

Reauthorisation of the Qantas/Emirates Alliance - Initial Advice

Reason for this briefing	Qantas and Emirates have applied for reauthorisation of their airline alliance. This briefing provides our initial advice on the proposal.
Action required	Advise whether you would like to discuss further with officials.
Deadline	1 March 2018.
Reason for deadline	The current authorisation expires on 31 March 2018.

Contact for telephone discussion (if required)

Name	Position	Telephone	First contact
[REDACTED]	[REDACTED]	[REDACTED]	
[REDACTED]	[REDACTED]	[REDACTED]	
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MINISTER'S COMMENTS:

Date:	22 February 2018	Briefing number:	OC05660
Attention:	Hon Phil Twyford cc: Hon Julie Anne Genter	Security level:	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- Withdrawn*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. This briefing provides our preliminary advice on an application by Qantas and Emirates (the Applicants) for reauthorisation of their airline alliance, under their Restated Master Coordination Agreement (the Restated Agreement).
2. Our preliminary advice is that the Restated Agreement should be authorised for a period of five years.
3. This briefing will be followed by a more detailed final report, which we will provide to your office in mid-March 2018.

Background

Airline alliances

4. International aviation is governed by a network of thousands of bilateral air services agreements. These agreements often restrict the destinations airlines are able to serve and the capacity they are able to provide. Many of these agreements also 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.
5. No airline in the world can operate every possible route combination that may be wanted by its passengers. Through alliance arrangements, airlines can expand their reach by, in effect, combining their separate route networks.
6. In order to overcome the restrictions imposed in bilateral air services agreements, and the inability to serve all routes with their own aircraft, airlines have developed means of working with one another to expand their global reach. Cooperation between airlines generally takes a number of forms.
 - “Interline” arrangement: in which one airline buys tickets for travel on another airline at a pre-determined price. This is the mechanism through which (for example) Qantas is able to sell its passengers a ticket from Melbourne to Invercargill, even though it does not operate a service to Invercargill.
 - Code-share arrangement: an 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. Code-share agreements are relatively common and rarely raise competition issues.
 - Revenue-sharing alliance: an extensive commercial agreement in which two or more airlines agree to co-operate 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 reduce competition. The agreement which the Applicants are currently working under, and the Restated Agreement, closely resemble a revenue sharing alliance.
 - Global airline alliance: many airlines are members of one of three global alliance groups - Star, Oneworld and Skyteam. Members of global alliances work together to provide services to consumers, by co-operating in areas such as marketing, scheduling, ticketing, and frequent flier schemes. The level of cooperation differs between members, however it is common for members of the same groups to enter into interline and code-share agreements with one another. Qantas is a member of the Oneworld Alliance. Emirates is unusual in that it does not belong to a global alliance.

7. Alliances can result in benefits to consumers, for example, better access to connecting flights, more choices of routes, and the ability to earn and redeem frequent flyer points across the networks of both airlines. Alliances also have the potential to reduce costs for airlines, which in competitive markets results in reduced costs for consumers.
8. However, alliances can carry significant risk as they typically result in a reduction in competition, which can lead to higher fares or reduced services.

The Restated Agreement

9. The Applicants are currently working together under a Master Coordination Agreement that was authorised by the Minister of Transport in May 2013. The agreement was authorised for a period of five years and expires on 31 March 2018.
10. The Applicants intend to continue their alliance under the Restated Agreement. The Restated Agreement provides for continued cooperation and coordination across the Applicants' global networks, including in relation to:
 - planning, scheduling, operating and capacity;
 - sales, marketing, advertising, promotion, distribution strategies, reservation priority and pricing (including fares, rebates, incentives and discounts) for passengers, freight customers and agents;
 - connectivity and integration of certain routes;
 - codeshare and interline arrangements;
 - control of inventories and yield management functions;
 - frequent flyer programs;
 - all passenger-related aspects to provide a consistent level of service to customers including ground services and lounge access;
 - harmonising service and product standards in order to provide a seamless product to passengers;
 - harmonising IT systems;
 - joint airport facilities;
 - joint offices for sales activities;
 - potentially other aspects of operations including ground handling, joint procurement¹ and flight operations;
 - where appropriate and mutually agreed, making joint submissions to authorities on operational matters; and
 - services and activities that are required to facilitate any of the matters referred to above.

