Contact officer: Darrell Channing
Contact number: 02 6243 4925

6 October 2016

Ms Marlene Tucker
Executive Director
International Air Services Commission
GPO Box 630
Canberra ACT 2601

Dear Ms Tucker

Re: Application from Qantas for variation of determinations relating services between Australia and Papua New Guinea

Thank you for inviting the ACCC to comment on Qantas' application for a variation of its determinations relating to services between Australia and Papua New Guinea.

The ACCC notes that in providing this submission it has not had access to information that will be relevant to evaluate the likely competition effects of the proposed code share arrangement (e.g. airline load factors and profitability on the Australia to Papua New Guinea route). Accordingly, the ACCC has focussed on issues of principle to inform the IASC's assessment.

The application for variation

The ACCC understands that existing IASC determinations allocate to Qantas 1888 seats per week in each direction on the Papua New Guinea route. Of these 1888 seats:

- 1000 seats have been allocated until 30 June 2017[1] and are currently used by Qantas to code share with Air Niugini[2] on services between Brisbane-Port Moresby and Sydney-Port Moresby

- 888 seats have been allocated until 24 March 2020[3] and cannot currently be used for code share purposes.

Earlier this year, the IASC renewed the allocation of 1000 seats to Qantas from 1 July 2017 to 1 July 2022[4] but there is currently no approval for Qantas to use these 1000 seats to code share with Air Niugini during that period.

[1] Determination [2011] IASC 132
[2] Determination [2012] IASC 215
[3] Determination [2014] IASC 105

Qantas is now requesting a variation to its determinations to enable it to use all 1888 seats to code share with Air Niugini from 30 October 2016 until 24 March 2020 with 888 seats and until 1 July 2022 with 1000 seats. Related to this request, Qantas proposes to:

- continue code sharing with Air Niugini on services between Brisbane-Port Moresby and Sydney-Port Moresby
- add Cairns-Port Moresby to the code share arrangement, following the withdrawal of its own operated Cairns-Port Moresby services and commencement of Brisbane-Port Moresby services and
- change the nature of the proposed code share arrangement with Air Niugini from hard block to free sale (discussed in more detail below).

Requirements under the Minister's policy statement

The ACCC understands that in circumstances where the IASC has serious concerns that a code share arrangement may not be of benefit to the public, the IASC may apply certain 'public benefit' criteria set out in paragraph 5 of the *International Air Services Policy Statement No.5* [5] (including competition benefits[6]) in its assessment of code share proposals. Before doing so, the IASC must consult the ACCC.

I note the IASC invited Qantas to address the paragraph 5 criteria in relation to the proposed code share arrangement with Air Niugini, and Qantas provided a supplementary application on 14 September 2016.

In this submission, the ACCC identifies a number of issues which are relevant to assessing the likely competitive impact of the proposed code share arrangement and whether it is likely to be of benefit to the public.

The code share arrangement between Qantas and Air Niugini

The ACCC understands that the current hard block code share arrangement requires Qantas to purchase from Air Niugini the same number of seats for each month of a scheduling period. Within the fixed number of monthly seats that Qantas purchases, there are variations in the numbers it purchases for each day of the week.

In its supplementary application, Qantas states that the current code share arrangement will not apply from 30 October 2016, and after that date, it is only in a position to code share on the Papua New Guinea route with Air Niugini on a free sale basis.

The ACCC has publicly stated that, from a competition perspective, a hard block code share generally is preferable to a free sale code share since it allows a greater degree of rivalry between the airlines.[7] Under a hard block arrangement (which places full commercial responsibility on the marketing carrier for a fixed number of seats) each carrier has an incentive to market their allocated seats independently of each other, including offering

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[4] Determination [2016] IASC 110

[5] Made under the *International Air Services Commission Act* (1992), section 11.

[6] *International Air Services Policy Statement No.5*, paragraph 5.1(a)

[7] ACCC submission to the IASC re South African Airlines code share; ACCC submission to the IASC re Air Niugini and Qantas code share 6 March 2012.

different prices. Under a free sale arrangement there is limited incentive to compete on price because the marketing carrier only pays for the seats it sells.

