

Reauthorisation of the Air New Zealand / Cathay Pacific Alliance 2019

Reason for this briefing	Air New Zealand and Cathay Pacific have applied for the reauthorisation of their North Asia Alliance Agreement and Code-Share Agreement. This briefing accompanies our detailed analysis regarding the proposed reauthorisation.
Action required	Agree to reauthorise the Alliance for a period ending 31 October 2024.
Deadline	30 August 2019.
Reason for deadline	The current authorisation expires on 30 October 2019. The airlines have asked for a decision in advance of this date, as the decision influences their business planning.

Contact for telephone discussion (if required)

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MINISTER'S COMMENTS:

Date:	2 August 2019	Briefing number:	OC190696
Attention:	Hon Phil Twyford	Security level:	Commercial: In Confidence

Minister of Transport's office actions

- Noted*
 Seen
 Approved
- Needs change*
 Referred to
- Withdrawn*
 Not seen by Minister
 Overtaken by events

Purpose of report

1. Air New Zealand and Cathay Pacific (the Applicants) have applied for the reauthorisation of their airline alliance, under their North Asia Alliance Agreement (the NAAA), the free sale code share, and related agreements contemplated in the NAAA (together, the Alliance).
2. This briefing seeks your agreement to reauthorise the NAAA and Code-Share Agreement under the Civil Aviation Act 1990 (the Act). The effect of reauthorisation is to exempt the arrangements from the provisions in the Commerce Act 1986 that prohibit practices substantially lessening competition.
3. Our detailed analysis is attached to this report. The North Asia Alliance Agreement, the Code-Share Agreement and the airlines' application are also attached.

Background

The 2012 application

4. In 2012, Air New Zealand and Cathay Pacific submitted an application seeking authorisation of a strategic alliance. The Alliance was authorised by the then Minister of Transport on 1 November 2012 for a period of three years.
5. At the time, we considered a three-year authorisation period would minimise the risks to New Zealand of the alliance not delivering benefits to consumers, while providing the airlines with an opportunity to demonstrate its value. The Alliance had a start date of 30 January 2013.
6. Under the Alliance, the two airlines have effectively merged their operations on services between New Zealand and Hong Kong. The airlines jointly set their prices, schedules and capacity, and share revenue. They have effectively ceased competing with each other on the New Zealand – Hong Kong market.

The 2015 reauthorisation

7. In 2014, the Applicants sought reauthorisation of the Alliance beyond the 30 January 2016 expiry date.
8. The alliance was reauthorised until 31 October 2019 (an additional three years and nine months). The applicants initially sought reauthorisation for five years but we concluded that we should be in a position to reassess the effects of the Alliance earlier than that. This was mainly due to lingering concerns that the Alliance might take advantage of its market position by restricting supply and increasing airfares.
9. In December 2017, Cathay commenced a new direct seasonal Alliance service between Hong Kong and Christchurch.

The current application

10. On 6 November 2018, the Applicants sought reauthorisation for a further five-year period, i.e. until 31 October 2024.
11. The Applicants have argued the Ministry's earlier concerns have not materialised and that the Alliance has been responsive to market conditions and set capacity and airfares at appropriate levels in an increasingly competitive environment.

The Alliance

12. The Alliance provides for varying levels of cooperation between the Applicants on passenger services on:
 - **Alliance Routes:** sectors directly between Hong Kong and New Zealand by either airline (currently Auckland – Hong Kong and Christchurch – Hong Kong)
 - **Feeder Routes:** the domestic New Zealand sector of an international route that includes both an Alliance route and a domestic New Zealand sector.
13. Under the NAAA, the Applicants coordinate their capacity, scheduling and pricing on the Alliance Routes and Feeder routes, while also sharing revenue on Alliance routes. The Alliance does not provide for such coordination on Cathay Pacific's Hong Kong connecting routes.
14. The NAAA sets out the principles and objectives that will underlie the establishment and maintenance of cooperation between the Applicants. It also details the markets that are covered and the level of cooperation attached to those markets.
15. A number of implementing agreements support the Alliance. These include:
 - **Code-Share Agreement** that covers both Alliance Routes (the Applicants do not code-share on Air New Zealand's feeder routes or Cathay Pacific's connecting routes beyond Hong Kong)
 - **Special Prorate Agreement (SPA)** which sets out the proportional rates, or "prorates" the Applicants will charge each other for seats on the flights they operate, on such feeding/connecting routes as the Applicants may agree. The SPA provides more favourable rates on connecting flights to certain "beyond" destinations on the Applicants' respective networks.
 - **Premium Customer Handling and Lounge Agreement** to provide reciprocal premium handling, including lounge access to the extent practical
 - **Frequent Flyer Programme (FFP) Agreement** to enhance the parties' existing frequent flyer programme agreement to the extent practical
16. The Applicants have only applied for authorisation of the NAAA, the Code-Share Agreement and the amendments to those agreements.

