Zealand’s passengers travelling to China would continue to travel with Air New Zealand and connect through Shanghai, rather than Hong Kong.

99. Other options that Air New Zealand could consider include:

i.

[REDACTED]

ii. Cooperating more closely with other Star Alliance carriers in the region, such as All Nippon Airways (based in Japan). It is also feasible that Air New Zealand could consider operating its own aircraft to either Seoul or Taipei, where it could conceivably strengthen its cooperative agreements with either Asiana Airlines or EVA Air (both Star Alliance members, based in South Korea and Taiwan, respectively). However, we accept that both options would be extremely challenging from a commercial perspective and would take considerable time to implement.

100. Appendix III shows the points that All Nippon Airways, Asiana, EVA Air, and Hong Kong Airlines serve in mainland China, in comparison to Cathay Pacific and Dragonair.

### **Cathay Pacific will also have other options to access regional centres in New Zealand**

101. For Cathay Pacific, a key benefit of the alliance has been improved access to Air New Zealand's domestic network as a result of the more favourable special prorate agreement. In the last 12 months, around [REDACTED] percent of New Zealanders travelling on Cathay Pacific services originated from outside of Auckland, compared to [REDACTED] percent in the 12 months prior to the alliance entering into effect. This is a key benefit of the alliance which has been clearly demonstrated.
102. Without the alliance, Air New Zealand would have limited incentives to provide favourable access for Cathay Pacific on its domestic services.
103. On the other hand, Jetstar does have strong incentives to provide favourable rates to Cathay Pacific. It is a wholly owned subsidiary of Qantas. Qantas is one of Cathay Pacific's partner airlines under the oneworld alliance, [REDACTED]. At present, Jetstar operates a relatively limited domestic network. However, Jetstar recently announced that it will be expanding its domestic operations in New Zealand. We understand that Jetstar will operate to four regional centres in New Zealand<sup>16</sup>. This will provide Cathay Pacific with a more viable alternative to Air New Zealand for passengers based outside of Auckland (or passengers travelling to destinations beyond Auckland).

### **The alliance has resulted in improved flight schedules**

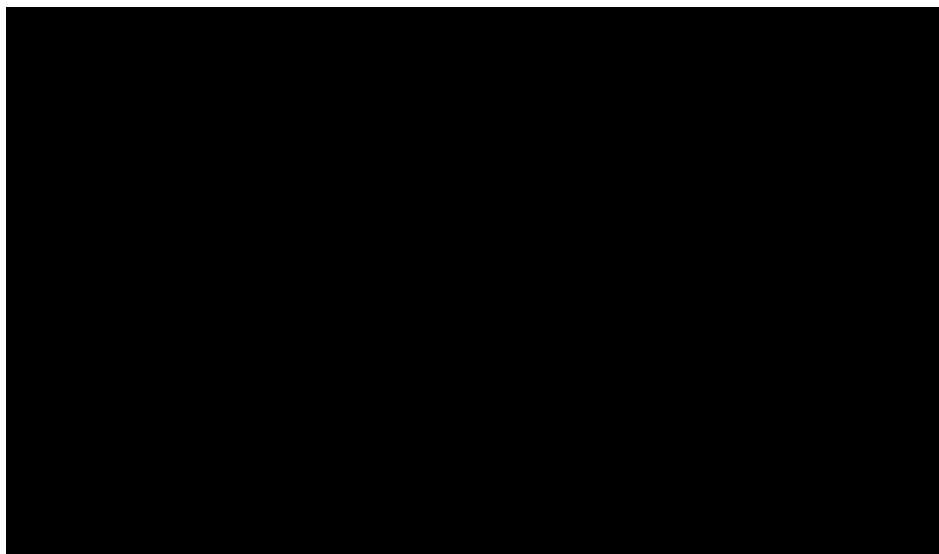
104. Prior to the alliance, the applicants did not operate flights at the same time of day. This meant there was little scope for improving flight schedules under the alliance.
105. Under the alliance, Air New Zealand has made a slight change to its schedule by bringing forward the departure time of its daily service to Hong Kong from 7.20pm to 5.50pm. The applicants state that this change provides customers with a better choice of flight times, including the ability to purchase cross-metal<sup>17</sup> tickets with more seamless connections.
106. The applicants point to the the large number of cross-metal sales that have occurred since the alliance came into effect (see figure 14, below). They suggest that any Air New Zealand ticketed passengers booked onto a Cathay Pacific operated flight (and vice versa) must be receiving a scheduling benefit, as they would not have been able to do this without the alliance, and would not do so unless they received a benefit from it.
107. Broadly, we accept the argument that every cross-metal sale is providing some consumer benefit. The benefit is likely to be relatively significant for time-sensitive

[REDACTED] However, we understand that the exact services to be operated have not yet been confirmed.

