NZ AIRPORTS

Mr Bruce Johnson
General Manager, Aviation & Maritime
Ministry of Transport – Te Manatu Waka
Wellington

By Email: b.johnson@transport.govt.nz
s.vandegeer@transport.govt.nz

Dear Bruce,

North Asian Airline Alliance Application

Introduction

NZ Airports wishes to thank the Ministry for the opportunity to submit views on Air New Zealand's and Cathay Pacific's application for authorisation of their proposed North Asian Airline Alliance (the proposed Alliance).

Air travel accounts for 99 % of New Zealand's international passenger movements, enabling 8.6 % of GDP through the direct and indirect contributions of tourism to the economy. Air cargo, carried primarily in the holds of passenger airliners, comprises over 22 % of imports and 14 % of exports by value. The sustainability and functionality of the air transport markets delivering this activity are therefore critical to airports, the cities and communities which they serve, and to the economic prospects of our remote country as a whole.

NZ Airports acknowledges the Ministry's recognition of this significance by providing the proposed Alliance application to members of the industry for comment.

Summary

NZ Airports' views on the application can be summarised as follows:

- NZ Airports has not been provided with full details of the application or the proposed Alliance, as much of the application (including the proposed Alliance itself) has been withheld on confidentiality grounds. The withholding of these details makes it difficult for NZ Airports to provide informed comment on the application.
- Although only limited information has been made available for use in evaluating the potential impact of the proposed Alliance, NZ Airports has identified clear potential for the arrangement to restrict growth on the affected routes to the detriment of consumers.

- While it is not an express requirement of section 88(2) of the Civil Aviation Act 1990, NZ Airports considers that the Ministry should undertake a comprehensive, robust and transparent cost-benefit analysis of the likely effects of authorising the proposed Alliance. The imperative for a comprehensive, robust and transparent analysis, which has recently been recognised by the Productivity Commission, particularly arises given the detriments that naturally flow from inhibiting the competitive dynamics that would otherwise exist on the affected routes.
- NZ Airports is particularly anxious that to ensure that, if the Minister—after due consideration—is minded to authorise the proposed Alliance, the authorisation is granted subject to appropriate conditions that will ensure the realisation of any claimed benefits. Any authorisation should also be appropriately time-limited.
- The Minister's powers under section 88(2) are limited to authorising (if appropriate) the particular provisions of the proposed Alliance that relate to international carriage by air and that relate, whether directly or indirectly, to the fixing of tariffs, the application of tariffs, or the fixing of capacity. The Minister must therefore analyse the individual provisions of the proposed Alliance carefully to ensure that any authorisation granted relates only to those provisions that fall within section 88(2). As explained below, not all of the provisions of the proposed Alliance appear to fall within section 88(2).

Some comments on the statutory test

NZ Airports is concerned that the application seeks authorisation of matters that go beyond what can properly be authorised under section 88(2) of the Civil Aviation Act 1990.

Section 88(2) gives the Minister a power to authorise, not necessarily whole arrangements, but individual provisions in contracts, arrangements or understandings that relate to international carriage by air and that also relate, directly or indirectly, to the fixing of tariffs, the application of tariffs, the fixing of capacity, or some combination of these things.

It would be open to the Minister to authorise all the provisions of a contract, arrangement or understanding relating to international carriage by air only if all the provisions fell within section 88(2). The Minister must therefore satisfy himself that each individual provision falls within section 88(2) before considering whether that provision should be authorised. Where particular provisions do not fall within section 88(2), the Minister cannot authorise them.

Since NZ Airports has not been provided with full details of the application (including the proposed Alliance), it is not possible to comment on individual provisions of the proposed Alliance. From what has been disclosed, however, it appears that some of the matters contemplated in the proposed Alliance go beyond the fixing of tariffs or capacity. For example, provisions relating to revenue allocation, scheduling, frequent flyer programmes or lounge access do not obviously relate, either directly or indirectly, to the fixing of tariffs or capacity. It is therefore important that the Minister carefully analyses the individual provisions of the proposed Alliance to ensure that only those provisions that fall within section 88(2) are considered for authorisation.