Authorisation is under section 88 of the Civil Aviation Act

17. The Applicants have requested authorisation of the Alliance and supporting code-share agreement under section 88 of the Civil Aviation Act 1990. The effect of authorisation under this section is that the arrangements under the Alliance are exempt from the provisions of the Commerce Act 1986 that prohibit arrangements substantially lessening competition.
18. Section 88 sets out a number of statutory pre-conditions that must be met before authorisation is granted. We have concluded that the provisions of the Alliance fall within the scope of section 88 of the Civil Aviation Act 1990 and meet the statutory conditions allowing them to be authorised.

Competition Analysis

19. As part of our analysis, we have reviewed how the Alliance likely affects, and will affect, competition in the market for international air services to and from New Zealand. We have defined the primary market as being that region, which is primarily affected by scheduling, pricing and capacity coordination under the Alliance. In the context of this application, we consider the relevant primary market to be the New Zealand – Pearl River Delta region¹, which includes the routes between New Zealand and Hong Kong.
20. We have compared airlines shares on the routes between New Zealand and the Pearl River Delta, airfares and considered other relevant aspects in our analysis. We have concluded that the competitive dynamic of the New Zealand – Pearl River Delta market has changed greatly since the initial authorisation of the Alliance, and it is clear from the data that the airlines operating the routes between New Zealand and the Pearl River Delta are competing for passengers. The Applicants have taken appropriate steps to defend their share in this market in spite of changing market dynamics.
21. While routes beyond Hong Kong are not “Alliance Routes” (being covered instead by the SPA), the impact that the Alliance will have on them is a relevant consideration in our analysis, since the routes from New Zealand to Hong Kong rely heavily on connecting traffic. Air New Zealand states that approximately [REDACTED] percent of its outward-bound passengers connect through Hong Kong to access beyond markets. We have therefore also considered the impact of the Alliance on the New Zealand – China, New Zealand – Asia (other than China), and New Zealand – Europe markets in our analysis as they cover the majority of all passengers connecting via Hong Kong.
22. The Applicants do not hold large shares in these markets and are unlikely to do so in the future given the ongoing competition on direct and one-stop services between New Zealand and these markets. We therefore consider the Alliance does not raise any competitive concerns in these markets.

Counterfactual

23. The counterfactual is the likely scenario that would occur if the Alliance is not reauthorised. Each Applicant has provided its own confidential analysis of the likely scenario in case of decline. Both airlines’ counterfactual submissions are very similar to those submitted in 2014 and 2015.
24. We accept Cathay’s claim that, absent the Alliance, [REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]
25. [REDACTED]
[REDACTED]
[REDACTED] Air New Zealand might find it hard to compete on the route given Cathay is likely to have more attractive take-off and landing slots and offer better onward connections than Air New Zealand could offer under a traditional SPA agreement with Cathay or other competing airlines operating to Hong Kong.

¹ The Pearl River Delta region includes the Special Administrative Regions (SAR) of Hong Kong and Macau, as well as parts of the Guangdong province in China (including the major cities of Shenzhen and Guangzhou). It is one of the most densely urbanized regions in the world.

26. We accept that, absent the Alliance, Air New Zealand might [REDACTED]
[REDACTED]
[REDACTED].

27. To summarise, we consider it [REDACTED]
[REDACTED] Our view is that Cathay [REDACTED]
[REDACTED], and that Air New Zealand [REDACTED]
[REDACTED]

Public benefits and detriments

28. The main public benefits of the Alliance are increased capacity and improved connectivity.

Increased capacity

29. The Alliance has grown capacity by 11 percent (in available seat kilometres (ASK)) between New Zealand and Hong Kong since reauthorisation, mainly in seasonal summer peaks.

30. This is the result of several factors:

- the up gauge of one of Cathay Pacific's daily services from the A340-400 to the B777-300ER aircraft, which have 75 additional seats
- the replacement of its A340 fleet with A350 aircraft
- the introduction of the new seasonal route between Christchurch and Hong Kong in New Zealand's summer, that the Applicants started to operate on 1 December 2017.

31. The Applicants have been able to maintain passenger volumes on Alliance services across the relevant markets despite the entry (for a time) of Hong Kong Airlines on the Auckland – Hong Kong route and China Southern and Qantas' increases of capacity during the period of reauthorisation.

32. We consider this capacity increase and network growth to be beneficial for New Zealand. It has increased the availability of services to and from New Zealand and provided more options for passengers. The Alliance has enabled the Applicants to sustain international services and to launch new ones in an economically sustainable way.

Stimulation of tourism to and throughout New Zealand

33. The Applicants claim that the Alliance has helped stimulate tourism to and throughout New Zealand by contributing to the growth of visitors travelling to New Zealand from/via Hong Kong.

34. More specifically, the Applicants state that the Alliance has increased point-to-point passenger volumes by 20 percent since the last application and by 26 percent since the Alliance started operating. They have estimated that the increase in inbound passengers (tourists) travelling on the Alliance services has added a value of \$NZ 75 million to the New Zealand economy.

35. It is clear that the introduction of the new route to Christchurch has increased the number of Alliance passengers travelling directly to and from the South Island, with an estimated number of 10,000 passengers arriving in Christchurch from Hong Kong since the opening of the route.

36. One of the goals of the New Zealand-Aotearoa Government Tourism Strategy is that tourism supports sustainable regions. This involves making sure that the benefits of tourism are distributed across all regions.
37. The Alliance has also led to more tourists travelling into regional New Zealand (through Air New Zealand's network). Cathay estimated that █ percent of its passengers connect through Air New Zealand to places other than Auckland, Wellington and Christchurch.
38. Many factors influence tourists in choosing New Zealand as a destination. However, the increase in total passenger volumes on Alliance services combined with the introduction of the new route suggest that the Alliance has contributed to the stimulation of tourism in New Zealand.

The Alliance has not led to increased airfares

39. Due to the complexity in pricing structures around booking windows, we have not reached a firm conclusion as to whether the Alliance has consistently provided for lower average airfares across all fare classes in the markets in which the Alliance operates.
40. However, we can confidently state that the Alliance has not led to increased airfares and responded appropriately to market conditions during the period of reauthorisation.

Greater connectivity

41. It is clear that the Alliance has facilitated greater connectivity by combining the networks of the two airlines.
42. During the period of reauthorisation, the Applicants have revised the SPA to include additional new routes, with Air New Zealand having access to █ routes on Cathay Pacific's network, █ more than in 2013. These changes also include lower average billing rates on both Cathay Pacific and Air New Zealand's like-for-like routes across available travel classes.
43. On the one hand, the Alliance increases Air New Zealand's ability to reach strategic beyond markets, including North Asia, China, and Europe on a daily basis through Cathay's network that could not be replicated otherwise. Air New Zealand states that passengers connecting onto Cathay Pacific's beyond network grew by five percent since reauthorisation.
44. On the other hand, for Cathay Pacific, the Alliance means access to Air New Zealand's domestic network. Cathay Pacific notes that the number of its passengers connecting onto Air New Zealand domestic network grew by █ percent since reauthorisation.
45. We consider this improved connectivity and better access to both Applicants' beyond markets as a key benefit of the Alliance. These commercial benefits flow through to consumers.
46. However, as noted in our detailed report, there are still significant regulatory and geopolitical barriers preventing the connectivity benefits of the Alliance from being fully realised █
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Optimisation of flight scheduling

47. The Applicants have made changes to their respective schedules to provide their customers with a better choice of flight times and connections, including the ability to purchase cross-metal tickets² with more seamless connections.
48. We accept the Applicants' claim that cross-metal sales provide some consumer benefits, especially to time-sensitive passengers and airlines' loyalty programme members. However, we consider that those benefits remain small since many customers travel for leisure, and price, rather than time of day, is likely to be a primary consideration.
49. Air New Zealand recently announced the outcome of a network-wide review to improve its overall performance. In some cases, this will be detrimental to passengers travelling on the Alliance service as it involves changes to schedules that will result in higher aircraft utilisation, but longer connecting times for customers connecting from Alliance services to some beyond destinations.

