

Chair
Cabinet Economic Growth and Infrastructure Committee

REAUTHORISATION OF THE ALLIANCE BETWEEN AIR NEW ZEALAND AND CATHAY PACIFIC

Proposal

1. I propose that the Committee note my intention to reauthorise the strategic alliance between Air New Zealand and Cathay Pacific for a period of three years and nine months, until 31 October 2019.

Executive summary

2. Alliances are becoming increasingly common in the aviation industry as a way for airlines to share risk, pool their resources, and grow their 'virtual' route networks. In New Zealand, alliances and other cooperative arrangements between airlines are typically authorised by the Minister of Transport under Part 9 of the Civil Aviation Act 1990 (the Act).
3. The alliance between Air New Zealand and Cathay Pacific, covering their services between New Zealand and Hong Kong, was authorised in 2012 for three years. The decision in 2012 was finely balanced. However, it was determined at the time that the alliance was likely to be preferable to the alternative ([REDACTED]).
4. The applicants are now seeking reauthorisation of the alliance beyond its 31 January 2016 expiry date. No Cabinet decision is required. Under the Act, I am responsible for authorising or declining alliance applications between international airlines.
5. Transport officials have assessed the impact of the alliance in detail and concluded that there is limited evidence to suggest that it has delivered significant benefits to consumers. However, there is also limited evidence to suggest that the alliance has resulted in detriments to consumers. Overall, the fact that the alliance has only been in place for two and a half years makes it difficult to reach a firm conclusion about its impacts.
6. If the alliance is not reauthorised, it is likely that [REDACTED]
[REDACTED]
[REDACTED] As a result, officials consider that the alliance is likely to continue to provide better outcomes to consumers and New Zealand overall than the most plausible alternative scenario, at least in the short term.

7. I intend to reauthorise the alliance for a period of three years and nine months until 31 October 2019. The relatively short time limit will mitigate some of the risks associated with the alliance. It will provide a strong incentive for the airlines to operate in a competitive manner, as they will need to clearly demonstrate that it continues to be in the public interest in order to obtain a further reauthorisation.

Background

Alliance agreements are a response to the international regulatory framework for aviation

8. International aviation is a highly regulated industry, governed by a network of 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.
9. In order to overcome these restrictions, airlines are increasingly seeking to enter into deeper commercial relationships with one another. In particular, Air New Zealand and a number of other airlines globally have built their international strategies around integrated alliance agreements. Alliances are extensive commercial agreements in which two or more airlines agree to cooperate on all aspects of pricing, scheduling, and service delivery in a particular market.
10. Alliances allow airlines to share risk, pool their resources, and expand their 'virtual' route networks. However, alliances also come with substantial risks as they have the potential to reduce competition in a market.

The legislative framework applying to alliance applications in New Zealand

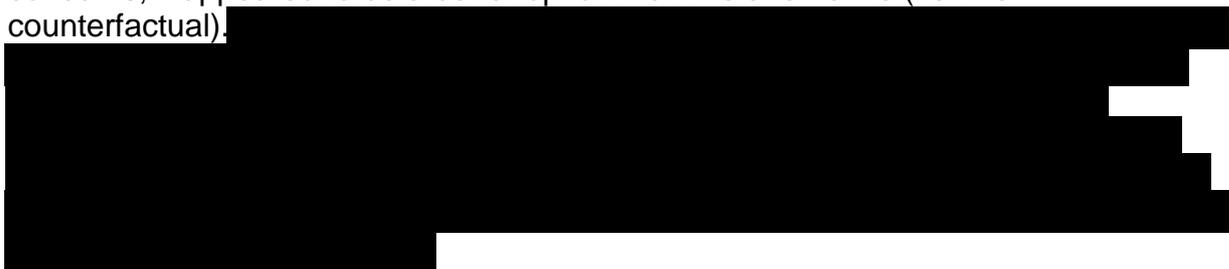
11. In New Zealand, airlines wishing to enter into an alliance are able to submit an application under the Civil Aviation Act 1990 (the Act). Arrangements that have been authorised by the Minister of Transport under the Act are exempted from Part 2 of the Commerce Act 1986. Four comprehensive revenue-sharing alliances have been approved under this legislation since 2010, three of which involve Air New Zealand.¹
12. The framework for assessing an application under the Act is a two-part process, consisting of:
 - 12.1. an assessment of whether the provisions of the relevant alliance agreements meet the statutory criteria set out in section 88 of the Act.
 - 12.2. a public interest test to consider whether the benefits of the proposed alliance would outweigh any costs or risks to consumers or New Zealand as a whole,

¹ In addition to the alliance between Air New Zealand and Cathay Pacific, the following alliances have been authorised and are currently in effect: Air New Zealand and Virgin Australia (authorised for 3 years in 2010 and reauthorised for 5 years in 2013); Qantas and Emirates (authorised for 5 years in 2013); Air New Zealand and Singapore Airlines (authorised in 2014 for 4 years). A number of code-sharing arrangements (involving a lesser degree of cooperation between airlines) are also in place.

compared to the counterfactual (i.e. what is likely to occur if the proposed alliance is not authorised).

The 2012 application

13. In 2012, Air New Zealand and Cathay Pacific submitted an application seeking authorisation to enter into an alliance covering their services between Auckland and Hong Kong.
14. The application had a number of unusual features, which were potentially concerning from a regulatory perspective. In particular:
 - 14.1. The alliance involved the only two airlines operating on the Auckland-Hong Kong route. This meant that authorisation would have resulted in the removal of direct competition.
 - 14.2. The alliance involved airlines with membership in two different global alliances (Air New Zealand is a member of the Star Alliance, while Cathay Pacific is a member of the oneworld alliance). This potentially magnifies the competition impacts of the alliance.
15. In addition, the airlines did not intend to engage in an extensive code-sharing arrangement, which is a common feature of most alliance agreements.² This is because code-sharing between Hong Kong and mainland China is prohibited under New Zealand's air services agreements with both Hong Kong and China. As a result, officials were concerned that passengers may not receive the same connectivity benefits that are often seen in other alliances.
16. Despite these unusual characteristics, the alliance was initially authorised for a period of 3 years.³ The key reason for this was that even though it raised a number of concerns, it appeared to be a better option than the alternative (i.e. the counterfactual).



The current application

17. In November 2014, Air New Zealand and Cathay Pacific submitted a new application under the Civil Aviation Act for reauthorisation of the alliance beyond its expiry date of

² Code-sharing allows airlines to sell seats on each others' flights and agree on how schedules and fares are set.

³ The Civil Aviation Act does not provide the Minister of Transport with the power to impose a time limit on an authorisation. The three year time limit was offered voluntarily by the applicants when it became clear that the alliance would not be authorised for the five years that they initially sought.

30 January 2016. The airlines stated in their application that the alliance had resulted in a number of public benefits including:

- 17.1. an improved spread of flights throughout the day, resulting in more convenient schedules for passengers
- 17.2. an increase in the number of passengers travelling on connecting services to points beyond Hong Kong and beyond Auckland
- 17.3. joint marketing of New Zealand as a tourism destination, which has contributed to a 13 percent increase in visitor arrivals from Hong Kong over the course of the alliance
- 17.4. maintaining competition in the freight market (as freight is not included in the alliance), and maintaining Air New Zealand's presence in a key Asian market.

Impact of the alliance

There is limited evidence to suggest that the alliance has resulted in public benefits

18. Ministry of Transport officials have undertaken a detailed analysis of the alliance and its impact. Overall, officials are not convinced that the alliance has delivered significant benefits to consumers. While some benefits (such as improved scheduling and reciprocal frequent flyer programmes) have been demonstrated, these are likely to be of limited value to the majority of consumers.
19. Total capacity (measured by the number of seats available for sale) has reduced by █ percent since the alliance came into effect. This is partly due to Cathay Pacific introducing premium economy seats on its aircraft (resulting in more choice of service, but less seats available in total on each flight); but it has also been influenced by Cathay Pacific shortening the length of its peak season in which it operates an additional daily flight. This reduction in capacity has occurred in a favourable operating environment in which many of the airlines operating to New Zealand added capacity.
20. Officials also consider that there is limited evidence of any significant connectivity benefits arising as a result of the alliance. Part of the justification for authorisation of the alliance in 2012 was that it would allow Air New Zealand to grow demand from new markets, including China, South East Asia, and India. However, there has been little change in the origins and destinations of passengers travelling through Hong Kong over the course of the alliance, and the total number of passengers travelling on alliance services remains essentially the same as in 2012.

Analysis of the application has been constrained by a small evidence base

21. While there is limited evidence that the alliance has delivered public benefits, the evidence of any detriments to consumers is also limited. Officials are also concerned that their analysis has been affected by a relatively small evidence base. As the alliance has only been operating for two and a half years, it is difficult to draw firm conclusions about its impacts.

22. It is notable that Cathay Pacific recently announced that it will be increasing its seat capacity on the Auckland-Hong Kong route over the peak 2015/16 summer period. This will result in an additional 13,500 seats on the route. This goes some way towards mitigating any concerns around the previous reduction in capacity.

The alliance remains preferable to the counterfactual

23. [REDACTED]
- [REDACTED]
- [REDACTED]
- [REDACTED]
- [REDACTED]
- [REDACTED] The economics of international air transport and restrictions in bilateral air services agreements mean that it is very unlikely that an airline from a third country would operate the Auckland-Hong Kong route. [REDACTED]

I intend to reauthorize the alliance until 31 October 2019

27. Officials consider it likely that the alliance will continue to deliver better overall outcomes to consumers and New Zealand overall than the most plausible alternative scenario.
28. I therefore intend to reauthorize the alliance. However, given the considerable risks associated with the alliance (discussed below) I am only prepared to authorise it until 31 October 2019. This would allow officials to examine the impact of the alliance over a six year period, should the applicants seek a further reauthorisation. This expiry date would also align with the end of an airline scheduling season, which would minimise potential disruptions to consumers if the alliance were not reauthorised again in 2019.
29. The Act does not provide me with the power to impose a time limit on an authorisation. However, the applicants have amended their application to include a provision requiring them to seek a further reauthorisation if they wish to give effect to

the alliance beyond 31 October 2019. This decision was made voluntarily by the applicants, once it became clear that I would not reauthorise the alliance for five years as they had initially requested.

Risks

There is a risk of anti-competitive behaviour

30. As with any alliance, there is a risk that the applicants will take advantage of their market position by restricting supply or increasing fares.
31. This will be mitigated by the relatively short time limit. A short time limit means that the applicants will have little to gain from behaviour that is likely to compromise their chances of gaining a further authorisation in the future.
32. The Ministry of Transport also intends to write to the applicants, to set out their concerns and what they expect the alliance to deliver over the next three years. This will make it clear that in assessing any subsequent application, the Ministry intends to specifically consider:
 - 32.1. whether the applicants have been responsive to market conditions and acted in a competitive manner when setting capacity on the Auckland-Hong Kong route
 - 32.2. whether the applicants have taken appropriate steps to defend their share of the New Zealand–Hong Kong point-to-point market
 - 32.3. whether fares have been set at competitive levels (taking account of changes in fares on comparable routes to and from New Zealand).

Some stakeholders may perceive the alliance as disadvantaging Christchurch

33. Christchurch Airport and a number of other South Island tourism organisations have opposed reauthorisation of the alliance. These stakeholders believe that the alliance is creating a barrier to direct services between Christchurch and Hong Kong.
34. Officials consider that the alliance is likely to reduce Cathay Pacific's incentives to operate a service to Christchurch. This is because Air New Zealand's international strategy is focussed on leveraging Auckland as a hub. An airline that is party to an alliance with Air New Zealand will no longer have incentives to differentiate itself from Air New Zealand by operating direct services to Christchurch. The alliance also provides Cathay Pacific with favourable access to Air New Zealand's domestic network, which provides it with an alternative and lower risk means of attracting passengers from other parts of New Zealand.
35. However, officials consider that the likelihood of Cathay Pacific operating a service to Christchurch would be very low even if the alliance is not reauthorised. It is widely anticipated that China Southern will commence direct services to Christchurch in the near future from its hub in Guangzhou (around 130km from Hong Kong). The wider market between greater China (including Hong Kong) and Christchurch is unlikely to be large enough to support services by both China Southern and Cathay Pacific.

[REDACTED]

36. In the absence of a direct service, the alliance is likely to provide a better outcome for Christchurch than the counterfactual, as Cathay Pacific customers are provided with better access to Air New Zealand's domestic flights.

[REDACTED]

[REDACTED]

The Civil Aviation Act provides very little guidance around the process to be followed when considering alliance applications, or the factors that should be taken into account when determining whether the alliance is in the public interest.

38. [REDACTED]

39. Officials are confident that they have taken account of and given appropriate weight to all relevant factors in the advice they have provided to me.

Consultation

40. The Treasury, the Ministry of Foreign Affairs and Trade, and the Ministry of Business, Innovation and Employment have been consulted on this Cabinet paper.
41. The Department of Prime Minister and Cabinet has been informed.

Financial implications

42. There are no direct financial implications for the Crown arising from this Cabinet paper. My decision may impact Air New Zealand's share price, which may have an indirect impact on the Government's fiscal position. However, this has not been a consideration in my decision.

Human rights, gender and disability implications

43. There are no human rights, gender, or disability implications arising from this paper.

Legislative implications

44. There are no legislative implications arising from this Cabinet paper.

Regulatory Impact Analysis

45. No decisions are being sought as a result of this Cabinet paper. Therefore, a Regulatory Impact Statement is not required.

Publicity

46. I intend to issue a media statement once the decision has been noted by Cabinet, announcing my decision to reauthorise the alliance until 31 October 2019.

Recommendations

47. I recommend that the Committee:
1. **note** my decision to reauthorise the Strategic Alliance between Air New Zealand and Cathay Pacific
 2. **note** that the applicants will be required to seek a further reauthorisation if they wish to continue implementing the Alliance beyond 31 October 2019.

Hon Simon Bridges
Minister of Transport

Dated: _____