The ACCC notes that the IASC raised concerns about the nature of the code share arrangement between Qantas and Air Niugini in its 2007, 2009 and 2012 decisions. In particular, the IASC was concerned about the small size of the hard block and that allowing Qantas to match flight seat numbers to forecast demand (to some extent) put limited pressure on Qantas to compete on price with its code share partner.

Additionally, in 2009, the IASC articulated strong concerns that the option for Qantas to purchase further seats up to an agreed limit on each Air Niugini flight within a 'soft block' of seats meant that Qantas could generate strong returns without the need to discount fares significantly. Following this decision, Qantas removed the soft block component when it applied for renewal of the code share arrangement in 2012.

Competitive environment

The ACCC notes that there have been two significant changes to the competitive environment since the IASC's last determination in 2012.

Firstly, Airlines PNG exited Brisbane-Port Moresby in July 2014 after operating on the route since 2005. This has left Air Niugini and Virgin as the operating carriers on that route, with Qantas marketing Air Niugini services under their code share arrangement.

Secondly, the ACCC understands that passenger traffic between Australia and Papua New Guinea has remained relatively stable over the period between January 2011 and June 2016. This is in contrast to the strong growth (12.4% per annum, on average) experienced during the five years preceding the 2012 decision.

The ACCC considers that the IASC should have regard to this reduction in the number of competing carriers and the stability of passenger demand as it assesses the likely competitive impact of the code share arrangement.

Likely future with and without

It will be important for the IASC to compare the likely future with and without the code share arrangement in place, in its assessment of competition or any other benefits.

As noted above, Qantas has publicly announced that from 30 October 2016 it will commence services between Brisbane and Port Moresby and discontinue its existing services between Cairns and Port Moresby. The ACCC understands that Qantas is likely to make this operational change with or without the proposed code share arrangement with Air Niugini.

The ACCC also notes that in its request to the Independent Consumer and Commission of Papua New Guinea for a variation of its code share arrangements between Port Moresby and Brisbane/Sydney, Air Niugini states Qantas will terminate those code share arrangements if the variation (including the proposed change from a hard block to free sale code share) is not granted.

Therefore, it seems that in the likely future without the code share arrangement in place:

- services between Brisbane and Port Moresby would be independently operated and marketed by Qantas, Air Niugini and Virgin

- services between Cairns and Port Moresby would be operated and marketed by Air Niugini. In the event that Air Niugini were to significantly raise price or reduce service, there would seem to be a real chance that either Virgin or Qantas would enter and contest Cairns-Port Moresby services

- services between Sydney and Port Moresby would be operated and marketed by Air Niugini. In the event that Air Niugini were to significantly raise price or reduce service, there would seem to be a real chance that either Virgin or Qantas would enter and contest Sydney-Port Moresby services.

Competition benefits

Under the proposed code share arrangement, it is likely that:

- services between Brisbane and Port Moresby would be operated by Qantas, Air Niugini and Virgin, with Qantas and Air Niugini able to market each other's services on a free sale basis.

- services between Cairns and Port Moresby would be operated by Air Niugini, with Qantas able to market those services on a free sale basis.

- services between Sydney and Port Moresby would be operated by Air Niugini, with Qantas able to market those services on a free sale basis.

Therefore, the key differences with the proposed code share arrangement in place are as follows:

- on the Brisbane to Port Moresby route, Qantas and Air Niugini would be able to market each other's services meaning there would be less competition between the two carriers in the marketing of their capacity

- on the Cairns to Port Moresby and Sydney to Port Moresby routes, Qantas would be able to market Air Niugini capacity, which makes it less likely that Qantas would commence operating on the route in the event that Air Niugini were to significantly raise price or reduce service. This leaves Virgin as the main source of competitive constraint on these routes.

In the absence of airline load factor and profitability data, and information about how Virgin would be likely to respond to higher prices or reduced service on the Brisbane to Port Moresby route and whether Virgin would be likely to commence services on other routes if Air Niugini were to raise price or reduce service, it is difficult for the ACCC to form a clear view on the likely effect of the proposed variation on competition. It will be important for the IASC to have regard to this information in reaching its decision.

However, the ACCC does consider that proposed free sale code share arrangement has the potential to lessen competition between Qantas and Air Niugini for the reasons outlined above. The ACCC is of the view that any claimed competition benefits need to be considered in this context.

The ACCC notes Air Niugini's submissions that the code share revenue earned from Qantas as a marketing carrier on these routes contributes towards the operating costs of Air Niugini's services. Air Niugini states that in the absence of that contribution:

- it would need to carefully review the ongoing sustainability of its Cairns to Port Moresby and Sydney to Port Moresby services
- it will not be able to sustain its current 13 per week operation on Brisbane to Port Moresby and
- in the medium to long term, it may have to substantially withdraw from operating wide body aircraft which provide critical freight capability.

The ACCC anticipates that the IASC will examine Air Niugini's load factors and profitability in order to verify these claims. However, the ACCC also notes that if Qantas decides to terminate the code share arrangement there are no regulatory barriers to Air Niugini pursuing an alternative code share arrangement with Virgin which also has a domestic Australian and international network, and has previously been involved in code share arrangements on the route with Airlines PNG.

Other benefits

In identifying the issues outlined above, the ACCC has focused on competition benefits as the pre-eminent consideration. The ACCC notes that Qantas has addressed all the paragraph 5 criteria and the IASC is therefore likely to assess the application against those criteria. Set out below are some brief observations on these other criteria.

Tourism benefits

The ACCC notes that:

- in its supplementary application, Qantas characterises the Papua New Guinea route as 'a historically challenging market, dominated by corporate traffic flows, with relatively limited opportunity for tourism growth'
- in its 2012 decision, the IASC concluded that in the case of Papua New Guinea, the tourism criterion is not a significant factor in assessing the application.

Consumer benefits

The ACCC anticipates that the IASC will investigate whether consumers are likely to benefit from lower fares or greater frequencies and choice of service as a result of the code share arrangement. Given the high degree of complementarity between the Qantas and Air Niugini networks, it will also be relevant to consider the potential for consumer benefits associated with better online connections for passengers travelling behind and beyond Brisbane and Port Moresby.

Trade benefits

The ACCC notes that in its 2012 decision the IASC concluded that the continuation of B767 services is important to maintaining frequent, low cost and substantial freight capacity between the two countries, and also between Papua New Guinea and markets in Asia.

The ACCC encourages the IASC to re-examine the extent to which the code share arrangement underpins the operation of Air Niugini's wide body services and whether there have been any changes to the nature of competition in freight services (including market shares).

Industry structure

The ACCC encourages the IASC to consider the likely impact of the code share arrangement on the number and sustainability of operating carriers servicing the Australia to Papua New Guinea route.

Period of approval

Qantas seeks approval to code share with Air Niugini until 24 March 2020 with 888 seats and until 1 July 2022 with 1000 seats. Given the number of significant changes occurring in conjunction with this application, namely:

- the operational changes being implemented by Qantas
- the change in the nature of the code share arrangement from hard block to free sale and
- uncertainty about the likely effect on competition of the code share arrangement

the ACCC notes that it is open to the IASC to grant any approval for a shorter duration than requested.

Conditions of approval

The ACCC notes that the IASC has previously imposed conditions of approval designed to encourage competition between the code share partners, such as minimum numbers of weekly frequencies which must be operated, and independent pricing.

If the IASC is minded to authorise the code share arrangement, it may wish to consider whether conditions are appropriate to address any concerns about the free sale code share arrangement diluting the competitive dynamic between the code share partners.

Conclusion

The ACCC considers that the proposed code share arrangement has the potential to lessen competition, but without the opportunity to examine airline load factors and profitability on the Australia to Papua New Guinea route or consider the extent of the competitive constraint that Virgin is likely to provide on all three routes under the proposed variation, it is not in a position to form a clear view on the likely extent of the effect on competition. In these circumstances, the ACCC has outlined a number of issues for the IASC to consider and anticipates that the IASC will examine any competition benefits by comparing the likely future with and without the code share arrangement.

Role of the ACCC

I note that any decision by the IASC to approve the code sharing arrangements between Qantas and Air Niugini does not provide any protection for the airlines under the *Competition and Consumer Act 2010*, and does not prejudice any possible future consideration of code share operations by the ACCC.

I hope that this submission assists you in your consideration of the application from Qantas. If you wish to discuss any aspect of this submission further, please do not hesitate to call Darrell Channing on 02 6243 4925.

Yours sincerely

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Baethan Mullen
Acting General Manager
Adjudication