NZ Airports also notes that the provisions that may be authorised are only those relating to "international carriage by air". It does not appear that this phrase is intended to include domestic legs of an international flight.

The importance of a comprehensive, robust and transparent cost-benefit analysis

Section 88(2) does not expressly require the Minister to carry out an economic cost-benefit analysis of the type that would be carried out by the Commerce Commission if the Commission were considering an application for authorisation in respect of a restricted trade practice. However, NZ Airports considers that any decision by the Minister to authorise the proposed Alliance would not have had due regard to all relevant factors if it did not consider the economic costs and benefits of authorising what would otherwise be a restrictive trade practice.

The effect of an authorisation under section 88 is to immunise conduct that would or may otherwise be anti-competitive from competition law scrutiny. It is therefore incumbent on the Minister to analyse and have due regard to the competitive effects of granting authorisation. In NZ Airports' view, ignoring those effects would be to disregard a highly relevant factor to the decision-making process under section 88(2). On this point, NZ Airports notes that the applicants appear to accept that some consideration of the competitive effects is required, because their application seeks to address questions of the likely costs and benefits involved.

The Productivity Commission has recently considered the operation of the Part 9 authorisation process and highlighted the importance to any authorisation process of this nature of a comprehensive, robust and transparent analysis of the costs and benefits of the restrictive trade practice in question. As the Productivity Commission noted[1], a comprehensive analysis of costs and benefits will maximise the likelihood that efficiency-enhancing trade practices are authorised and minimise the likelihood that harmful forms of coordination are authorised.

NZ Airports comments on the potential costs and benefits of the proposed Alliance below.

The importance of retaining competition on the AKL-HKG route

The AKL – HKG route is a long-established route between New Zealand and its primary visitor markets in Asia and Europe. The route delivers around 17% (120,000 passengers) of the annual traffic between New Zealand and Europe, along with 17% (290,000 passengers) of the traffic between New Zealand and Asia, as well as providing material cargo capacity linking New Zealand's importers and exporters to key trading partners in Asia and beyond. Protecting the sustainable development of this route and the competitive environment in which that development (and potentially the development of other comparable routes) occurs is important to all members of our association.

The restrictive trade practices provisions of the Commerce Act 1986 generally operate in the airline industry (as in other sectors of the economy) to preserve and enhance the economic benefits that the competitive process generates. Collusive conduct that substantially lessens the competitive process is permissible only where there are or are likely to be countervailing benefits to the public that outweigh the lessening of competition.

In NZ Airports' view, there is insufficient evidence to suggest that the benefits claimed by the applicants are sufficient in this instance to allow authorisation under section 88 of what would otherwise be a restrictive trade practice. Competition on the AKL-HKG route delivers positive outcomes for consumers and should be encouraged, not inhibited.

[1] *International Freight Transport Services Inquiry*, Productivity Commission, April 2012, p 248.

The benefits of competition

In principle, NZ Airports is supportive of maintaining airline competition on New Zealand's international and domestic routes. Routes served by more than one carrier in a competitive environment have been shown to deliver higher levels of capacity at lower prices than otherwise comparable routes served by a single carrier[2]. This simple concept is well proven in the air travel industry and is the product of rational airline operators seeking to maximise returns on investment by establishing a market price which optimises the ratio of revenue to operating cost.

The effect of the restrictive trade practices provisions of the Commerce Act 1986 is to prohibit collusive agreements between airlines which, if allowed to coordinate decisions relating to price and capacity, can limit natural market growth by removing the incentive that each airline would otherwise have to compete against the other on price and on service quality. Collusive agreements also remove incentives to take capacity from competitors, which generally has the result, in a competitive market, of stimulating demand and growing the overall size of the market.