<sup>17</sup> Where one carrier sells tickets onto the other carrier's Auckland-Hong Kong services.

business passengers (particularly those with onward connections beyond either Hong Kong or Auckland), and passengers with a strong loyalty towards a particular airline (who would not have previously considered travelling with the other airline). However, in many cases the scheduling benefit is likely to be of marginal value, as many leisure passengers are likely to be indifferent as to the time of day they travel.

**Figure 14: Coss-metal sales on the Auckland-Hong Kong route**



108. The applicants also note that the schedule change has made it possible for business travellers to travel overnight to Hong Kong for a full working day and return to New Zealand on a late night service. Our analysis indicates that in the 2014 calendar year, 80 New Zealanders travelled to Hong Kong for a duration of one day. While this is a large increase from 20 passengers in the 12 months before the alliance came into effect, the numbers are not large enough for us to confidently attribute this to the alliance, and are too small to carry any real weight in our analysis.

### **Some consumers have benefitted from reciprocal frequent flier schemes and joint lounge access**

109. Air New Zealand submits that Airpoints accruals<sup>18</sup> have risen over the period of the alliance from around [REDACTED] on the Auckland-Hong Kong route in the year immediately preceding the alliance to over [REDACTED] in the year to September 2014. This amounts to an additional [REDACTED] earned over the period of the alliance.
110. The alliance also provides for reciprocal lounge access on the Auckland-Hong Kong route. The Applicants stated in their application that [REDACTED]
111. We note that reciprocal lounge access is frequently negotiated by airlines that are not party to a revenue-sharing alliance.

<sup>18</sup> Accruals are the number of one-way journeys that have earned Airpoints.

112. While it is clear the alliance has delivered frequent flyer and lounge access benefits for consumers, the benefits apply primarily to frequent flyers and business travellers who make up [REDACTED] passengers on the Auckland-Hong Kong route. As a result, we consider these benefits to be modest.

**There is no evidence that consumers have benefitted from cost savings or operational synergies**

113. A frequently cited benefit of alliance agreements is the potential for the airlines to achieve cost savings through initiatives such as joint ground-handling arrangements. Operational cost savings can result in benefits to consumers by creating scope for fare reductions.
114. In their application, the applicants note that they have not entered into a joint ground-handling arrangement, [REDACTED]
115. The applicants note in their response to third-party submissions that a further five-year authorisation would provide additional opportunities for them to identify and implement additional cost savings or synergies. They note that this was part of our justification in recommending that the Air New Zealand/Virgin Australia alliance be extended for five years.
116. Given the relatively narrow scope of this alliance, we consider the scope for further operational cost savings to be extremely limited. It is likely that any meaningful cost savings have already been implemented.

**The alliance may have had a role in stimulating tourism to New Zealand, but the impact is difficult to measure**

117. The alliance has incentivised both airlines to coordinate their marketing of the Hong Kong-Auckland route. In particular, Air New Zealand has been able to market New Zealand as a destination to Cathay Pacific's customer base in Hong Kong and China. The effect of this is difficult to quantify, but it is clearly a benefit that would not occur in the absence of the alliance.
118. Air New Zealand has also worked closely with Tourism New Zealand, investing over [REDACTED] in joint venture marketing activity in 2014 to grow visitor arrivals from Hong Kong and Southern China. The applicants have agreed to undertake a number of joint venture promotions activities in the 2016 financial year, many of which will include Tourism New Zealand.
119. Since the alliance came into force, demand for travel from Hong Kong and China has grown significantly (16% and 32% respectively from the 12 months prior to the alliance to the year ended December 2014). The number of Hong Kong residents travelling on alliance services has increased by [REDACTED]
120. It is difficult to determine conclusively whether the alliance has had a positive impact on tourism. In assessing this aspect of the alliance we have assumed that the tourism benefits of an alliance are dependent upon whether the alliance has increased passenger volumes. The fact that total passenger volumes on alliance services (across



all markets) are essentially the same as in 2012, suggests that the tourism benefits have not been substantial.

