2018/19 Annual review of Air New Zealand Limited

Report of the Transport and Infrastructure Committee

March 2020

Contents

Darroch Ball
Chairperson

Air New Zealand Limited

Recommendation
The Transport and Infrastructure Committee has conducted the annual review of Air New Zealand Limited for 2018/19, and recommends that the House take note of its report.

About Air New Zealand Limited

Air New Zealand is the national airline and operates passenger and air cargo services domestically and internationally. It is a public company listed on the New Zealand and Australian stock exchanges. The Crown is a 51.91 percent shareholder and is also holder of the Kiwi Share, a single share that does not carry general voting rights but requires the Crown's consent for certain actions. This is designed to maintain Air New Zealand's status as a substantially New Zealand-owned and -controlled company.

An independent seven-member board governs Air New Zealand. Tony Carter stepped down as Chairman in September 2019 and was replaced by Dame Therese Walsh. Also in September, Christopher Luxon stepped down as Chief Executive, a role he had held since 2012. Air New Zealand's Chief Financial Officer, Jeff McDowall, was acting Chief Executive until Greg Foran, current President and Chief Executive of Walmart US, assumed the role in the first quarter of 2020.

Financial overview and audit results

In 2018/19, Air New Zealand generated operating revenue of $5.785 billion. Most is passenger revenue ($4.960 billion) which increased by 5.6 percent from the previous year. Air New Zealand attributes this growth to the launch of new routes to Chicago and Taipei, increased frequency to Singapore, and growth on the trans-Tasman route following the end of the Virgin Australia alliance.

Air New Zealand's operating expenditure increased by 9.6 percent to $4.605 billion in 2018/19. Fuel costs increased by 28.8 percent, from $987 million to $1.271 billion. Air New Zealand reported that the average fuel price increased 19 percent compared to the prior year, resulting in $191 million of additional costs.

For 2018/19, Air New Zealand recorded a net profit of $270 million. This was a 30.8 percent decrease from the previous year. As well as fuel price increases, other factors that contributed to the change in profitability included the temporary disruption caused by global problems with Rolls-Royce engines, and a slowing of growth in demand.

The Office of the Auditor General issued a standard audit report, and is satisfied that the information it audited fairly reflected the company's activities for the year and its financial position at the end of the year.

Focusing on the Pacific Rim

In October 2019, Air New Zealand decided to withdraw its daily Los Angeles to London service. We heard that Air New Zealand has struggled to compete with other international carriers on the Atlantic route, which have the home-base advantages of being well-known to consumers and enjoying greater economies of scale.

Withdrawing from the Atlantic route will free up capacity for Air New Zealand to focus on its services and alliances in the Pacific Rim, where its brand is recognised and preferred by international visitors for its association with New Zealand. Air New Zealand believes that focussing on the Pacific Rim offers the greatest opportunity for long-term profitable growth.

When it concludes its Los Angeles–London service in October 2020, Air New Zealand will launch a non-stop service between Auckland and New York.

Challenges in the Asian market

We heard that Japan remains a good and reliable source of high-value tourism to New Zealand, but demand from China has been more variable. Although there has been massive growth in visitor arrivals from China, Air New Zealand competes against an increasing number of international airlines. These airlines are well-known to consumers in China, have travel partners that allow them to distribute their product very effectively, and have a lower cost-base than Air New Zealand.

Air New Zealand told us it has increased the profitability of its services between New Zealand and China by two means. It has targeted its services to Chinese cities where a high proportion of New Zealanders travel, such as Shanghai. It has also targeted its services to higher-value Chinese and New Zealand consumers who prefer to fly on a premium service, such as those travelling for business.

Some of us observed that Air New Zealand’s fares to and from China can be double those of some Chinese carriers. In this competitive market, Air New Zealand said, Chinese carriers are often prepared to offer lower fares than it would find economic. This could be because the Chinese carriers have a lower cost base or a different expectation for the performance of their operation.

Balancing profitability with obligations as the national carrier

Air New Zealand told us it is committed to ensuring its profitability for its shareholders. However, it recognises that a significant amount of its value is derived from its New Zealand-associated brand and remaining aligned to the needs of New Zealanders.

We asked what Air New Zealand thought about the Crown investigating minority stakes in other airlines.[1] Air New Zealand told us that its top concerns are that New Zealanders are well served and that all airlines operate in a healthy economic environment. Although, as

[1] The Provincial Development Unit, which administers the Provincial Growth Fund, recommended that the Government invest in two unnamed airlines in return for Crown shareholding. The proposal was declined by the Regional Economic Development Ministers in December 2018.

New Zealand's national carrier, it would appreciate being part of the dialogue, it remains firmly focussed on its own business growth and obligations.

Supporting regional coverage

Air New Zealand told us it has incentives to promote growth in the regions. Adding flights to a regional destination makes it a more attractive proposition for consumers, and this demand further supports and drives growth in services to the regions. Air New Zealand estimates that it has increased the number of seats in its domestic network by 25 percent over five years.

We also heard that Air New Zealand replaced its 19-seater Beech aircraft fleet with 50-seaters. Not only has this increased passenger capacity to the regions, it has also allowed Air New Zealand to lower fares, as the 19-seaters were expensive to operate.

However, operating in the regions continues to present economic challenges, as evidenced by Jetstar's withdrawal, in November 2019, of its Auckland to Napier, Nelson, New Plymouth and Palmerston North routes, as well as between Wellington and Nelson. We were pleased to hear that Air New Zealand has been assisting these regions by offering discounted rates to customers on cancelled Jetstar routes, increasing their capacity by almost 50,000 seats, and committing to keeping entry-level fares unchanged until the end of 2020.

Some of us expressed concern that fares to the regions are expensive, sometimes costing as much as a flight to Sydney or Brisbane. Air New Zealand told us that its strategy is to offer a broad range of fare options. Offering cheap fares builds frequency on regional routes, but higher fares compensate for the costs of running flights that are in high demand or booked quite late.

Offsetting carbon emissions

Air New Zealand offsets 100 percent of its domestic carbon emissions through the New Zealand Emissions Trading Scheme. From 2020, we heard that it will also need to provide carbon offsets for any growth from a base, as part of its participation in the CORSIA agreement.[2]

Additionally, Air New Zealand's "FlyNeutral" programme allows customers to elect to voluntarily offset the emissions associated with their flight by adding the cost of carbon offset credits to the total cost of their ticket. In the past year, Air New Zealand customers have offset more than 60,000 tonnes of CO_2 through the programme.

Deferring fleet investment

We are pleased that Air New Zealand will be replacing its current fleet of Boeing 777-200 aircraft with Boeing 787-10 Dreamliners. The new fleet is expected to improve fuel efficiency by 25 percent. However, Air New Zealand has recently reviewed its network, fleet, and cost base to ensure its profitability and resilience after some slowing in demand growth. As a result of this review, Air New Zealand will defer $750 million of fleet investments and

2 In 2016, the United Nation's International Civil Aviation Organization (ICAO) adopted the Carbon Offsetting and Reduction Scheme for International Aviation (CORSIA) to address CO_2 emissions from international aviation.

implement a two-year cost reduction programme. We asked what effect the deferral will have on Air New Zealand's projected financial performance, including fuel efficiency, carbon emissions, and costs.

Air New Zealand told us that the bulk of the deferred investment relates to the new 787-10 Dreamliners. Although deferring their delivery means it will operate a less fuel-efficient fleet, Air New Zealand told us that slower growth in demand means it will require fewer aircraft overall. So even though it will not achieve the reduction in carbon emissions by operating a more fuel-efficient fleet, Air New Zealand's carbon profile will remain low as it does less flying.

Although we are disappointed by the delay, we note that Air New Zealand operates one of the most fuel-efficient fleets in the world, and was awarded Eco Airline of the Year in 2019.

The provision of aviation security

Avsec is New Zealand's official provider of aviation security, which includes screening passengers and baggage. It is part of the Civil Aviation Authority of New Zealand, a Crown agency.

Air New Zealand told us it is satisfied with Avsec's operational performance, but is concerned by the rising levies it pays, which are soon to increase by 23 percent. Air New Zealand said it did not have a view on whether the contract for airport security should be put out to tender, but it would be interested in any discussion about this as a key stakeholder. It noted that in some jurisdictions airlines provide their own aviation security services.

Australian alliances

We noted that Air New Zealand had concluded an alliance with the Australian carrier Virgin in 2017/18, and entered into a codeshare with another Australian carrier, Qantas, in 2019. We asked why Air New Zealand had changed its strategy and direction away from Virgin and towards Qantas.

Air New Zealand explained that it began its alliance with the low-cost carrier Virgin in 2010. At that time both airlines were trying to implement a hybrid model where passengers could choose from a range of low-cost to full-service options. The aim was that passengers would receive the level of service they had chosen, regardless of which airline operated the flight. However, Air New Zealand's customers consistently reported that the service from Virgin-operated flights did not meet their expectations.

The alliance also aimed to open up the Australian market for Air New Zealand, where it could benefit from Virgin's visibility and consumer preference. However, Air New Zealand was able to successfully develop its own brand in Australia and attract Australian customers, especially when it opened new routes to North America. Its reliance on Virgin as a distribution partner in Australia diminished significantly.

When Air New Zealand reviewed what carriers would provide the best service for its customers to connect to points in Australia, it found that Qantas was a better fit, particularly in its price, frequency, access to network, and breadth of destinations. In return for accessing Qantas' network in Australia, Air New Zealand gave Qantas access to its domestic network.

We wondered whether the Qantas codeshare would hurt Jetstar's operations in New Zealand. Jetstar is a low-cost subsidiary of Qantas and also codeshares with Qantas across New Zealand routes. We observed that with Air New Zealand offering more frequent flights across a larger network in New Zealand, Qantas passengers should have more incentives to fly with Air New Zealand. Air New Zealand said that Jetstar has struggled to achieve profitability in New Zealand, even before the codeshare arrangement was introduced.

Managing problems with the Rolls-Royce engines

In December 2017, an Air New Zealand flight to Japan had to return to Auckland after one of the Rolls-Royce engines on its 787-9 aircraft failed and had to be shut down. Rolls-Royce engines are fitted to the majority of Air New Zealand's Boeing 787-9 fleet. It has continued to experience network disruption related to issues with the Rolls-Royce engines since then, including cancellation of more than 80 international flights, affecting 14,000 passengers in November 2019.

We asked about the extent to which the engine issues had disrupted Air New Zealand's operations, the subsequent cost to Air New Zealand, and what contingencies Air New Zealand had planned for any similar future disruption.

For commercial sensitivity reasons, Air New Zealand could not disclose any details about compensation received from Rolls-Royce. However, it told us that its relationship with Rolls-Royce remained strong and the engine issues had only a relatively minor effect on its financial statements.

Air New Zealand said it immediately brought in leased aircraft and crew to service routes that were disrupted by the engine issues. Although the leased aircraft were expensive and offered a different level of service than customers were used to, it was the quickest and least disruptive solution for customers. Air New Zealand also increased staffing in airports and call centres to respond to the higher level of customer enquiries.

When it became clear that the engine issues were continuing, Air New Zealand brought in three more aircraft on medium-term leases. It said that these additional aircraft give it flexibility in its flight scheduling. One further aircraft is available for contingencies.

Appendix

Committee procedure

We met on 14 November 2019 and 19 March 2020 to consider the annual review of Air New Zealand Limited. We heard evidence from Air New Zealand Limited and received advice from the Office of the Auditor-General.

Committee members

Darroch Ball (Chairperson)
Chris Bishop
Paul Eagle
Raymond Huo
Matt King
Jan Logie
Jami-Lee Ross
Jamie Strange
Tim van de Molen

Advice and evidence received

We received the following documents as advice and evidence for this annual review. They are available on the Parliament website, www.parliament.nz, along with a transcript of our hearing.

Office of the Auditor-General (Briefing on Air New Zealand).

Air New Zealand (Responses to written questions).