

Chair
Cabinet Economic Growth and Infrastructure Committee

AUTHORISATION OF A STRATEGIC ALLIANCE BETWEEN AIR CHINA AND AIR NEW ZEALAND

Proposal

1. I propose that the Committee note that I intend to authorise the strategic alliance (the alliance) between Air New Zealand and Air China (the applicants) until 31 March 2021.

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. No Cabinet decision is required.
3. Air New Zealand and Air China have submitted an application seeking authorisation of a strategic alliance until 31 March 2021. The applicants intend to closely coordinate operations on services between and within New Zealand and China. Under the alliance, Air China intends to commence a new daily service between Auckland and Beijing.
4. Transport officials have assessed the impact of the alliance in detail and concluded that the alliance is likely to provide a net benefit to consumers and New Zealand overall. The alliance improves the prospects of competition between Auckland and Shanghai. It also provides benefits for tourism and freight. China is likely to interpret authorisation of the alliance as a positive development in its overall bilateral relationship with New Zealand.
5. The alliance also poses some risks for consumers. The co-existence of two Air New Zealand alliances (with Air China and Cathay Pacific) in the wider China market risks artificially high pricing by those airlines on some connecting services in China. The alliance may also reduce the incentives for Air China to pursue an aggressive growth strategy in the market the way that other Chinese airlines (China Southern and China Eastern) have.
6. I intend to authorise the alliance until 31 March 2021. This term will mitigate some of the risks associated with the alliance. It will provide a strong incentive for the applicants to operate in a competitive manner, as they will need to clearly demonstrate that the alliance continues to be in the public interest in order to gain reauthorisation.

Background

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

7. 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.
8. 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.
9. 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.

Framework for considering alliance applications

10. 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 alliances have been approved under this legislation since 2010, three of which involve Air New Zealand.¹
11. My decision is informed by advice officials provide on:
 - 11.1. whether the provisions of the alliance agreements meet the statutory criteria in Section 88 of the Act to be capable for authorisation
 - 11.2. whether authorising the alliance would be in the public interest (i.e. the likelihood that the benefits of the alliance outweigh the costs).
12. The Act does not provide me with any powers to impose time limits, minimum capacity requirements or any other stipulation on an authorisation.
13. While the Act does not provide me with the power to impose a time limit, every revenue sharing alliance that has been authorised in NZ has been subject to a time limit. These time limits have been voluntarily imposed by the applicants, in recognition of the perceived risks that alliances may pose.

¹ In addition to the alliance between Air New Zealand and Cathay Pacific for which I am considering an application for reauthorisation, 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 for 4 years in 2014). A number of code-sharing arrangements (involving a lesser degree of cooperation between airlines) are also in place.

The application by Air New Zealand and Air China

14. In March 2015, Air New Zealand and Air China submitted an application under the Act seeking authorisation of a strategic alliance. The applicants have indicated they are seeking authorisation until 31 March 2021. This timeframe would coincide with the close of the peak summer season and reduce the risk of disruptions to consumers in the event that the alliance is not reauthorised in the future.
15. The applicants intend to share their revenue, code-share² and coordinate capacity and pricing on direct services between New Zealand and China. This includes Air New Zealand's current daily Auckland-Shanghai service and a proposed new daily service by Air China between Auckland and Beijing.
16. The applicants intend to code-share and coordinate pricing, but not share revenue, on domestic services in New Zealand and China that connect to an international service between both countries.

Current level of cooperation

17. Air New Zealand and Air China are members of the Star Alliance³ and already cooperate on frequent flyer programs and airport lounge access.
18. The applicants are also parties to a code-share agreement under which:
 - Air China code-shares on Air New Zealand's Auckland-Shanghai service and seven trans-Tasman services.
 - Air New Zealand code-shares on four of Air China's Australia-China services and three domestic services in China.

Expected benefits of the alliance

The alliance increases the prospects of sustained competition on the Auckland-Shanghai route

19. The alliance provides Air New Zealand with a local partner
Air New Zealand would receive more favourable code-share access on Air China's network beyond Shanghai. The alliance would also provide more effective sales and distribution channels to support Air New Zealand's marketing activity in China.
20. the alliance would help to maintain competition on that route with China Eastern, a recent entrant onto the market.

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

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

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

21. The alliance provides Air China with a low risk business case to commence an Auckland-Beijing service immediately. In particular, the alliance provides incentives for Air New Zealand to support the new service by Air China because both airlines would be sharing revenue on that service.

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

22. The alliance provides incentives for Air China to market New Zealand as a destination to its customer base. As long as tourism infrastructure continues to keep pace with growth in arrivals from China, the alliance will provide benefits for the industry.
23. The alliance also provides access for Air China's strong frequent flyer customer base to earn and redeem frequent flyer points services to New Zealand.

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

24. China is an important bilateral partner for New Zealand. China is our second largest tourist market, behind Australia, with visitor arrivals forecast to double in the next five years. China is also our number one export destination for goods and services with annual exports to China reaching \$11.3 billion in September 2014.⁴
25. Air New Zealand and Air China's intention to enter into this alliance was announced during President Xi's State visit to New Zealand in November 2014. The Prime Minister, Rt Hon John Key and President Xi were present at the announcement.
26. In Australia, an alliance between China Eastern and Qantas was similarly announced during a State visit. Following a draft determination in Australia to decline authorisation of that Alliance, the Chinese Ambassador wrote to the Australian Competition and Consumer Commission (ACCC) to state that he saw the arrangements to be in the long term interests of both Australia and China. He expressed his hope that the ACCC could bear in mind the interests of the overall relationship and make a fair and reasonable decision. We could expect the Chinese government to take a similar position with regards to this alliance.

Increased competition and capacity in the cargo market

27. Air freight accounts for around 16 percent⁵ of total trade between New Zealand and China by value and tends to comprise high value, perishable goods.
28. As the applicants do not intend to cooperate in relation to cargo services, the alliance enables Air China to compete for freight between New Zealand and China.

⁴ Data from Statistics New Zealand.

⁵ Data from Statistics New Zealand.

Potential risks associated with authorising the alliance

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

29. Air New Zealand has argued that from a regulatory perspective, its alliance with Air China can sit alongside its alliance with Cathay Pacific, as Shanghai, Beijing and Hong Kong are complementary gateways with minimal overlap in terms of connecting traffic.
30. However, analysis by officials indicates that Shanghai and Hong Kong appear to be competitive gateways for a high proportion of Chinese passengers travelling to New Zealand.
31. The alliance may dilute competition between Air New Zealand's alliance partners. The co-existence of Air New Zealand's alliances with Air China and Cathay Pacific makes it more likely that the fares Air New Zealand sets on connecting services through those alliances are aligned. This risks higher prices for consumers travelling between New Zealand and other cities in China via Shanghai, Beijing and Hong Kong.
32. However, indirect competition from airlines providing one-stop services (such as Qantas, Singapore Airlines and Malaysia Airlines) is likely to constrain the applicants' ability to increase fares.

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

33. The 'big three' state-owned Chinese carriers (China Southern, China Eastern and Air China) have all pursued aggressive growth strategies over the last decade, capitalising on growing demand for international air travel among Chinese residents. In New Zealand, both China Southern (from three times a week to twice daily in under three years) and China Eastern (from a daily seasonal service to a year round four times weekly service in under a year) have commenced and grown their services rapidly.
34. If Air China were to enter the Beijing market on its own, officials would expect to see it employ a similar growth strategy to the other Chinese carriers.
35. However, under an alliance with Air New Zealand, Air China may have less incentive to pursue an aggressive growth strategy. Air New Zealand typically takes a more cautious approach to growing capacity and could use the alliance to constrain the growth of Air China's capacity on Auckland-Beijing.

This could further reduce Air China's incentives to grow its services quickly, which may reduce the prospect of lower fares being offered to travellers in the short to medium term.

36. Strong competition from other airlines (particularly China Southern and China Eastern) should ensure that the applicants still have incentives to grow their services.

The alliance has received broad support from a range of stakeholders

37. The majority of tourism and airport stakeholders have been broadly positive about the value provided by the alliance to New Zealand. Many stakeholders highlighted the tourism benefits to New Zealand, and referred to the New Zealand-China market as relatively competitive. A few stakeholders raised concerns around the impact of the alliance and Air New Zealand's alliance strategy in general.

Concerns on the impact of the alliance on New Zealand regions

38. Christchurch Airport, Wellington Airport, the New Zealand Airports Association and the Tourism Industry Association have commented on the need to ensure the benefits of the alliance are spread around the country.
39. The benefits of the alliance are generally weighted towards Auckland, reflecting Air New Zealand's single hub strategy of directing as many passengers as possible through Auckland.
40. However, any impact on the prospects of direct services to other airports is likely to be minimal, at least in the short to medium term. The key reason is that Air China is a member of the Star Alliance. If Air China was to operate to New Zealand on its own (without being part of an alliance with Air New Zealand), it would still have relatively good access to Air New Zealand's domestic network (as Air New Zealand has an incentive to provide favourable interline rates to other Star Alliance airlines).
41. It is unlikely that Air China would consider operating a service to Christchurch until it has firmly established itself in the Auckland market, regardless of whether the alliance is authorised. The alliance could become a barrier to the commencement of direct services to Christchurch in the longer term if demand for travel to the South Island continues to grow.

Concerns with Air New Zealand's alliance strategy

42. Christchurch Airport and Wellington Airport have expressed concerns that alliances in general are reducing the incentives for airlines to operate new direct services between New Zealand and Asia, in particular to cities other than Auckland.
43. To a certain extent, Air New Zealand's alliances do limit the incentives for its partners to operate to cities outside Auckland. However, the practical implications of this are limited as none of Air New Zealand's current alliance partners would have strong incentives to operate to airports outside Auckland, even if they were not cooperating with Air New Zealand.
44. Officials are confident that none of the alliances that have been authorised in New Zealand to date have resulted in an airline operating to Auckland when it would have otherwise operated to Christchurch or Wellington.

I intend to authorise the alliance until 31 March 2021

45. Officials consider that the sum total of the likely benefits associated with the alliance outweighs the potential risks. Compared to the most plausible alternative scenario, the alliance is likely to deliver better overall outcomes to consumers and New Zealand overall.
46. The applicants have applied for authorisation until to 31 March 2021 and I consider this to be an appropriate length of time. This term will allow officials to reassess the impacts of the alliance if the applicants apply for reauthorisation before in the future. It incentivises the applicants to behave competitively (in order to achieve reauthorisation) while providing the applicants with sufficient time and confidence to invest in integrating and expanding their operations.

Consultation

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

Financial implications

49. There are no financial implications arising from this Cabinet paper.

Human rights, gender and disability implications

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

Legislative implications

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

Regulatory Impact Analysis

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

Publicity

53. I intend to issue a media statement once the decision has been noted by Cabinet, announcing my decision to authorise the alliance until 31 March 2021.

Recommendations

54. The Minister of Transport recommends that the Committee:
1. **note** the Minister of Transport intends to authorise the Strategic Alliance between Air China and Air New Zealand until 31 March 2021
 2. **note** that the applicants will be required to seek reauthorisation if they wish to continue implementing the Alliance beyond the initial term of authorisation.

Hon Simon Bridges
Minister of Transport

Dated: _____