**The prospects of competition from a third-party are negligible, with or without the alliance**

121. Most long-haul routes to/from New Zealand can be categorised as long and thin, meaning they involve long travel times and cater to a relatively small customer base. The Auckland-Hong Kong route is one such route and as a result it is unlikely to be large enough to support a third airline competing against Air New Zealand and Cathay Pacific.
122. The airline that is most likely to consider operating the Auckland-Hong Kong route is Hong Kong Airlines. However, Hong Kong Airlines is unable to pursue an expansion of its long haul aircraft fleet due to restrictions placed on it by the Hong Kong civil aviation regulator requiring it to meet certain safety requirements.
123. Until recently, there had been speculation that a new airline under the Jetstar brand would establish a hub at Hong Kong. This may have provided a competitive threat to the alliance in the longer term. The proposed airline would have operated as a joint venture between Qantas, China Eastern, and Shun Tak Holdings. However, in June 2015 the Hong Kong Air Licensing Authority rejected the airlines' application for an operating certificate. This decision further highlights the fact that additional competition from another Hong Kong based carrier is unlikely.
124. As noted in our 2012 report, a number of third-country airlines also hold the necessary traffic rights under the relevant bilateral air services agreements to operate services between Hong Kong and New Zealand. However, the most obvious candidates to operate such a service are European airlines. No European airline has operated to New Zealand for more than a decade, as these services are generally uneconomic (as evidenced by Air New Zealand suspending its Hong Kong-London service).
125. We do not envisage any other airline being in a position to operate between Auckland and Hong Kong in the short or medium term (i.e. within the next five years). Accordingly, we have not placed any weight on the prospects of market entry from another airline in our analysis. It is a neutral factor that is unlikely to be relevant in any of the plausible counterfactual scenarios. In the longer term, the prospects for competition on the route would be higher without the alliance, as the alliance provides a competitive advantage that no other carrier could reasonably be expected to replicate.

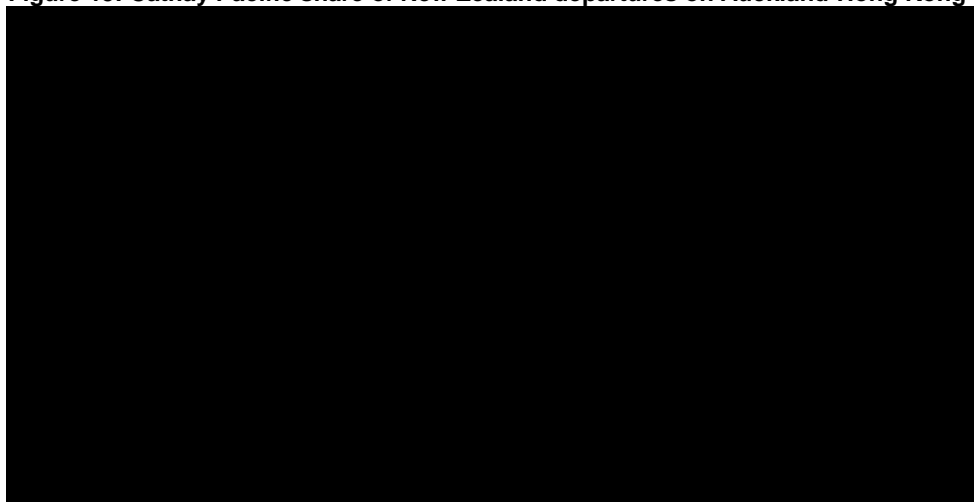
126.



### The alliance is likely unlikely to result in new routes being developed between New Zealand and Hong Kong

127. The applicants stated in their 2012 application that the alliance was expected to *“create opportunities to put additional capacity onto the Alliance Routes, as well as potentially commence operating additional sectors between New Zealand and Hong Kong”*.
128. No new routes have been developed under the alliance.
129. Under the alliance, Cathay Pacific has been able to achieve greater access to passengers throughout New Zealand by gaining better access to Air New Zealand’s domestic network at a lower price (see figure 15, below). In many respects, this is an advantage of the alliance. However, it also reduces Cathay’s incentives to operate its own aircraft to other parts of New Zealand (such as Christchurch).

**Figure 15: Cathay Pacific share of New Zealand departures on Auckland-Hong Kong services**



130. [REDACTED]
131. [REDACTED] they also suggest that a Christchurch service is more likely with the alliance than without, and that the alliance has delivered benefits to Christchurch passengers even without a direct service.
132. In our opinion, the likelihood of a direct service between Christchurch and Hong Kong is relatively low in either case. Any prospects of a direct service would be further diminished in the event that China Southern commenced a direct service between Christchurch and Guangzhou (which we consider to be highly likely within the next 1-2

years<sup>19</sup>). As a result, this has not carried significant weight in our analysis. It is also consistent with the view we expressed in our 2012 report, where we noted that “without direct competition, the applicants would appear to have little incentive to establish new routes such as Christchurch-Hong Kong, which would incur additional fixed costs”.

133. The significance of this issue lies more in the fact that one of the purported benefits of the alliance in 2012 has now been proven to be false. The fact that the potential for a Hong Kong-Christchurch route to be developed in future was not even referred to in the current application is telling. In his expert statement, Dr Michael Tretheway suggests that the applicants may have been reluctant to develop a new route because of the uncertainty that the alliance may not be reauthorised. However, the applicants would be aware that developing a new route would have significantly enhanced the prospects of the alliance being reauthorised.
134. The potential for new routes to be developed is often raised in alliance applications, but in our experience, alliances tend to have the opposite effect. For example, under the trans-Tasman alliance between Air New Zealand and Virgin Australia, there has been an overall reduction in services to/from regional airports, and the total number of routes operated has reduced, rather than increased. We have noted however that Singapore Airlines has recently announced that it will be offering additional services to Christchurch over the peak 2015/16 summer period, despite the fact that it operates the Singapore-Christchurch route under an alliance with Air New Zealand.

### The applicants still compete in the freight market

135. The alliance does not provide for the applicants to coordinate in the freight market. This has allowed Air New Zealand to continue to compete with Cathay Pacific for freight between Auckland and Hong Kong.
136. When the alliance was authorised in 2012, competition in the freight market was considered a key benefit because absent the alliance, we expected Air New Zealand to reduce its capacity and eventually withdraw from the Auckland-Hong Kong market.

137. As detailed in the *Counterfactual* section below (paragraphs 141 to 149),

[REDACTED]

[REDACTED]

[REDACTED] The total value of exports by air to Hong Kong is around \$227 million. However, this has been trending downwards since 2009, and there are now greater options for exporting direct to China (in particular as a result

<sup>19</sup> <http://www.stuff.co.nz/travel/news/65573111/direct-link-from-christchurch-to-quangzhou>

of China Southern increasing its capacity between Auckland and Guangzhou, just 130 km from Hong Kong).

140. Airlines providing one-stop services do and will continue to provide a competitive constraint in the freight market. A range of airlines operate one-stop services to Hong Kong and China. Indirect competition in the freight market can provide a significant constraint, as most exporters will be less concerned about their goods travelling via indirect routings to get to their final destination.

### Counterfactual

141. A key part of our analysis is the counterfactual. This is the likely scenario that would eventuate if the alliance is not reauthorised.

142. Air New Zealand has stated in its confidential submission that the counterfactual is

[REDACTED]

143. Cathay Pacific has stated in its counterfactual that it would carefully assess performance on the route.

[REDACTED]

144. We did not dispute Air New Zealand's counterfactual submission in 2012 given it was

[REDACTED]

145. As mentioned earlier in this report, there have been several significant market developments since 2012.

[REDACTED]

- a. Air New Zealand is in a much better financial position than it was in 2012.

[REDACTED]

- b. Air New Zealand's costs are likely to reduce significantly due to lower fuel prices (assuming the low prices are sustained).

[REDACTED]

- [REDACTED]
- c. Almost every alliance market has grown since 2012, and the prospects for future growth are good.
- [REDACTED]

146.

[REDACTED]

147.

We consider it highly unlikely that both airlines would significantly reduce their capacity at the same time. [REDACTED]

[REDACTED]

148. Overall, we believe the most plausible counterfactual scenario is:

i. Cathay Pacific [REDACTED]

ii. Air New Zealand [REDACTED]

[REDACTED]

149. While we consider this to be more likely than any other scenario, the counterfactual is highly uncertain. [REDACTED]

[REDACTED]

he uncertainty over the counterfactual has been taken into account in our analysis.

## Submissions

150. We published the alliance application on our website, and invited views from interested parties to help inform our analysis. The period during which submissions

were received was from 9 December 2014 to 23 January 2015. Four submissions were received in total.

151. Auckland Airport stated that it was generally supportive of airline initiatives aimed at alleviating the economic pressures faced by airlines, provided there is no reduction in capacity or other detrimental impact on New Zealand's international air services.
152. Christchurch Airport initially supported reauthorisation of the alliance, but recommended a two-year term of reauthorisation. This would allow the alliance to operate for a total of five years – the initial term of authorisation sought in 2012. However, Christchurch Airport has since provided a further submission and now opposes reauthorisation of the alliance. It is particularly concerned that the alliance may be reducing the incentives for the airlines to develop a direct service to Christchurch.
153. Wellington Airport did not provide a view on whether the alliance should or should not be authorised. However, it submitted that careful assessment of the costs and benefits of the alliance is required and that these should be monitored over the duration of reauthorisation if granted.
154. The Tourism Industry Association submitted that the alliance should be reauthorised provided there has been no customer detriment and the arrangement stimulates inbound tourism. It recommended a review period is built in at a mid-way point as part of any reauthorisation. The Tourism Industry Association also stated that it would be wrong to reauthorise the alliance if it prevented the establishment of additional direct air services between Hong Kong and other New Zealand airports.

**Appendix I - Map of China**



**Appendix II - Air New Zealand interline passengers to Northern regions in China from Hong Kong (Source: Air New Zealand)**

Region (% of total connecting traffic)	Airport	Airlines operating from Hong Kong	% Air NZ passengers on Cathay/Dragonair (last 12 months)	% Air NZ passengers on other airlines (last 12 months)
<i>Northeast China (1.1%)</i>	Harbin Airport	Hong Kong Airlines Hong Kong Express	██████████	██████
	Dalian Airport	Air China	██████████	██████
	Shenyang Airport	China Southern	██████████	██████
<i>North China (16%)</i>	Beijing Airport	Air China Cathay Pacific China Southern Hong Kong Airlines Dragonair Hong Kong Express	██████████	██████████
	Tianjin Airport	Air China Hong Kong Airlines Dragonair	████	██████
<i>Northwest China (0.8%)</i>	Xi'an Airport	China Eastern Dragonair Hong Kong Express	██████	██████
<i>Southwest China (2.9%)</i>	Chongqing Airport	Air China Hong Kong Airlines Dragonair	██████	██████
	Chengdu Airport	Air China Hong Kong Airlines Dragonair	██████	██████
	Kunming Airport	China Eastern Hong Kong Airlines Dragonair Hong Kong Express	██████	██████







### Appendix III – Comparison of possible partner airlines for Air New Zealand to serve China<sup>20</sup>

Airline	Points served in China	Total #
<b>Air China (from Beijing)</b>	<i>Aksu, Baotou, Bayannur, Beihai, Changchun, Changsha, Changzhou, Chaoyang, Chengdu, Chifeng, Chongqing, Dalian, Dandong, Daqing, Datong, Dazhou, Fuyang, Fuyuan, Fuzhou, Ganzhou, Guangyuan, Guangzhou, Guilin, Guiyang, Haikou, Hailar, Hangzhou, Harbin, Hefei, Hohot, Hotan, Huangshan, Jiamusi, Ji'an, Jinan, Jingdezhen, Jiujiang, Karamay, Kashi, Korla, Kunming, Lanzhou, Lhasas, Lijiang, Liuzhou, Mianyang, Mudanjiang, Nanchang, Nanjing, Nanning, Nantong, Ningbo, Ordos, Qingdao, Qiqihar, Quanzhou, Sanya, Shantou, Shanghai, Shenyang, Shenzhen, Taiyuan, Taizhou, Tonghua, Tongliao, Ulanhot, Urumqi, Weihai, Wenzhou, Wuhai, Wuhan, Wuxi, Xiamen, Xi'an, Xiangyang, Xilinhote, Xining, Yancheng, Yangzhou, Yanji, Yantai, Yibin, Yichang, Yichun, Yinchuan, Yining, Yiwu, Yuncheng, Zhangjiajie, Zhanjiang, Zhengzhou, Zhuhai, Zunyi</i>	<b>87</b>
<b>Air China (from Shanghai Pudong)</b>	<i>Beijing, Changsha, Chengdu, Chongqing, Dalian, Guangzhou, Guilin, Guiyang, Hohot, Jinan, Jingdezhen, Kunming, Lanzhou, Nanchang, Qingdao, Quanzhou, Sanya, Shenyang, Shenzhen, Taiyuan, Tianjin, Wenzhou, Xiamen, Xi'an, Yantai, Yinchuan, Zhuhai</i>	<b>27</b>
<b>Air China (from Hong Kong)</b>	<i>Chengdu, Chongqing, Dalian, Hangzhou, Tianjin, Wuhan</i>	<b>6</b>
<b>Hong Kong Airlines (from Hong Kong)</b>	<i>Beijing, Chengdu, Chongqing, Fuzhou, Guilin, Guiyang, Haikou, Hangzhou, Harbin, Nanjing, Nanning, Sanya, Shanghai Hongqiao, Shanghai Pudong, Taiyuan, Tianjin, Xiamen, Xuzhou,</i>	<b>18</b>
<b>Singapore Airlines/Silk Air (from Singapore)</b>	<i>Beijing, Changsha, Chengdu, Chongqing, Guangzhou, Hangzhou, Kunming, Shanghai, Shenzhen, Wuhan, Xiamen</i>	<b>11</b>
<b>All Nippon Airways (from Tokyo Narita)</b>	<i>Beijing, Chengdu, Guangzhou, Hangzhou, Shanghai, Shenyang, Qingdao, Xiamen</i>	<b>8</b>
<b>EVA Air (from Taipei)</b>	<i>Beijing, Chengdu, Chongqing, Dalian, Fuzhou, Guangzhou, Guilin, Hangzhou, Harbin, Hohhot, Huangshan, Ningbo, Jinan, Shanghai, Shenyang, Shenzhen, Tianjin, Wenzhou, Zhengzhou</i>	<b>12</b>
<b>Asiana Airlines (from Seoul)</b>	<i>Beijing, Changsha, Changchun, Chengdu, Chongqing, Dalian, Guangzhou, Guilin, Hangzhou, Harbin, Huangshan, Jinan, Nanjing, Qingdao, Shanghai, Shenzhen, Tianjin, Xi'an, Yancheng, Yanji, Yantai</i>	<b>22</b>
<b>Cathay Pacific/Dragonair (from Hong Kong)</b>	<i>Beijing, Changsha, Chengdu, Chongqing, Fuzhou, Guangzhou, Guilin, Haikou, Hangzhou, Kunming, Nanjing, Ningbo, Qingdao, Sanya, Shanghai, Tianjin, Wenzhou, Wuhan, Xiamen, Xi'an, Zhengzhou</i>	<b>21</b>

<sup>20</sup> This list is intended to provide a broad indication of the airlines' networks. It does not show the frequency of flights operated to each of these destinations. We acknowledge that a key advantage of Cathay Pacific/Dragonair is the relatively high frequency of their flights to many of the destinations listed.

## Appendix IV – Assessment of the extent to which the benefits outlined in the 2012 application have been delivered

Claimed benefit	Delivery	Comment
<b>Immediate access to more connecting flights</b>	✓	Both airlines are selling more tickets on connecting flights operated by the other airline. Passengers who would have previously only considered travelling with one airline are now able to choose from a greater range of flights throughout the day.
<b>Improved flight schedule benefits</b>	✓	Air New Zealand has rescheduled its outbound flight to Hong Kong, in order to facilitate connections beyond Hong Kong on Cathay Pacific and Dragonair flights.
<b>Frequent flyer and lounge access benefits</b>	✓	There has been a significant increase in frequent flyer accruals on alliance services. This is a genuine benefit to certain passengers (primarily business passengers and frequent fliers). Joint lounge access is a minor benefit which is valued by a relatively small proportion of passengers and could be achieved even without the alliance.
<b>Stimulation of inbound tourism</b>	?	The China and Hong Kong markets have grown significantly, but it is not clear that this has been driven by the alliance. Any impact on tourism is likely to be relatively small, given that capacity has reduced and the total number of passengers travelling on alliance services is roughly the same as in 2012.
<b>Access to more lower priced inventory</b>	?	The impact of the alliance on airfares is unclear. However, there is no evidence that more of the lowest priced seats have been made available.
<b>Cost savings and efficiencies</b>	✗	Load factors have increased significantly, but this appears to be driven by capacity reductions rather than the alliance stimulating demand through lower prices or an improved product offering. The applicants note that they have not entered into a joint ground-handling arrangement, [REDACTED] [REDACTED] There is no evidence of cost savings being passed on to consumers.
<b>Additional capacity on the Auckland-Hong Kong route</b>	?	Total capacity has reduced. However, the applicants have announced that they will increase capacity by 5 percent over the 2015/16 peak summer period.
<b>Opportunities for additional sectors between New Zealand and Hong Kong</b>	✗	There appears to be little or no incentive for the alliance to consider operating additional sectors to points other than Auckland.