Joint lounge access and premium customers' benefits

50. We accept that the Alliance provides additional benefits to consumers with respect to loyalty programs and lounge access. However, these benefits remain modest and limited to a subset of premium and/or frequent customers.

Stakeholder views

51. The Ministry consulted stakeholders on the proposed reauthorisation of the Alliance. We received submissions from Auckland International Airport, Tourism Industry Aotearoa and Christchurch International Airport Limited. A short summary of these submissions is provided below.

Auckland International Airport (Auckland Airport)

52. In its submission, Auckland Airport noted that it supports market structure arrangements that are consistent with fair and balanced competition, and which provide clear benefits for travellers.
53. Based on its own analysis, Auckland Airport has not seen any behaviour under the Alliance that would cause it concern. The Airport notes that in part, this is because sufficient competitive restraint exists on surrounding routes such that consumers travelling to/from Auckland have adequate alternative airline options when travelling to/from the connecting markets beyond the Hong Kong hub.

Tourism Industry Aotearoa (TIA)

54. TIA supports the renewal of the Alliance. It considers that the Alliance has stimulated travel to New Zealand from Hong Kong and achieved the benefits it has sought without impacting negatively on connectivity or competitiveness in the international market.
55. It pointed to the fact that tourism in New Zealand has entered a new phase where growth is less spectacular than recent years, so it is important that alliances such as this continue to support the sustainability of our air network and the national airline.

² Where one carrier sells tickets onto the other carrier's Auckland/Christchurch - Hong Kong services.

Christchurch International Airport Limited (CIAL)

56. CIAL did not provide a view on whether the Alliance should or should not be authorised. However, it provided a view on the principles that alliance applications should meet to be authorised. It stressed that before determining if the Alliance is in the public interest, the Ministry should demonstrate that a set of conditions, such as recent market changes and the cumulative impacts of existing alliances the Applicants are party to, and that have been previously authorised by the Minister, have been met.

We recommend that the Alliance be authorised for a five-year term

57. We consider the Alliance has, and will, provide benefits to New Zealand. It provides greater international airline capacity (number of seats and flights) into New Zealand and improved connectivity for passengers travelling between New Zealand and key markets in Southern China, Europe, and Northern Asia.
58. There are risks that alliances can reduce competition in some markets. However, we consider that in this case, these risks are outweighed by the public benefits described above.
59. We recommend that the Alliance should be authorised for a five-year term ending on 31 October 2024 in order to aid Alliance business planning.

We intend to publish a copy of our detailed analysis on our website

60. Consistent with our approach to previous alliance applications, we intend to publish this report and our detailed analysis on our website. This will provide transparency to interested parties on the decision-making process and the factors that were taken into account in making your decision. We will withhold any sensitive information in accordance with the Official Information Act 1982.

Next steps

61. We intend to publicise your decision regarding authorisation on the Ministry of Transport website, and advise relevant stakeholders.
62. As previously discussed with your office, we will provide a draft media statement advising the public of the decision.

Recommendations

63. The recommendations are that you **authorise** pursuant to section 88(2) of the Civil Aviation Act 1990:
- (a) the provisions of the North Asia Alliance Agreement between Cathay Pacific and Air New Zealand dated 16 January 2014, as amended by the Sixth and Seventh Amendments until 31 October 2024 Yes/No
 - (b) the provisions of the Code-Share Agreement between Air New Zealand and Cathay Pacific dated 21 May 2012, as amended by the First and Second Amendments Yes/No

Tom Forster
Manager International Connections

MINISTER'S SIGNATURE:

DATE: