

3 February 2021

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Hon Michael Wood
Minister of Transport**Action required by:**
Friday, 12 February 2021

AIR NEW ZEALAND-AIR CHINA STRATEGIC ALLIANCE REAUTHORISATION

Purpose

This briefing seeks your agreement to reauthorise the Air New Zealand – Air China Strategic Alliance Agreement (the Alliance) until 31 March 2026. This briefing accompanies our detailed analysis regarding the proposed reauthorisation.

Key points

- Air New Zealand and Air China have applied for reauthorisation of their Strategic Alliance for a further five year period.
- The Alliance meets the statutory conditions allowing it to be authorised under section 88 of the Civil Aviation Act 1990 (the Act). We recommend you reauthorise the Alliance if you consider that it is in the public interest.
- We consider the Alliance has provided, and will continue to provide, real benefits to New Zealand through greater international airline capacity (number of seats and flights) into New Zealand and will be vital as the tourism industry seeks to recover from the impact of COVID-19.
- There are risks that alliances can reduce competition in some markets. However, we consider that, in this case, the identified public benefits outweigh these risks.

Recommendations

We recommend you:

- 1 **agree** to reauthorise the Air New Zealand – Air China Strategic Alliance Agreement (which includes the “Implementing Agreements” and their amendments) for a period ending 31 March 2026. Yes / No



Tom Forster
Manager, Economic Regulation

2 / 2 / 2021



Hon Michael Wood
Minister of Transport

9 / 2 / 21

- Minister's office to complete:**
- Approved Declined
- Seen by Minister Not seen by Minister
- Overtaken by events

Comments

Contacts

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AIR NEW ZEALAND - AIR CHINA STRATEGIC ALLIANCE REAUTHORISATION (2020)

Background

The 2015 authorisation

- 1 In March 2015, Air New Zealand and Air China (the Applicants) submitted an application under the Civil Aviation Act 1990 (the Act) seeking authorisation of a strategic alliance. The Alliance was authorised on the 1 September 2015 by the Minister of Transport for a period of five years, and is due to expire on 31 March 2021.
- 2 Under the Alliance, the Applicants have merged their operations on the Auckland – Shanghai route and Auckland – Beijing route, which includes jointly setting prices, schedules and capacity, and sharing revenue. In effect, they have ceased competing with each other on those routes.
- 3 At the time of this application, we determined the risks did not outweigh the potential benefits of the Alliance, and that a term of five years term provided a sufficient level of certainty and stability to the Applicants to make long-term investment decisions.

The current application

- 4 The Applicants are seeking reauthorisation of the Alliance for another five years, until 31 March 2026.
- 5 The Applicants argue the Ministry of Transport's (the Ministry) earlier concerns have not materialised. That is, the Alliance has not constrained growth or competitive pricing on the Auckland – Shanghai or Auckland – Beijing routes, and that it has not prevented the launch of other direct and indirect services between China and New Zealand.
- 6 Given the outbreak of COVID-19 impacted Alliance services from as early as January 2020, the Applicant's limited their application to an assessment of the historical performance of the Alliance between the dates of December 2015 – December 2019.
- 7 The Ministry's report accounts for pre-COVID performance, considers how COVID-19 restrictions may impact the future of the Alliance, and analyses the potential benefits, risks and unknowns of reauthorising this Alliance in a COVID-19 environment.

Scope of the Alliance

- 8 Under the Alliance, the Applicants coordinate their operations between and within New Zealand and China. The Alliance provides for varying levels of cooperation between the airlines on:
 - 'Alliance Sectors' being sectors operated by either airline directly between New Zealand and China (i.e. Auckland – Shanghai and Auckland – Beijing); and

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- *'Feeder Routes'* comprising domestic services within New Zealand and China which include an Alliance Sector.
- 9 The Alliance Agreement 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.
- 10 In addition, the Alliance is supported by several "Implementing Agreements". These include:
- *Codeshare Agreement*: which includes both Alliance Sectors and Feeder Routes, with the number of Feeder Routes increasing over the course of the Alliance;
 - *Special Prorate Agreement (SPA)*: which provides favourable rates and access to each party's network;
 - *Frequent Flyer Programme Agreement (FFP)*: which aligns the parties' FFP programmes; and
 - *Revenue Sharing Agreement*: which sets out the terms on which the parties will allocate revenue generated on the Alliance Sectors.
- 11 The Applicants have applied for reauthorisation of the Alliance Agreement (which includes the "Implementing Agreements" above) and the amendments to those agreements. The reauthorisation does not include any changes to the Alliance agreement, but does include some minor changes to the Codeshare, SPA and Revenue Sharing Agreement.

We recommend that you reauthorize the Alliance

- 12 The Minister of Transport is responsible for authorising or declining applications for airline alliances under the Act. The Ministry provides advice to the Minister on whether authorisation would be consistent with the criteria set out in the Act and in New Zealand's interest.
- 13 We consider the Alliance has, and will, provide benefits to New Zealand that outweigh the potential detriments. It provides greater international airline capacity (number of seats and flights) into New Zealand and will be vital as the New Zealand tourism industry seeks to recover from the impact of COVID-19.
- 14 We consider that a five-year term provides a sufficient level of certainty and stability to the Applicants to make long-term investment decisions, particularly under COVID-19 uncertainty, and allows for the reassessment of the Alliance at an appropriate interval.
- 15 On that basis, we recommend that the Alliance be reauthorised for a period ending 31 March 2026.

Authorisation meets section 88 of the Act

- 16 The Applicants have requested authorisation of the Alliance and supporting Implementing Agreements under section 88 of the Act. 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.
- 17 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 Act and meet the statutory conditions allowing them to be authorised.

Competition analysis

- 18 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, which includes the relevant COVID-19 considerations.
- 19 We have defined the primary market as being the markets mainly affected by scheduling, pricing and capacity coordination under the Alliance. For this application we consider the relevant primary market to be the China – New Zealand market, with a specific focus on the catchments areas around the cities directly connecting the Alliance Routes (Auckland – Shanghai and Auckland – Beijing).
- 20 As such, the main Chinese markets of focus for the Alliance are:
- the Yangtze River Delta region that comprises the provinces of Shanghai, Jiangsu, Zhejiang and Anhui; and
 - the Jing-Jin-Ji Metropolitan region that includes the provinces Beijing, Tianjin, Hebei.
- 21 We have compared airlines market shares on the routes between New Zealand and the Yangtze River Delta and Jing-Jin-Ji regions, and considered other relevant aspects in our analysis. We have concluded that, while the Applicants hold high shares in both markets, they continue to face competition from other carriers for passengers and have not prevented other carriers from entering or expanding services in these markets.

Counterfactual

- 22 The counterfactual is the likely scenario that would occur in the event that authorisation is declined. The counterfactual effectively forms the baseline against which the costs and benefits of the Alliance should be assessed.
- 23 Both Applicants explain in their counterfactual [REDACTED]

24 While it is too early to assess with some level of accuracy what the impact of COVID-19 on Alliance services would be, the Ministry's assessment of the counterfactual proposes the consideration of two high-level, opposing scenarios to illustrate what is possible on both sides of the spectrum.

- The current situation continues or worsens. Travel demand and/or airline capacity are considerably reduced in the medium term.
- The current situation improves. Aviation markets return to something close to their previous size and configuration within the next three to four years.

25 As explained in the report, if the situation continues or worsens, the decision of whether to authorise the Alliance would make little to no difference to market competition considerations. At present, Alliance services cannot operate as Air China has suspended all of its international flights to New Zealand and most international airlines have grounded most of their fleets due to border closures, poor travel demand or strict passenger quotas in place. There is very little competition in the relevant markets.

26 Conversely, if the situation improves, and the Alliance is reauthorised, many of the public benefits identified in the report would likely be realised. The Alliance would help re-stimulate the China – New Zealand tourism and trade markets (especially Chinese tourists coming to New Zealand) and provide the Applicants with the ability to plan services effectively to ensure business viability going forward.

27 In this improved scenario, if the Alliance is not reauthorised, many of the benefits listed in the report would not be realised. More specifically, it would very likely limit inbound tourist travel from China through a drastic reduction of capacity on the routes and therefore, of the related consumer benefits (e.g. direct flights, lower fares).

28 We believe that, without the Alliance, it would be difficult for Air New Zealand to sustain operations on the Auckland – Shanghai route, even in the context of a positive scenario. Without Air China's assistance, Air New Zealand would not be able to secure new slots at Shanghai Pudong International Airport. It would also not be able to attract the same consumer base absent Air China's sales and distribution support. The lack of support from a strong Chinese carrier would significantly reduce Air New Zealand's competitiveness with other Chinese carriers and further contribute to Air New Zealand's inability to stay viable on the route.

29 In saying this, Air New Zealand would likely try to maintain some capacity when services resume, but may have to eventually exit the route if it becomes too challenging to operate financially, and remains unprofitable in the foreseeable future.

30 We also fully accept Air New Zealand's claim that it lacks the ability to operate a Beijing service on its own absent the Alliance. We are aware that this route was previously unprofitable for Air New Zealand, and experienced great difficulty in obtaining slots at Beijing Airport.

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- [REDACTED]
- 32 Overall, we believe that alliances are and will continue to be crucial to help re-establish and maintain global networks, and enable national carriers to compete effectively and survive.

The Alliance benefits for New Zealand

- 33 The main public benefits of the Alliance are the capacity increase and improved connectivity. The Alliance will also aid New Zealand's economic recovery from COVID-19.

Capacity increase

- 34 The Applicants state that the overall Alliance capacity has increased by approximately eight percent over the period of authorisation.
- 35 We can confirm that the Applicants have demonstrated some increase of Alliance capacity on the Auckland – Beijing route and managed to maintain capacity and passenger numbers on the Auckland – Shanghai route over the period of authorisation.
- 36 We consider this capacity increase beneficial for New Zealand by growing the availability of services to and from New Zealand, and by providing more options for consumers.

Lower average fares

- 37 It is difficult to reach 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 due to the complexity of pricing structures around booking windows.
- 38 However, in our report, we observed there had been some reduction in the average airfares (for all travel classes) offered by the Applicants on both routes since the beginning of the Alliance period. Therefore, overall, we can conclude that the Alliance has not led to increased airfares and has responded appropriately to market conditions during the period of authorisation.

Improved connectivity

- 39 The Alliance has enabled the expansion of their existing Codeshare Agreement and SPA to allow for more additional routes. This has resulted in improved connectivity and better access to both Applicants' beyond markets, in particular Air China's access to Air New Zealand domestic network.
- 40 To a lesser extent, there has been some improved connectivity into mainland China, giving Air New Zealand passengers connecting on Air China services more access into China's domestic network.

Optimisation of flight scheduling

- 41 As set out in the report, the Applicants state they have launched and optimised the schedule of the Beijing service to provide their customers with a better choice of flight times to other parts of New Zealand and China respectively.
- 42 Air New Zealand further emphasises that, with Air China support, they have gained a greater consistency for departure times from Shanghai by securing better slot times at the airport. This consistency in departure time has reduced the ground time that Air New Zealand's aircraft spend in China, thus resulting in much needed operational efficiencies and cost savings for Air New Zealand.
- 43 We accept the Applicants' claim that optimised flight schedules provided consumer benefits and operational efficiencies over the period of authorisation.

Stimulation of tourism

- 44 The Applicants claim the Alliance has helped stimulate tourism in New Zealand by contributing to the growth of visitors travelling from/via Beijing and Shanghai catchment areas.
- 45 While many factors influence tourists in choosing New Zealand as a destination, an increase in total passenger volumes on Alliance services combined with the launch of the Beijing service in the previous alliance authorisation, suggests that the Alliance has contributed to the stimulation of tourism in New Zealand.
- 46 We also agree that this is a particularly important benefit as the New Zealand tourism industry seeks to recover from the impact of COVID-19.

Enhanced premium customers' benefits and joint lounge access

- 47 We accept that the Alliance provides additional benefits to consumers with respect to loyalty programs and lounge access. While we have considered these benefits as modest in previous alliance applications, the Air New Zealand-Air China Alliance is an exception given the size of the Chinese market.
- 48 Effectively, Air New Zealand operated services from Shanghai are made available to some of Air China's 50 million strong frequent flyer customer-base.

Airfreight market competition

- 49 The Alliance does not provide for the Applicants to coordinate sales in the airfreight market, with cargo revenue being excluded from the definition of Alliance revenues. Therefore Air New Zealand competes with Air China for freight between New Zealand and China.
- 50 Overall, airfreight has been relatively steady since 2015 and remains a contributor to the New Zealand – China trade market. However, since the emergence of COVID-19, Air China has stopped operating flights to New Zealand and thus is not currently competing for freight with Air New Zealand.
- 51 Provided the Alliance enables the Applicants to sustain the services in a post COVID-19 world, the ongoing competition between the Applicants in the freight market could be seen as a key benefit as exporters would be able to choose between several

providers of airfreight services, including Air New Zealand, Air China, and China Eastern.

Stakeholders views

- 52 The Ministry consulted stakeholders on the proposed reauthorisation of the Alliance, between 29 July 2020 and 31 August 2020. Submissions were received from Auckland International Airport, Auckland Tourism, Events and Economic Development, Tourism New Zealand, Tourism Industry Aotearoa, and Christchurch International Airport.

Auckland International Airport (Auckland Airport)

- 53 In its submission, Auckland Airport notes that it supports market structure arrangements that are consistent with fair and balanced competition, and which provide clear benefits for travellers. Auckland Airport does not have any concerns about this alliance application and believes it will provide additional connectivity and choice to consumers.
- 54 Auckland Airport also notes the impact of COVID-19 on aviation, and emphasises the Ministry's role in ensuring that the overall outcomes for travellers and the New Zealand public are positive.

Auckland Tourism, Events and Economic Development (ATEED)

- 55 ATEED strongly endorses the renewal of the Alliance for a further five years. It considers the Alliance supports the ease of travel to New Zealand from important existing and emerging markets and acknowledges China as one of New Zealand's most important trade partners.
- 56 The submission also noted that the Alliance will play a key role in the economic recovery post-COVID-19. The ease of travel and direct services from international ports, including Beijing and Shanghai to Auckland will stimulate economic growth, create new jobs in our region and raise its profile as a place to visit, study, invest in and do business.

Tourism New Zealand

- 57 Tourism New Zealand supports the Alliance reauthorisation. It notes the Alliance has contributed to an increase in tourism from China and will be crucial for the re-establishment of air connectivity between New Zealand and China. The submission also notes the Alliance has delivered stability of services to New Zealand in a market where carriers otherwise have to react to demand fluctuation.

Tourism Industry Aotearoa (TIA)

- 58 Similar to Tourism New Zealand, TIA supports the Alliance reauthorisation emphasising the importance of strong air connections to support New Zealand's COVID-19 recovery, and support the New Zealand Tourism industry's growth framework – Tourism 2025 and Beyond.
- 59 It cites connectivity as a key theme of the framework, and that the Alliance will facilitate these much-needed connectivity links with one of New Zealand's biggest

international markets, China. This will help support the rebuild of international tourism in New Zealand.

Christchurch International Airport Limited (CIAL)

- 60 CIAL did not provide a view on whether the Alliance should or should not be authorised. However, it did provide a view on the factors that should be taken into consideration in the analysis of the Alliance. It stressed that the Ministry should demonstrate that it has undertaken a rigorous analysis of factors, including the impact of COVID-19 and recent market changes and the cumulative impacts of existing alliances the Applicants are party to, before determining if the Alliance is in the wider public interest.

Next steps

- 61 We intend to publicise your decision regarding authorisation on the Ministry of Transport website, and advise relevant stakeholders. We will provide a draft media statement advising the public of the decision.