In the context of the two sole carriers serving a particular route colluding to form a partnership on that route, the outcome has clear potential to lead to higher average fares as the climate in which the airlines seek to win the business of travellers and freight customers is altered. Presently, Air NZ and Cathay each set fares in the knowledge that, if prices are set at a level materially above those set by the other they will lose market share. This competitive tension works to maintain fares at an equilibrium reflective of operating cost and an acceptable margin for each carrier. In the absence of this tension, the carriers would be enabled to set and maintain fares at a higher level, reflective of the point at which demand for services is affected.

According to Sabre ADI data, 8% of the point to point market is comprised of business and first class traffic. For this market of 11,000 passengers per annum (each paying on average US$2,940 per flight and in total contributing 22% of market revenue), the demand is likely to be inelastic[3]. This means that, following authorisation of the proposed Alliance the carriers would be incentivised to increase fares in the absence of the competitive restraint provided by the competing carrier.

This point to point business class/first class market, notably the most lucrative and beneficial from an economic perspective, would have no protection from the proposed Alliance's ability to increase fares. Whilst fare increases would have clear benefits for the carriers, market growth would be constrained and this would not be in the public interest.

The graph below illustrates the AKL<>SIN route passenger volumes and average fares from 2004 to 2011. The data collected over this period shows very clearly the benefits of competition on this route, being a comparable route to AKL<>HKG.

---

[2] *Impact of Proposed Virgin Blue Airlines/Air New Zealand trans-Tasman Alliance,* ASM Ltd, 2010 (Attached to Key Wellington Stakeholders Submission to MOT, 2 July 2010).
AIAL Submission to the Ministry of Transport regarding Proposed Virgin Blue Airlines/Air New Zealand trans-Tasman Alliance, 2 July 2010, PAC analysis.

[3] Figure 3 – 1, Intervistas Elasticity Study 2007, commissioned by the International Air Transport Association.

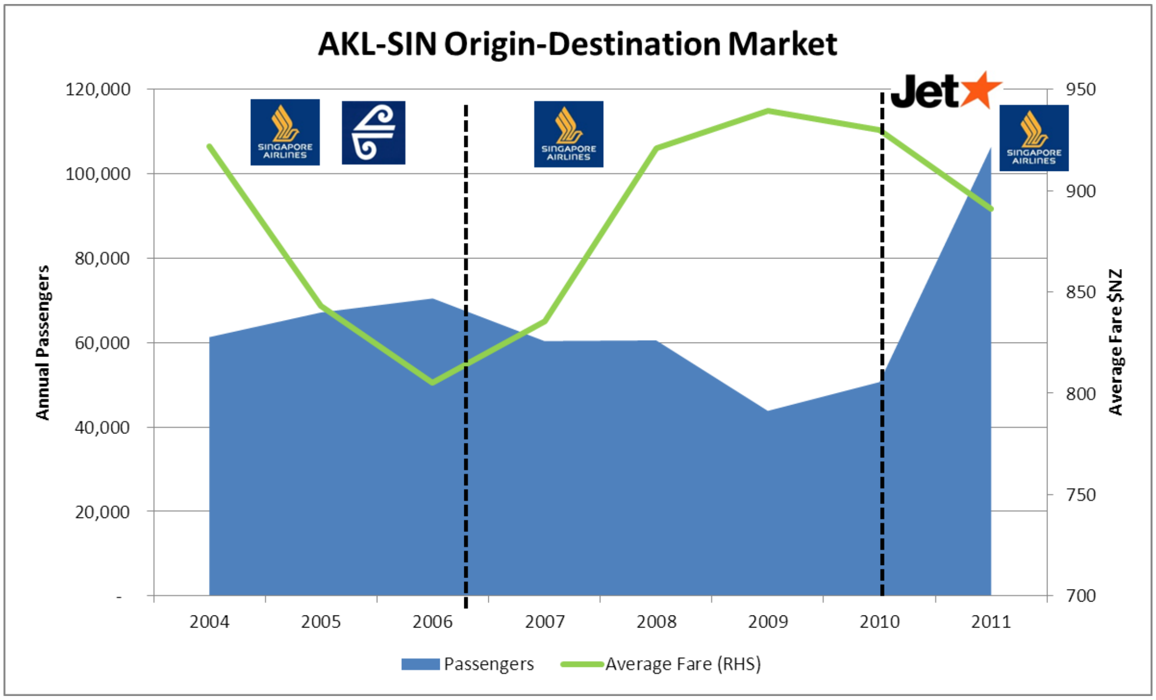

Figure 1: AKL<>SIN passenger volumes/average fares 2004 – 2011, SABRE ADI, NZ Airports analysis

The SIN market case study clearly illustrates the benefits of competition on a market which closely compares with the AKL<>HKG market. The periods during which more than one carrier has provided capacity to the route show growth in passenger volumes and reducing average fares. The period between the black vertical lines during which the route was operated by Singapore Airlines alone illustrates the potential for a sole operator on a route to increase fare levels and constrain demand.

Of NZ's direct routes to Asian hubs, only two are genuinely competitive with more than one airline operating regular scheduled services. Given the time it takes for such competition to be developed, and the barriers to entry for additional competitors, collusion on this market should not be allowed without cogent, tested evidence that such action would be in the public interest.

No evidence to suggest that current fare levels are unsustainable

NZ Airports is supportive of airlines seeking to operate profitable and sustainable businesses. The association also recognises that some agreements between airlines deliver benefits which outweigh the detriments often associated with a degraded competitive environment. NZ Airports would prefer to support airlines in genuine attempts to reach agreement which will add genuine growth to the market for air services. With the limited information provided relating to the NAAA proposal, NZ Airports has analysed available data to compare the AKL<>HKG route to other comparable routes. This analysis does not indicate that current services have suffered material detriment following the commencement of China Southern Airlines services as suggested in the NAAA application.

The scattergraph below shows the average fare per km over a range of comparable routes to the AKL<>HKG route. The blue dots show where each route falls regarding fare per mile versus average load factor. This information shows the differences between the markets, with some operating lower yielding services at higher load factors and vice versa.

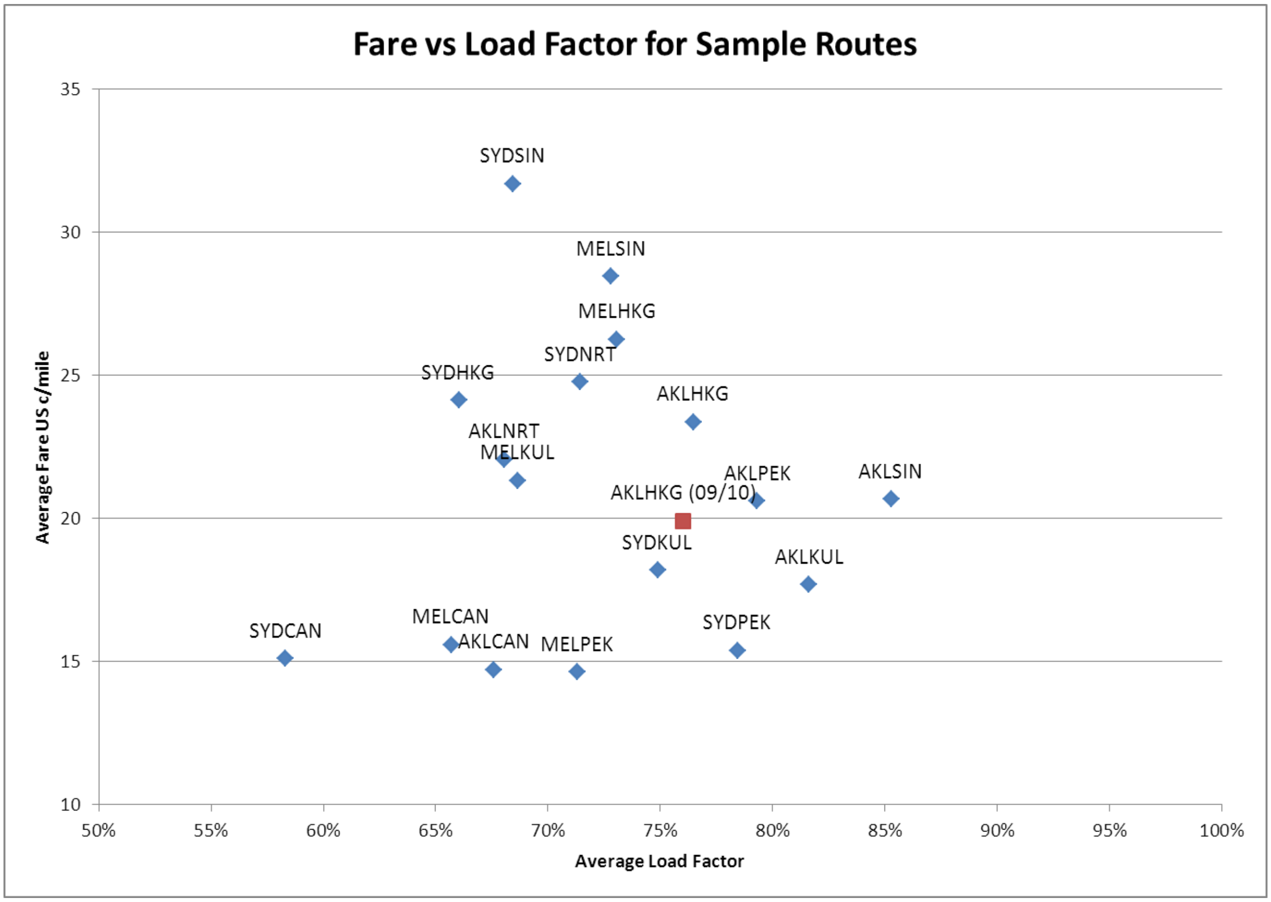

Figure 2: Asian Hub Routes fare versus load factors, SABRE ADI, NZ Airports analysis

The AKL<>HKG route fits comfortably in the middle of the range, highlighting the fact that this service is operating is the normal range relative to comparable routes. The red dot shows the same information for the AKL<>HKG route prior to the entry of China Southern services to AKL. Interestingly, this shows that little has changed, and the route has not experienced a material decline in operating performance. Indeed, if any change is to be noted, it is that since China Southern Airlines entry into the AKL market the yields have improved on the AKL<>HKG sector.

Figure 3 below illustrates another point regarding the “Pearl River Delta” market cited by the applicants as the market in question. This shows the passenger volumes flown on both the AKL<>HKG and the AKL<>CAN route by the three operating airlines. Although the applicants’ chart on page 11 of the application implied that China Southern Airlines had entered the market at considerable expense to the applicants, this information suggests that the new services have tapped into a largely separate market, with passenger demand on AKL<>HKG sectors increasing by 5% since China Southern Airlines’ AKL service commencement. Although the current capacity delivered by the applicants’ services is 12% lower following the introduction of the China Southern Airlines Services, it is the same as the capacity operated by the applicants in 2006/7. This data illustrates that passenger volumes over the period have fluctuated to levels above and below the current route performance with more effects seen as a result of external influences than the impact of competition on neighbouring routes.

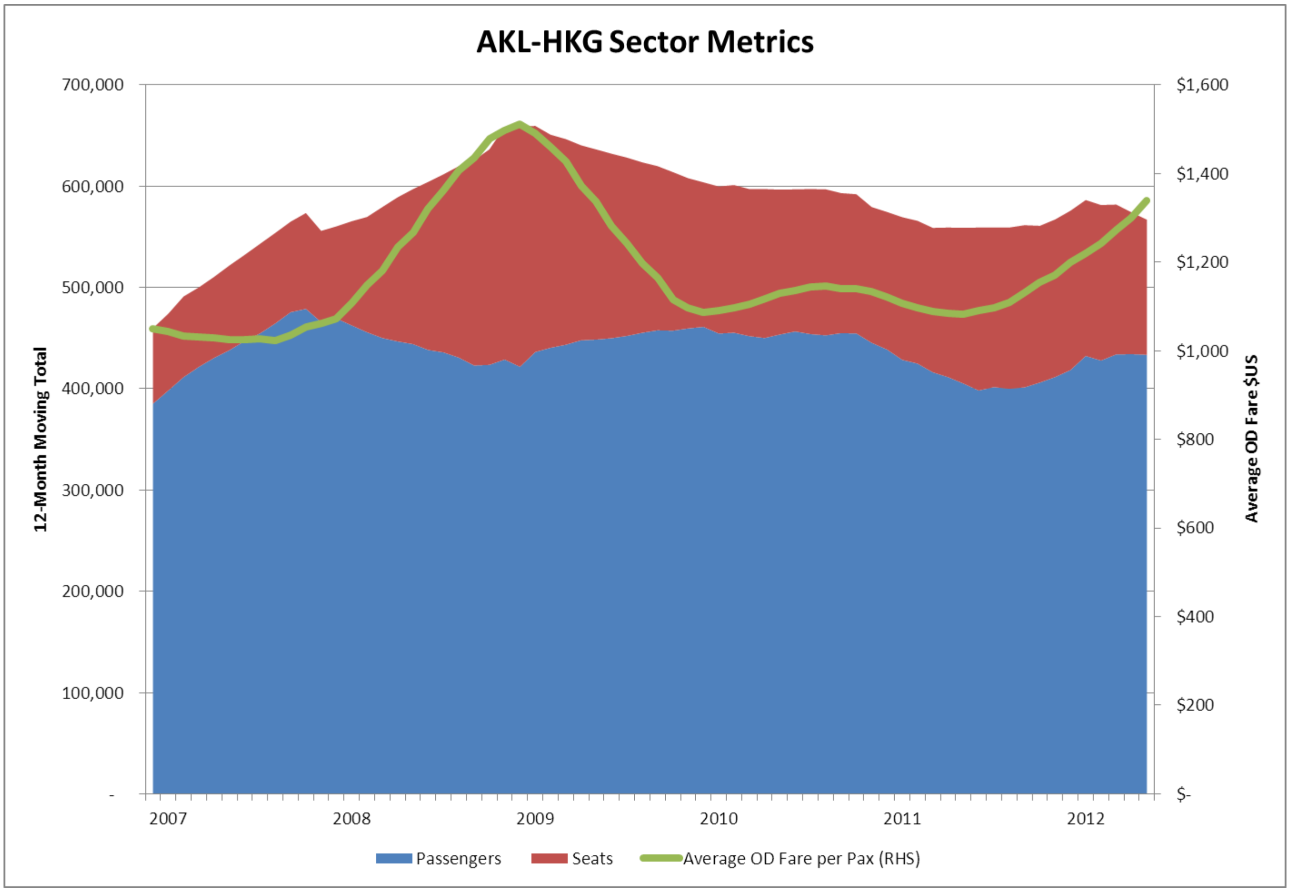

Figure 3: AKL<>HKG seat capacity, passenger volumes and average fares, SABRE ADI, NZ Airports Analysis

The market information shows comprehensively that the AKL<>HKG route is currently operating at levels of volume and yield favourable to past experience on the sector. The suggestion that the emergence of limited competition to a nearby location is unsettling the sustainability of current levels of capacity should be met with intense and careful scrutiny. Although it may be correct that competition does not fit within the profit maximization strategy of incumbent carriers on a route or market, it does not follow that such competition will render services uneconomic for those carriers. The prospect and onset of additional capacity provided by both new and existing operators is a fundamental feature of the airline business.

NZ Airports' analysis highlighted the AKL<>HKG route as being significant in the New Zealand context as one of only two direct routes to an Asian hub airport on which consumers receive the benefits of any genuine airline competition. This is a hugely valuable feature of this particular route and the positive effects of this competition should not be underestimated by the Ministry.

The route analysis indicates that there should be no reason why both Air NZ and Cathay cannot operate sustainable operations on the AKL<>HKG route. NZ Airports can understand each carrier's desire to manipulate service offerings to optimise the joint competitive position and individual returns. However, in a collusive environment there is real potential for these gains to come at the expense of the users of these services and in turn at the expense of the New Zealand economy which is heavily dependent upon its air links to the rest of the world.

Anti-competitive regulation will deter new entrants

Additional capacity delivered through the commencement of point to point services to new locations is central to the natural development of air services. A policy implemented by the New Zealand regulator that the emergence of such services should be met with sanctioned collusion on neighbouring routes is certain to deter the development of new services. Such a restriction placed on market growth will work against the public interest by delaying or eliminating the introduction of new capacity and the trade opportunities and economic activity that accompany capacity.

A comprehensive, robust and transparent cost benefit analysis is required

When evaluating the merits of proposals such as the NAAA, it is vitally important that a comprehensive, robust and transparent cost benefit analysis is conducted to discover and test the outcomes expected from the proposed Alliance versus the counterfactual.

In its investigation of the workings of New Zealand's international freight transport services industry completed in 2012, the New Zealand Productivity Commission made a number of recommendations relating to the aviation industry, including in respect of the process for authorising airline alliances under the Civil Aviation Act. As mentioned above, the Productivity Commission particularly recognised that a comprehensive analysis of costs and benefits would maximise the likelihood that efficiency-enhancing trade practices are authorised and minimise the likelihood that harmful forms of coordination are authorised. It also recognised the importance of a transparent authorisation process so that stakeholders, as well as applicants, could make their case.

In NZ Airports' view, the Productivity Commission's recommendations on these matters can and should be incorporated into the Ministry's current process in assessing the application for authorisation of the proposed Alliance. To that end, NZ Airports formally requests that it participate in the Ministry's analysis of the costs and benefits of the proposed Alliance. In particular, NZ Airports would be pleased to assist the Ministry in submitting further information regarding the data which has been redacted from the current public version of the application. In the absence of this information, it is not possible to provide a detailed analysis.

Any authorisation should be subject to conditions

If, following consideration of the views of affected parties, the Ministry is minded to progress the application further, NZ Airports considers that any authorisation that is granted should be made subject to appropriate conditions that will ensure the realisation of any benefits that the applicants claim will result from the proposed Alliance.

There are obvious and real detriments to restricting the competitive processes that would otherwise operate on the affected route; that is why the restrictive trade practices provisions of the Commerce Act 1986 generally operate to prohibit such collusion. Those detriments should not be sanctioned by authorising the proposed Alliance unless the applicants commit to providing the benefits they claim the proposed Alliance will bring. For that reason, NZ Airports submits that any authorisation that is granted should be subject to appropriate conditions making continued operation of the authorisation conditional upon those benefits being realised.

NZ Airports is also concerned at the duration of the authorisation sought by the applicants. It appears that the proposed Alliance is intended to operate for at least five years, although it is not possible to tell from the heavily-redacted application how long the proposed Alliance could potentially last.

Since airline markets can be fast moving, NZ Airports considers that scope should be kept for re-assessment of the merits (or otherwise) of the proposed Alliance, if it is authorised, as market conditions change. Accordingly, NZ Airports suggests that any authorisation that is granted, as well as being subject to appropriate conditions, is limited to three years, with the applicants free to apply again at the end of that period.

I look forward to further engagement on this issue if it is to be progressed beyond this stage.

Kevin Ward
Chief Executive
NZ Airports

27 July 2012