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Confidential and commercially sensitive

Nick Brown
General Manager Aviation and Maritime
Ministry of Transport – Te Manatū Waka

Dear Nick

APPLICATION FOR AUTHORISATION UNDER SECTION 88 CIVIL AVIATION ACT 1990

Pursuant to the provisions of Section 88 of the Civil Aviation Act 1990, Air New Zealand Limited (“Air NZ”) and United Airlines, Inc. (“United”) (together “Applicants”) hereby file for authorisation by the Minister of Transport of a side agreement to the Alliance Expansion Agreement previously entered into between the Applicants and authorised by the Minister.

BACKGROUND

Air NZ and United entered into an Alliance Expansion Agreement (“AEA”) in December 1999.¹ The AEA provides for cooperation between Air NZ and United in a number of areas including coordination of capacity, pricing, marketing and distribution, frequent flyer programs and revenue sharing, in order to generate network efficiencies and provide benefits to the travelling public.

The AEA was authorised by the US Department of Transportation (“DOT”) and NZ Minister of Transport (“Minister”) in 2001 and 2002 respectively. As part of its authorisation, DOT imposed carve-outs in relation to coordination on certain US point-of-sale LAX-AKL and LAX-SYD point to point fares due to DOT’s assessment of market conditions existing at the time of the authorization. The Minister subsequently authorised the AEA and, similar to DOT, did not authorise coordination in relation to certain New Zealand point-of-sale LAX–AKL fares.²

Air NZ and United have recently signed an Implementing Agreement pursuant to the AEA to deepen their cooperation on routes between New Zealand and USA with a metal neutral revenue sharing arrangement (“Arrangement”). This was notified to the MOT, and formally approved by the DOT. Air NZ and United wish to extend this coordination and revenue sharing to the Carved-out fares. In addition to this application, the parties have also informally approached the DOT to extend coordination to the Carved-out fares, and expect to submit a formal application to the DOT in the coming months.

To allow the Applicants to extend the Arrangement (and other aspects of the Applicants’ current coordinated activity) to the Carved-out fares, the Applicants request authorisation of the attached Side

¹ The AEA enhanced existing arrangements between the Applicants, including a Marketing Cooperation Agreement and a Code Share and Regulatory Agreement, both of which were concluded between the parties in 1996. The AEA also provided for the parties to enter into “Implementing Agreements” subsequent to the AEA to further define and put into effect various details of the proposed coordination.

² The carve-outs adopted by the Minister were in relation to “pricing, inventory or yield management coordination, or pooling of revenues by the parties, with respect to unrestricted coach-class (economy class) fares or any business or first-class fares for local New Zealand-point-of-sale passengers flying nonstop between Auckland and Los Angeles or the provision by one party to the other of more information concerning current or prospective fares or seat availability for such passengers than it makes available to airlines and travel agents generally.” (The “Carve-outs” or “Carved-out fares.”) The Carve-outs are subject to certain exceptions listed in paragraph 3 of the Applicants’ December 2001 application for authorisation.

Agreement, in which the Applicants agree (subject to necessary regulatory approvals) to now coordinate on the Carved-out fares under the terms of the AEA.

SCOPE AND TIMING

As the Ministry will be aware, the DOT's 2001 decision allows the parties to apply to the DOT at any time to have the US Carve-outs removed. There is nothing similar in the MOT decision, as Part 9 of the Civil Aviation Act 1990 ("CAA") does not allow for the amendment of an existing authorisation. It does, however, provide for the authorisation of agreements, hence the need for the parties to make this application in its current form. Notwithstanding the difference in procedure, the Ministry's substantive analysis of the current application should be substantially similar to that of the DOT, i.e. whether the public benefits of removing the Carve-outs will outweigh any competitive detriment, especially now that there is a metal neutral revenue sharing agreement in place.

The Ministry cannot re-visit its decision to approve the AEA or the reasons for its decisions; it does not have the ability to do so under Part 9 of the CAA. Nor should the Ministry consider the merits, or otherwise, of the parties' current coordination on services that are not subject to the Carve-outs; this coordination is authorised for an unlimited period, so can continue whether or not the Side Letter is also authorised. In summary, and consistent with the Ministry's approach to Part 9, the assessment of the Side Letter is narrow in scope: whether the Side Letter, and hence the ability to coordinate on the Carved-out fares, will create public benefits for New Zealand and otherwise meet the criteria in Part 9. This is the basis for the analysis below.

The Applicants will shortly apply to the DOT to have the Carve-outs removed in relation to US point-of-sale, a process that could take anywhere from three to nine months. However, the Ministry is not constrained by the timing of the DOT's decision. In 2002 the Applicants included the Carve-outs in their application to MOT as a way to avoid any potential competition issues the AEA might have created in relation to business passengers travelling on Auckland – Los Angeles and Auckland – Sydney services. The Carve-outs were adopted by the Minister to resolve any such issues in the New Zealand market (i.e. New Zealand point of sale) and were not dependent on the DOT carve outs (which were specifically aimed at the US point of sale). Given the fact that fares are currently determined based on point of sale, as soon as the Ministry removes the Carve-outs many of the benefits described below would start to accrue in respect of New Zealand point-of-sale. This will be the case even if the US Carve-outs continue to apply.

REASONS FOR AUTHORISATION

The sections below outline why the Minister should exercise his discretion to approve the Side Agreement under Section 88.³ In summary:

- the Carve-outs are not necessary to protect against competitive detriment, particularly given changed market conditions;
- Changes in the meaning of "unrestricted fares" since 2002 mean the Carve-outs as written no longer apply as DOT and MOT intended;

³ For the same reasons as set out in the Ministry's 2002 recommendation the Side Agreement does not contravene any of the provisions of Section 88(3)-(4) which limit the MOT's discretion to grant authorisation.

- removal of the Carve-outs would allow the Applicants to realize the full scope of benefits generated under the Arrangements;
- the Carve-outs create an uneven playing field in the face of strong competition.

1. Current competitive conditions mean the Carve-outs are not necessary for protection of consumers

The Carve-outs are not needed in today's competitive environment, which differs in material respects from the environment that existed when the Minister authorised the arrangements subject to the Carve-outs.

At the time the Minister adopted the Carve-outs, both Air NZ and United operated AKL-LAX and SYD-LAX. This is no longer the case. As of March 2003, Air NZ and United ceased to overlap on AKL-LAX; United withdrew and has never re-entered. In addition, Air NZ no longer operates on routes between USA and Australia. Accordingly, there is no market concentration resulting from an Air NZ/United alliance on AKL-LAX or SYD-LAX.

The following features of today's competitive environment also support removal of the Carve-outs:

- American Airlines plans to operate AKL-LAX beginning in June 2016 in a revenue share arrangement with Qantas. As the Minister will be aware, Qantas and American Airlines have an established trans-Pacific partnership (that commenced in 2011). This new service is part of an expanded "Joint Business Agreement" which has been approved by the Minister and the ACCC and is pending DOT approval, which is expected to come in the next few months. As a result, Air NZ will face competition on AKL-LAX from an alliance with a strong network presence at both ends of the route, with the possibility of additional routes in the future.
- Delta has entered the Australasian market since the Carve-outs were imposed and currently operates LAX-SYD (amongst other routes) in a revenue share alliance with Virgin Australia. This revenue share alliance has operated since 2009, has been approved by the Ministry of Transport for an indefinite period, and recently received an unconditional approval from the ACCC for a further five years. The MOT authorisation would allow Delta and Virgin Australia to launch joint services between the US and New Zealand at any time. The threat of potential entry operates as a constraint to the behaviour of Air NZ and United as well as other operators in the market.
- LAX has grown significantly since the carve-outs were imposed and today is a dynamic and highly competitive international gateway.
- There are more one-stop options for travel between New Zealand and LAX via Australia than there were when the Carve-outs were applied, including services operated by Virgin Australia and Delta.

Given the absence of overlapping services between Air NZ and United on the carved-out sectors and the direct and indirect competition provided by the American/Qantas and Delta/Virgin authorised

alliances, limits on the ability of the Applicants to provide a fully coordinated offering on AKL - LAX are not needed to protect consumers.

2. Changes in industry fare structures and definitions have rendered the Carve-outs obsolete

Fare definitions and structures have changed materially since the Carve-outs were imposed such that preventing coordination on “unrestricted fares” would no longer achieve the outcome that the MOT intended in 2002 and creates confusion for the airlines applying the carve-outs in today’s fare environment.

The carve-outs preclude coordination with respect to “unrestricted coach-class fares” and “business or first-class fares.” In its 2001 Order to Show Cause, DOT described “unrestricted fares” as “published fares not requiring either a Saturday night stay or a minimum stay of seven days or more.”⁴ DOT’s stated intention was to protect time sensitive/business travellers whose lack of flexibility meant they were less able to take advantage of competing one-stop and connecting fares than more flexible travellers.⁵

Saturday night stay and minimum stay requirements are far less common today than they were in 2001 (in part due to the move to one-way fare structures) for New Zealand point-of-sale. This means that most economy class fares offered today could be characterized as “unrestricted” according to DOT’s definition. Accordingly, at a definitional level the carve-outs are no longer tailored to protecting time sensitive/business travellers as originally intended and instead may be interpreted to have much broader application.

The changes in fares structure since the Carve-outs were imposed creates practical difficulties as to how they should be applied, and frustrates the Applicants’ ability to undertake some approved activities that are likely to be efficiency-enhancing. By removing the Carve-outs, the MOT will not only provide the Applicants with a level of comfort in undertaking activities that are consistent with what was intended by the initial authorisations, but will also allow the Applicants to undertake further activities that will maximise the benefits of the Arrangements for consumers.

3. Removal of the Carve-outs will allow greater benefits to be generated by the alliance

Leaving the Carve-outs in place would inhibit the realisation of efficiencies and consumer benefits from the Arrangements. In particular:

- With unrestricted revenue sharing or price coordination on AKL-LAX there is more incentive and ability for United and Air NZ to jointly promote this service, increasing the potential for in-bound tourism growth.
- The Carve-outs prevent United and Air NZ from efficiently coordinating to match tactical fare reductions initiated by competitors on AKL-LAX.
- The inability to price coordinate fully on AKL-LAX complicates pricing discussions and revenue sharing for other New Zealand-USA routes, thereby reducing the overall efficiency of the alliance. The Applicants are working on agreed processes to continue to keep their activities compliant with the Carve-outs in place, if necessary. While this may be technically

⁴ DOT Order to Show Cause, page 14 (2 March 2001).

⁵ Ref footnote 4.

feasible given the small size of the AKL-LAX point to point market relative to the alliance as a whole⁶, it introduces unnecessary complexities in circumstances where the original reasons for imposing the Carve-outs no longer exist.

- Allowing for revenue sharing on the Carved-out fares creates a greater incentive for the Applicants to provide metal neutral FFP benefits and/or lounge access over and above those already provided through their existing relationship.

4. Removal of the Carve-outs will create a level playing field with competing trans-Pacific alliances

As noted above, Air NZ and United will soon be competing against two substantial and established revenue share alliances in the trans-Pacific market, both of which have been authorised unconditionally (Qantas/American and Delta/Virgin) by the NZ Minister of Transport. The Carve-outs prevent the Applicants from providing a fully coordinated offering in competition with these airlines. Not only does this put the Applicants at a disadvantage from an operational perspective (for the reason set out in section 3), it also creates confusion for the Applicants' customers due to this partial coordination, whereby some fares on the Applicants' services will always be marketed at different prices between UA and NZ and others are marketed at a similar price.

Removal of the Carve-outs would ensure that the Applicants are not at a competitive disadvantage to their trans-Pacific competitors.

SUMMARY

Current competitive conditions do not warrant retention of the Carve-outs and retaining them would limit the competitive and consumer benefits of the Applicants' recently expanded cooperation. The changes in fare structures and terminology during the 14 years since the Carve-outs were imposed have rendered the language obsolete. Removal of the Carve-outs will enable full realization of the benefits of the AEA and the Applicants' metal neutral revenue sharing arrangement and will put the Air NZ/United alliance on a level playing field with competing trans-Pacific alliances. Accordingly, authorisation of the Side Agreement pursuant to section 88 of the Civil Aviation Act is appropriate.

Should you require any elaboration on or clarification of any of the above, please do not hesitate to contact me.

Yours sincerely

Andrea Jane
Head of Alliances

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