¹ The parties are not seeking authorisation for joint procurement because this is outside the scope of the Civil Aviation Act

11. Under the original agreement, a 'benefit transfer model' applied. This model provided a basis for the Applicants to share incremental profits (or losses) resulting from the alliance, on specified 'main trunk routes'.
12. [REDACTED]
[REDACTED] The Restated Agreement states that this model is designed to align incentives of the Applicants, so that each Applicant has an incentive to encourage passengers to select either party as the operating carrier, over competing airlines.
13. The Restated Agreement covers bodies corporate related to the Applicants, including Qantas subsidiaries Jetstar Airways and Jetstar Asia Airways [REDACTED]
[REDACTED]
[REDACTED]

Authorisation is under Section 88 of the Civil Aviation Act

14. The Applicants have requested authorisation of the Restated Agreement under section 88 of the Civil Aviation Act 1990. The effect of authorisation under this section is that the arrangements under the Restated Agreement are exempt from the provisions of the Commerce Act 1986 that prohibit arrangements substantially lessening competition.
15. Section 88 sets out a number of statutory pre-conditions that must be met before authorisation is granted. We have determined that the application for authorisation meets these conditions. A full analysis of how the provisions in the Restated Agreement relate to each of the section 88 pre-conditions will be provided in our final report.
16. [REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]

Public benefits of the alliance

17. We consider the main public benefit of the alliance is improved connectivity for passengers travelling to and from New Zealand. In the application for re-authorisation, the Applicants have pointed to the fact that the alliance has allowed passengers access to more than 2,000 origin/destination points over their combined networks.
18. The alliance has allowed the Applicants to play to their strengths. Passengers are able to benefit from Qantas' greater presence in the Australia and New Zealand markets, while also benefiting from Emirates' greater network reach in regions such as Europe and the Middle East.
19. Absent the alliance, the Applicants would have little ability or incentive to co-ordinate their schedules to allow customers more options in terms of routes and timings across their respective networks.

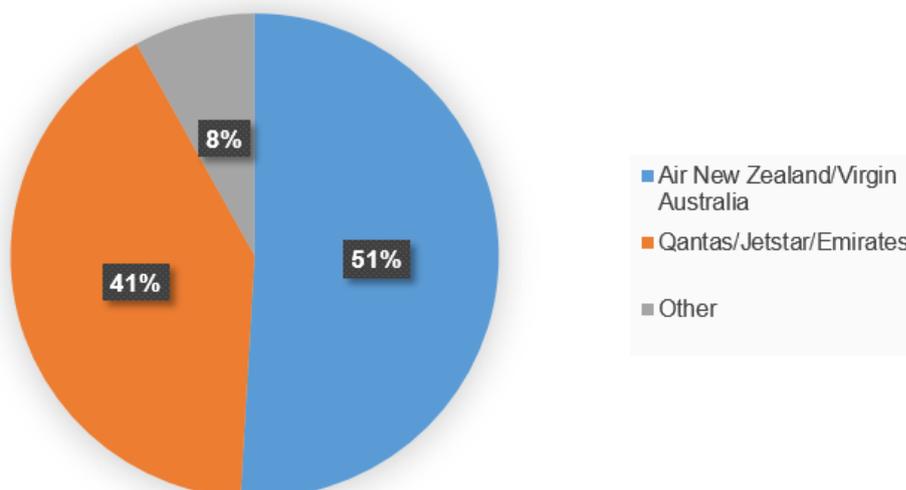
Our main consumer welfare concerns relate to trans-Tasman services

20. In order to determine the impact on consumer welfare, we have analysed each of the individual routes which are relevant to the authorisation of the Restated Agreement. In general, alliances between airlines with complementary networks are more efficient and less restrictive of competition than those involving airlines with more overlapping networks. The networks of Qantas and Emirates are somewhat complementary, but they do involve some direct and indirect overlaps (routes which both Applicants operate over).
21. In most cases, we consider that there is sufficient market presence from competing airlines to ensure that there is no substantial lessening of competition on these routes. Our main concerns relate to the market for trans-Tasman services. These concerns, which were echoed by stakeholders, are detailed below.

The trans-Tasman Market

22. As detailed in the chart below, the trans-Tasman air transport market is dominated by only two players. These are the alliance of Emirates and Qantas, competing with the alliance of Air New Zealand and Virgin Australia. Together these two competitors represent over 90 percent of the trans-Tasman market.
23. Given the dominance of the two alliances, there is a risk that the market is not functioning efficiently, to the detriment of consumers.

Market shares trans-Tasman year ending September 2017



Source: Sabre Global Demand data

Emirates withdrawal from trans-Tasman services

24. The capacity (number of seats) operated by Emirates on trans-Tasman routes is decreasing. In July 2017 it ceased operating its daily service between Auckland and Sydney. It also plans to drop its daily Auckland – Brisbane and Auckland – Melbourne services in March 2018.
25. From 25 March 2018, the only flight which will be operated by Emirates across the Tasman will be its daily Christchurch – Sydney service.

26. In order to backfill these services, Qantas has advised that it plans to add 10,500 seats per week collectively from Sydney, Brisbane and Melbourne into Auckland. However, this will only partially replace the capacity provided by Emirates, which we estimate previously operated 20,500 seats per week, across the three routes.
27. This 10,000 seat per week shortfall represents roughly 10% of the estimated 105,000 seats per week that are provided across all airlines operating across the three routes. Although there is a shortfall, the Applicants note that Emirates' average seat factor (percentage of seats filled) on the Tasman for the 2016/17 financial year was [REDACTED]. The average seat factor on Qantas and Jetstar aircraft was [REDACTED].
28. Assuming this reduction in capacity is not replaced by competitors, Emirates' withdrawal from these routes may result in less seats across the Tasman. Reduced capacity has the effect of reducing supply, which could, in turn raise airline fares on these routes.

How does the alliance affect Emirates' decision regarding its trans-Tasman services?

29. With respect to the authorisation, a key question to consider is whether Emirates would reverse its decision to withdraw from these routes, if the Restated Agreement is not authorised. If it did reverse its decision, this would increase capacity, and in effect, introduce another competitor in the market.
30. It is likely the alliance with Qantas has had some bearing on Emirates' decision to withdraw these services. Under the alliance, it can rely on Qantas' services across the Tasman to feed its international services to and from Australia, rather than operating them itself.
31. However, as outlined below, there also some compelling reasons to suggest that Emirates may choose not to re-enter these services, regardless of whether the Restated Agreement is authorised.

Potential reasons for the withdrawal

More one-stop options

32. In the past few years, there have been a number of new routes announced, providing consumers with direct flights to and from places in the Middle East and China. Including:
 - daily Auckland – Beijing flights operated by Air China beginning December 2015
 - three-weekly Christchurch – Guangzhou flights operated by China Southern beginning December 2015 (now operated daily in peak seasons)
 - daily Auckland – Dubai flights operated by Emirates beginning March 2016
 - three-weekly Auckland – Chongqing – Tianjin services operated by Tainjin Airlines beginning December 2016
 - three-weekly Auckland – Shenzhen – Xi'an services operated by Hainan Airlines beginning December 2016
 - daily Auckland – Doha flights operated by Qatar Airways beginning February 2017.
33. The Applicants claim that because there are now more direct flights out of New Zealand, consumers are choosing to take these services, rather than transiting through Australia on trans-Tasman routes. The Applicants claim that this has shifted 'demand dynamics' on the Tasman, and is part of the reason Emirates withdrew services.

Emirates aircraft are not suited for trans-Tasman services

- 34. The Emirates fleet is primarily made up of Airbus A380 and Boeing B777 aircraft. The A380s used by Emirates on the Tasman carry between 489 – 519 passengers depending on configuration, while the B777 available in Emirates fleet can carry 266 – 428.
- 35. The large A380 aircraft (and to a lesser extent the B777) are not ideally suited to the shorter routes across the Tasman. Given the flight times involved, these routes are better served by lower capacity aircraft, where passenger loads can be spread across multiple aircraft, over greater frequencies. Qantas, for example, operate the majority of its trans-Tasman flights using its Boeing B737 aircraft, which seats only 174 passengers.
- 36. The aircraft operated by Emirates also tend to be configured with first class cabins and a number of business class seats. The A380 it operates on the Auckland to Melbourne sector are configured with 14 first class, 76 business class and 399 economy seats. Compared with the B737 operated by Qantas, which offers no first class seating, 12 business class, and 162 economy seats.
- 37. Given the short journey time on trans-Tasman flights, passengers are less likely to choose more expensive first and business class seats. It is therefore more economical to operate aircraft with a higher proportion of economy seats.
- 38. The large aircraft operated by Emirates on the Tasman may also be contributing

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

- 42. Emirates' preference to move away from the Tasman, in favour of other routes, can be seen in its recently announced decision to operate Dubai – Bali – Auckland. These flights will begin in June 2018 and will be operated using its 354-seat B777 aircraft.

We consider it unlikely that Emirates will re-enter the Tasman services

43. For the reasons mentioned above, on balance, we believe it is unlikely that Emirates will re-enter these trans-Tasman services, regardless of whether the Restated Agreement is authorised. Therefore, we have determined that concerns regarding competition on the Tasman are unlikely to be resolved through declining authorisation.

The Australian Competition and Consumer Commission

44. In Australia, collaborative arrangements in international air services are considered by the Australian Competition and Consumer Commission (the ACCC). Given the Restated Agreement covers a number of routes to, from and through Australia, decisions made by the ACCC can impact our assessment of the Application.

The ACCC's 2013 authorisation

45. On 27 March 2013, the ACCC issued a determination giving approval to the arrangements between the Applicants for five years. This was subject to a condition that the Applicants commit to maintaining a minimum level of capacity (seats) on a bundle of the four overlapping routes across the Tasman. These were:

- Sydney – Auckland
- Melbourne – Auckland
- Brisbane – Auckland
- Sydney – Christchurch

46. These minimum levels were based on capacity offered by the Applicants in the year prior to authorisation of the original agreement.

The ACCC is proposing to re-authorise without capacity conditions

47. The ACCC released its draft determination on the re-authorisation of the alliance on 16 February 2018. In its draft determination, the ACCC propose to re-authorise the Applicants' proposed conduct, for a period five years.
48. In line with our analysis, the ACCC considered that Emirates would be unlikely to re-enter the Auckland – Brisbane, Melbourne and Sydney routes, whether or not the alliance is authorised. Therefore, it is not proposing to re-apply capacity conditions on these routes.
49. The ACCC is however concerned about the Sydney – Christchurch route, which from 25 March 2018 will be the only overlapping route the Applicants will operate on the Tasman. The ACCC note that on this route, the alliance reduces the number of independently operating competitors from three to two (Emirates/Qantas and Air New Zealand/Virgin Australia).
50. The Qantas/Emirates alliance has a 68 percent share of seats flown on this route. Given its dominant market position, the ACCC consider there is potential for the Applicants to limit capacity and increase airfares on the route.

51. Despite its concerns, the ACCC is not proposing to re-apply capacity conditions on the Sydney – Christchurch route. It suggests that imposing such a condition on only one route may risk unintended consequences. It notes:
- a capacity condition set too high risks having excess capacity on the route, which may crowd out other potential competitors and raise barriers to entry
 - capacity conditions on one route may result in an inefficient allocation of capacity. This could artificially restrict growth on other routes, and limit the Applicants' flexibility to best match capacity with demand, and overinflate growth on the route where capacity is required to be maintained.
52. In its draft determination, the ACCC propose requiring the Applicants to report each 6-month scheduling season on the number of seats flown, route specific costs, revenues and average fares on the Auckland – Australia and Sydney – Christchurch routes. This information will be used to assess whether the Applicants are reducing capacity in order to raise fares on the Sydney – Christchurch route. If the ACCC believe this is happening, it can chose to impose capacity conditions.

We did not include capacity conditions in the 2013 authorisation

53. Capacity conditions were not included in the New Zealand authorisation of the original agreement. Our advice was not to include these conditions because:

[REDACTED]

[REDACTED]

- Imposing the same conditions as part of any New Zealand approval as the ACCC has put in place would have no practical effect (as the airlines would have to meet them in any case) but would increase compliance costs.
- Imposing different and potentially conflicting conditions could have unpredictable consequences.

We propose not including capacity conditions as part of this authorisation

54. For the reasons mentioned in the case of the 2013 authorisation, and the reasons outlined by the ACCC's draft determination, we believe that capacity conditions should not be imposed, should you decide to authorise the agreement.

55. If at any time we believe the Applicants are artificially restricting capacity in order to raise fares on the Christchurch – Sydney route, [REDACTED]

Length of authorisation

56. If you choose to authorise the agreement, we advise that this should be for a period of five years. This will allow us to reassess the alliance at an appropriate time, and aligns with the ACCC's proposed period of authorisation.

Stakeholder views

57. The Ministry consulted on the proposed authorisation of the Restated Agreement on 18 October 2017. Submissions were received from Auckland International Airport Limited, Tourism Industry Aotearoa (TIA) and The NZ Airports Association.

Tourism Industry Aotearoa

58. TIA support the application and believe the Applicants have provided a solid rationale for why the application for re-authorisation should be approved. TIA also believe that the original agreement has created “real and substantial benefits to New Zealand”.

NZ Airports Association

59. The Airports Association has urged that the application should be subject to a rigorous analysis of whether authorisation is in the public interest. It also suggested that any authorisation be subject to a period of no longer than 5 years, with possibility of renewal if the Applicants clearly demonstrate the coordination is in the public interest.
60. The Association was particularly concerned about the effect the alliance has on competition on the Tasman, where it notes that the short Tasman sectors can be relatively expensive when compared with other routes. It pointed to the effective duopoly between the two dominant alliances as a possible cause of this.
61. The Association also mentioned the capacity conditions imposed by the ACCC when the original agreement was authorised in 2013. It suggested that consideration be given to imposing similar conditions on this authorisation, to ensure airline groups on the Tasman retain an incentive to grow capacity over time, in order to keep pace with market growth.

Auckland International Airport Limited

62. Auckland Airport submitted a short letter to the Ministry regarding the proposed re-authorisation of the alliance. It acknowledged the economic pressures that airlines operate under and that it is generally supportive of measures that alleviate these pressures. However, the Airport reinforced the need to carefully consider the application, to ensure it does not adversely affect competition, especially on the Tasman.
63. The Airport finished by pointing to the trans-Tasman capacity conditions imposed by the ACCC under its 2013 authorisation. Like the Airports Association, It suggested that this may be a sensible approach to protect consumer interests.

Summary

64. We believe there are public benefits in authorising the Restated Agreement, as it will provide improved connectivity for passengers travelling to and from New Zealand.
65. We do have some concerns about the trans-Tasman market for air services, and the lack of competition on these routes. These concerns were echoed by stakeholders, and the Australian Competition and Consumer Commission (ACCC). However, we do not believe that declining authorisation will alleviate these concerns in any material way.
66. We do not advise applying conditions which compel the applicants to maintain minimum levels of capacity on trans-Tasman routes. However, we note the ACCC propose to monitor the Sydney – Christchurch route, and have the ability to impose conditions on the route, if they see fit.
67. We advise that you authorise the Restated Agreement for a period of five years.

Next steps

68. In mid-March, we will provide you with a report containing our full analysis regarding the authorisation of the Restated Agreement. In the meantime, officials are available to discuss the authorisation, should you require.
69. Because the Civil Aviation Act does not specifically provide for you to impose conditions, we would need to seek the Applicants' agreement to limit the authorisation to five years. They will be expecting this as a similar process was undertaken in 2013.

Recommendations

The recommendations are that you:

- (a) **note** the Applicants' Restated Master Agreement is due for authorisation on 31 March 2018
- (b) **note** that we will provide you a report containing our full analysis in mid-March 2018
- (c) **note** that we believe the Restated Agreement should be authorised without conditions, for a period of five years
- (d) **authorise** officials to enter into discussions with the applicants to limit the duration of any authorisation to five years Yes/No
- (e) **advise** whether you would like to discuss with officials prior to our submission of our final report Yes/No

Tom Forster
Manager International Connections

MINISTER'S SIGNATURE:

DATE: