RENEWAL DETERMINATION

DETERMINATION NO:	**[2002] IASC 108**
RENEWAL OF:	**DETERMINATION IASC/DET/9701**
THE ROUTE:	**JAPAN**
THE APPLICANT:	**QANTAS AIRWAYS LIMITED (ACN 009 661 901) (QANTAS)**
PUBLIC REGISTER FILE:	**IASC/APP/200124**

1 The application for renewal

1.1 On 20 January 1997, the Commission issued Determination IASC/DET/9701 (the Determination) allocating 51 B767 units of capacity per week in each direction on the Japan route. The Determination was varied to 45.6 units of weekly capacity by IASC/DEC/9914 of 17 May 1999, in response to an application from Qantas. The Determination expires on 30 June 2002.

1.2 Qantas applied to the Commission for a renewal of the Determination. The Commission published a notice on 31 August 2001 inviting submissions about the application, and other applications for an allocation of the capacity subject to renewal. No submissions or other applications were received.

1.3 At its meeting of 13 December 2001, the Commission decided to defer its decision about the Qantas' application to renew the Determination, as it wished to review its authorisation, first given in Decision IASC/DEC/9608 of 22 November 1996, for Qantas to use the capacity to code share with Japan Airlines. The arrangement between the two airlines involves code sharing by Qantas on Japan Airlines' Brisbane-Tokyo services and by Japan Airlines on Qantas' Tokyo – Cairns services. The number of seats which can be exchanged is not to exceed 1,500 per week in each direction.

1.4 As a result of changes to the air services arrangements between Australian and Japan in December 2000, capacity used by a marketing carrier in code sharing on another carrier's services no longer count against the marketing carrier. This means that Qantas' purchase of seats on Japan Airlines' services no longer counts as an exercise of Australian capacity entitlements. Accordingly, Qantas no longer requires Commission approval to code share on Japan Airlines' services. However, Qantas does still require Commission approval to allow Japan Airlines to code share on Qantas' services.

1.5 In deciding to review the code sharing authorisation, the Commission recalled its long-standing concern about the implications for competition of code sharing between Qantas and Japan Airlines on the Japan route. It noted that circumstances had changed with the ending of services by All Nippon and Ansett International on the route. This had led to significantly reduced competition for Qantas and Japan Airlines, and this situation was likely to continue if a replacement entity for Ansett International, or another Japanese carrier, did not return to the route.

1.6 Subsequently, the Commission wrote to Qantas on 7 January 2002, inviting the airline to make a submission against the paragraph 5 criteria in the Minister's Policy Statement, arguing why Qantas should continue to be authorised to use the capacity in question to code share with Japan Airlines.

1.7 Qantas responded with a submission dated 15 March 2002. Subsequently, submissions were received from Japan Airlines (18 March 2002), the Queensland Government on 19 March 2002, the Cairns Port Authority and other Queensland bodies on 25 March 2002,and from the Australian Competition and Consumer Commission (ACCC) on 26 March 2002. Qantas responded to the ACCC submission on 28 March 2002. All non-confidential material supplied by the applicant and other submitters is filed on the Register of Public Documents. Confidential material supplied by the applicant is filed on the Commission's Confidential Register.

2 Current services

2.1 Qantas operates the following weekly services, effective for the Northern Summer 2002 scheduling period:

- 7xB747 Sydney-Tokyo (Narita A) and vv;
- 7xB747 Cairns-Nagoya-Osaka-Cairns;
- 3xB767-300 Perth-Tokyo and vv
- 7xB747 Cairns-Tokyo (Narita A) (Japan Airlines code shares – 191 seats per flight) and vv; from 18 April 2002 to become 14 B767-300 Cairns-Tokyo (daily Narita A and daily Narita B) with a total of 3206 seats per week (Japan Airlines code sharing);
- 2xB747 Sydney-Cairns-Osaka and vv

2.2 JAL operates the following weekly services:

- 7xB747 Sydney-Tokyo and vv;
- 7xB747 Brisbane-Tokyo (2,792 seats per week) and vv (Qantas code shares); and
- 7xB747 Sydney-Osaka-Brisbane-Sydney (Qantas code shares).

2.3 Until mid-September 2001, Ansett International had operated 7xB747 services Sydney-Osaka and vv with All Nippon code sharing. Those services ceased with the financial collapse of the Ansett group of companies.

3 Traffic levels

3.1 The number of visitor arrivals from Japan to Australia as a whole has declined substantially since 1997. This decline has coincided with weakness in the Japanese economy and, more dramatically in late 2001, with the events of 11 September 2001. In the months just prior to September 2001, the market had been showing evidence of moderate growth. In 1996 there were over 1.6 million visitor arrivals to Australia from Japan, with the (provisional) number in 2001 being 1.36 million. Without the events of September 11, the 2001 number may have been closer to 1.45 million, still a significant decline from 1996 levels.

3.2 Focussing specifically on the Brisbane and Cairns to Tokyo routes, namely those subject to the code share arrangement under review, traffic levels have increased over the same five year period. In 1996, the last full year prior to the code share commencing, just over 200,000 passengers were carried between Cairns and Tokyo compared with approximately 234,000 in 2001 (based on airline data reported to the Department of Transport and Regional Services). Similarly, about 207,000 and 231,000 passengers were carried between Brisbane and Tokyo in 1996 and 2001 respectively. Thus the level of carriage on both Cairns – Tokyo and Brisbane – Tokyo has risen, as has the share of traffic on these routes relative to the overall level of traffic between Australia and Japan.

4 Provisions of relevant air services arrangements

4.1 The Australia – Japan air services arrangements permit code sharing between the designated airlines of Australia and Japan. Where the designated airlines code share, capacity is counted as being exercised only by the operating carrier.

5 Summary of submissions received

Qantas

5.1 Qantas made its submission on the sole basis that it is for the purposes of consideration of the extension of the conditions of the Determination, rather than in relation to renewal of the capacity allocation itself. Qantas considered that the neither of the conditions contained in paragraph 8 of the Minister's Policy Statement are met, and therefore there are no grounds for not renewing the capacity.

5.2 Qantas summarised its submission by arguing that the code share is delivering the public benefits anticipated and against which it was authorised by the Commission, and that Qantas and Japan Airlines have been able to maintain services in a difficult period while services on other routes have been reduced. Qantas argued it is important for the Commission to consider the likely outcomes and consequences if the code share is not allowed to continue. These include possible withdrawal from Cairns by Japan Airlines and reduced capacity to Cairns operated by Qantas. Qantas concluded that the current arrangement is preferable to alternatives.

5.3 In its detailed submission, Qantas noted that Qantas and Japan Airlines have been authorised to code share over the Tokyo-Brisbane and Tokyo-Cairns routes since Northern Summer 1997. Qantas outlines the weakness in traffic levels that have prevailed throughout the period since that time. Reductions in traffic levels saw the scaling back of operations by incumbent carriers, including the withdrawal of direct services by Air New Zealand and All Nippon Airways. Although traffic levels showed signs of recovery through late 2000 to September 2001, the events of 11 September 2001 significantly affected Japanese consumer confidence. Traffic levels appear to have fallen substantially in the wake of those events. Continued weakness in the Japanese economy points to low growth at best, with quoted forecasts for growth in visitor arrivals of 3.1% per annum over the next five years.

5.4 Qantas claims of public benefits against the paragraph 5 criteria in the Minister's Policy Statement are as follows:

Tourism benefits

5.5 Code sharing has facilitated operation of daily non-stop services to both Cairns and to Brisbane. This has enhanced Queensland's position to attract Japanese tourists. The Japanese holiday market is competitive. Brisbane and Cairns are part of a group of destinations in the Asia-Pacific market. Non-stop services allow the two cities to be marketed as more attractive options. This is particularly important in attracting passengers who already have to make a domestic connection at Narita when travelling from other cities.

5.6 Qantas has intensified its marketing effort with the contraction of market demand. Details were provided on a commercial-in-confidence basis. Qantas and Japan Airlines market their Tokyo-Queensland services independently, but Japan Airline's marketing efforts in relation to Cairns attract passengers to Qantas' Cairns services. Japan Airlines has the most established and developed distribution networks in the Japan market and its marketing of Cairns plays a large part in increasing Japanese consumer awareness of Cairns as a destination.

5.7 Qantas proposes to increase capacity and frequency to Cairns from 31 March 2002 with the introduction of double daily B767 services replacing daily B747s. This involves a capacity increase of 10%, representing additional tourism opportunities.

5.8 Qantas advised that most seats are sold at market levels, which are below published fare levels. Qantas provided details of its average yield per passenger kilometre since January 1996. This was provided on a commercial-in-confidence basis. In summary, yields have been fairly flat, on a gradual downward trend. Qantas does not expect an improvement in yield in the medium term.

Consumer benefits

5.9 Qantas noted that a significant proportion of Australian traffic travels for business purposes. Direct flights from Brisbane have reduced travel time for business travellers, compared with flights travelling via Cairns. Schedule changes following introduction of the code share provided more convenient departure times for Australian business travellers. Average yields for business class fares have declined over the past six years, at a greater rate than have economy fares.

5.10 Qantas noted that the operation of non-stop services has offered savings to it, and Japan Airlines, on aeronautical charges, facilitation fees, fuel and labour costs. This has been important in keeping fare levels down in a period of rising fuel costs and a decline in the value of the Australian dollar against the yen and US dollar.

Trade benefits

5.11 Qantas claimed that the operation of non-stop services from both Brisbane and Cairns has benefited exporters, particularly those in Brisbane with perishable products. Rates for the carriage of freight to Japan have remained constant during the code share period, although there was an increase in rates across the Qantas network implemented on 1 February.

Competition benefits

5.12 Qantas submitted that the code share arrangements had not adversely affected competition. It noted that the code sharing involves a hard block arrangement with no provisions for the hand back of seats. Pricing, marketing and sales are conducted independently by each carrier. Qantas provides incentives to wholesalers to sell its product in the Japanese market. Qantas noted that only 18% of seats operated by the two carriers on the Japan route as a whole involve code sharing. Qantas pointed to the availability of competing destinations in the region which offer competition to the Brisbane and Cairns services.

5.13 Qantas noted that substantial unused capacity remains available to Japanese carriers and suggested that All Nippon Airways may choose to re-enter the market, as may Air New Zealand. Increased competition from indirect carriers is expected.

Industry structure

5.14 Qantas stated that the code share arrangement had enabled the operation of viable non-stop Cairns-Tokyo services. The competitive product and efficiencies arising would enhance Qantas' competitiveness and contribute to a strong Australian aviation industry.

<u>Other issues</u>

5.15 Qantas indicated that the entry of Australian Airlines would have no direct impact on the Qantas/Japan Airlines code share. Australian Airlines would not compete on sectors served by Qantas. Rather, it would operate between Cairns and Osaka, Nagoya and Fukuoka.

5.16 Qantas provided a comparative financial analysis of benefits associated with options available to it if the code share was no longer authorised, compared with a base case reflecting proposed schedules by Qantas and Japan Airlines with code sharing continuing on each others' services. That schedule involves double daily B767 services by Qantas between Cairns and Tokyo and daily B747 services by Japan Airlines between Brisbane and Tokyo. The details of the analysis were provided on a commercial-in-confidence basis. Qantas notes as a prelude to the analysis that the air services arrangements between Australia and Japan allow Qantas to code share on Japan Airlines without approval from the Commission. The only approval required by the Commission is for Japan Airlines to code share on Qantas.

5.17 Qantas' scenario 1 assumes that Qantas and Japan Airlines adopt schedules as proposed above, with Qantas continuing to code share on Japan Airlines, but no code sharing by Japan Airlines on Qantas. Profitability is reduced. The absence of Japan Airlines at Cairns would reduce Qantas' ability to attract traffic to the services. The Cairns market would contract and Qantas could not sustain capacity levels.

5.18 Under Qantas' scenario 2, Qantas would retain its existing daily service to Cairns and extends an additional daily service from Cairns to Brisbane. Japan Airlines is assumed to operate its Brisbane services via Cairns, in the absence of the code share. Qantas does not code share on the Japan Airlines services. This scenario is equivalent to the actual operating pattern of the two carriers before the code share was authorised originally. There is a severe financial impact for Qantas. Qantas suggested that the effect on Japan Airlines' services would be similar.

5.19 Qantas concluded its submission by stating that if the code share with Japan Airlines cannot continue, it would expect to have no alternative but to reduce Cairns-Tokyo capacity and redirect it elsewhere. Japan Airlines may also re-evaluate its presence in the Australian market. The result would be diminished tourism opportunities and weakened long term growth prospects for the market, particularly at Tokyo.

Japan Airlines

5.20 Japan Airlines argued that the code share arrangements with Qantas on the Tokyo-Brisbane and Tokyo-Cairns services had worked well, allowing Japan Airlines to offer an improved product to Brisbane while still offering seats to Cairns. The airline argued that the public benefits, found by the Commission in its original assessment of the code share, remain.

5.21 Japan Airlines has limited resources to devote to the Australian market. The code share arrangement allows it to focus operations on Brisbane and Sydney, reducing costs and overheads. It allows marketing by Japan Airlines of holidays with a choice of Cairns or Brisbane rather than Brisbane alone, making this a more attractive product.

5.22 Japan Airlines advised that it is rationalising its international network, in light of the events of September 2001 and the economic downturn in Japan. The loss of the ability to offer codeshare services to Cairns would place Japan Airlines' Australian operations in a commercially difficult position. The carrier argued that it would not be realistic to conclude that Japan Airlines would resume own operations to Cairns at this time. Operating via Cairns to Brisbane would not enhance the economic viability of Brisbane services because it would increase the costs of operations considerably.

Queensland Government

5.23 The Queensland Government strongly supported the continuation of the code share arrangements. It noted that Japan is the second largest international visitor market to Queensland and captures the highest proportion of Japanese visitor arrivals to Australia of any State. The Queensland Government argued that any decline in the amount of seat capacity and frequency from Tokyo to Cairns would have a substantial adverse impact on tourism development.

5.24 In support of its position, the Queensland Government advised that it considers the continued presence of Japan Airlines in the Cairns market would be placed in doubt if authorisation for code sharing ceased. Further, Qantas has indicated that its proposed twice daily B767 Tokyo-Cairns service would not be commercially sustainable in its own right. The airline has advised that its frequency and capacity is likely to be reduced by 50%. The Queensland Government believed there would be a devastating impact on the regional economy of Cairns and northern Queensland if this occurred. The Queensland Government also considered that if Japan Airlines exited the Cairns market, the ending of marketing and distribution by that airline would further damage visitation and growth from Tokyo to Cairns.

5.25 The submission concluded by indicating that Queensland's support for retention of the code share arrangements is predicated on no change to the number of airlines servicing the Tokyo-Cairns route. If that situation changed, the Queensland Government would seek to review its position.

Cairns Port Authority

5.26 The Cairns Port Authority's submission was jointly signed by representatives of the Cairns City Council, Tourism Tropical North Queensland, Advance Cairns, Cairns Regional Economic Development Corporation, Cairns Chamber of Commerce, and the Australian Tourism Export Council.

5.27 These organisations strongly recommended that the IASC give favourable consideration to the Qantas/Japan Airlines code share continuing, for the benefit of tourism and the economic well being of the region.

5.28 The submission outlined the importance of tourism to the Cairns and Tropical North Queensland region. Tourism is the largest industry in the region, contributing $1.45 billion to the regional economy. It is the third largest holiday destination in Australia for international visitors. Visitors from Japan contribute one quarter of international visitors to the region.

5.29 Similarly, the submission identified the importance of aviation to the region. Cairns is the fifth busiest international airport in Australia. The region depends heavily on air services for access to key markets. Studies commissioned by the Cairns Port Authority show that there are 2,250 jobs on Cairns airport, with nearly 29,000 jobs created directly and indirectly in the region. Tourism in the region is predominantly dependent upon Cairns airport for its success.

5.30 The submission noted that the number of aircraft landings declined with introduction of the code share, but available seat capacity was unaltered. Passenger movements on the Narita route show a pattern of increases subsequent to introduction of the code share, leaving aside the impact of the Asian crisis in 1997 and 1998. Solid growth for both Qantas and Japan Airlines has been apparent over the past four years. There is no evidence of a lack of capacity on the route and market shares are virtually the same. There appears to be reasonable evidence of competition between the two carriers. Qantas will add about 10% more capacity with its B767-300 aircraft replacing B747s with double the previous frequency. The prospect of Australian Airlines commencing services may add competition.

5.31 The submission outlined concerns at the possible consequences if the code share is no longer authorised. Both Qantas and Japan Airlines have suggested strongly that they would not operate currently proposed schedules. The large reduction in capacity that would result would lead to immediate reductions in visitor nights, tours and spending in the region. It would be difficult to see how removal of the code share could benefit any party. Growth rates in the number of direct access visitors from Japan would be significantly affected.

Australian Competition and Consumer Commission (ACCC)

5.32 The ACCC noted the demise of Ansett International and closure of offices in Australia by All Nippon, together with the issue of access to Narita, and suggested that the chance of new direct operators entering the market in the medium term is negligible. The ACCC considered that Qantas and Japan Airlines dominate the market and are likely to do so for the foreseeable future.

5.33 The ACCC argued that the code share arrangement provides less competitive tension than would be the case of there was no arrangement. The ACCC pointed to interdependency between the two airlines through joint co-ordination of capacity and scheduling. It argued that they would never compete on price to the point where each other's operations were threatened. The two carriers stand to benefit if they price match, rather than compete hard with an alliance partner. The ACCC noted that Qantas has demonstrated on other routes that it can be an effective competitor.

5.34 The ACCC saw inconsistencies in Qantas' claim that yields and traffic are declining, while expanding services at Cairns. It also saw inconsistencies in the two airlines' claims about how they would respond to cessation of the code share.

5.35 The ACCC considered that the code share arrangement may have effects going beyond the code share route. It suggested that it was unlikely the carriers would compete aggressively on price on the Sydney – Tokyo route for example. The ACCC also considered that market allocation may be a result of the partnership agreement, even in the absence of collaboration between the carriers. The ACCC noted that neither Qantas nor Japan Airlines is subject to competitive forces on Osaka services.

5.36 In summary, the ACCC considered that the code share arrangement raises competition concerns, as the code share is between two carriers that dominate a high traffic, high frequency route with little indirect competition and little chance of competition from new direct entrants. The ACCC considered that the arrangement acted to the detriment of public benefit and there would need to be substantial offsetting benefits if it was to be approved. The ACCC argued that consideration needed to be given to whether tourism was being constrained rather than enhanced by the arrangement and whether increased competition could result in greater tourism benefits.

Further Qantas submission

5.37 Qantas responded on 28 March 2002 to the ACCC submission. Qantas contended that the code share should not give rise to competition concerns. It noted that tourism and industry leaders and the Queensland strongly support the code share on tourism and economic benefit grounds. None of these bodies expressed reservations about the impact on competition of the code share. Qantas noted that the change from a daily B747 services to double daily B767s represents a doubling of frequency and a 10% increase in capacity. This increases Qantas' access to scarce Narita slots. Qantas contended that it competes vigorously with Japan Airlines on routes outside the code share relationship, such as Sydney – Tokyo.

6 Commission's consideration

6.1 Under the Minister's Policy Statement (No. 3), of 23 April 1997, as amended on 9 March 1999, there is a rebuttable presumption in favour of the carrier seeking the renewal. For the Commission not to renew the capacity, it would have to find that Qantas had failed to service the route effectively <u>and</u> that there was another proposal for the use of the capacity that would provide greater public benefits than would continued use of the capacity by Qantas.

6.2 The Commission notes that:

- Qantas has been fully utilising the relevant capacity;
- there are no other applicants for this capacity; and
- there is no evidence that Qantas has failed to service the route effectively.

6.3 In these circumstances, the Commission concludes that the capacity should be reallocated to Qantas for a term of five years.

6.4 When renewing determinations, it has been the Commission's long standing approach to renew original determinations with updated terms and conditions. Under the *International Air Services Commission Act 1992* (s.19(3)), the Commission may make changes to the terms and conditions included in the original determination where it is satisfied these are warranted because of changes in circumstances since the original determination was made.

6.5 As noted in the Application for Renewal section above, in considering terms and conditions to be attached to a renewal of this Determination, the Commission has signalled its intention to focus on whether code sharing should continue to be authorised. The Commission has generally looked closely at code sharing in the Australia – Japan market, because Qantas and its code share partner Japan Airlines have together held a very large share of direct capacity. There is also limited competition provided by third country carriers.

6.6 Recent events have heightened the Commission’s concern at the possible impact on public benefit of continued code sharing by Qantas and Japan Airlines. The event of principal concern was the withdrawal of Ansett International from the Japan market, following the collapse of the Ansett group of companies in September 2001.

6.7 In November 1996, when the Commission first authorised Qantas to use its allocated capacity to code share with Japan Airlines, there were five airlines providing direct services in the Australia – Japan market – Qantas, Japan Airlines, All Nippon Airways, Air New Zealand and Ansett International. These latter three carriers provided 15 services per week over a range of city pairs between the two countries. Over time, all three of these operators have withdrawn their services. As noted, the most recent termination of services was by Ansett International in September 2001. A corollary to this was that All Nippon, which had code shared on Ansett International’s services, closed its Australian offices in November 2001. This has left Qantas and Japan Airlines as the only direct operators between Australia and Japan. Indirect services are provided by several airlines, although these carriers between them carry only about 12 percent of total Australia – Japan traffic.

6.8 The loss of services by Ansett International and the marketing presence of All Nippon had a direct effect on the Sydney – Osaka route, on which Ansett International’s daily B747 services had been operated. While a separate route from the Queensland – Tokyo routes the subject of this case, the loss of Osaka services has removed the marketing and promotional efforts of Ansett International and All Nippon in developing the Australia – Japan market, particularly in terms of tourism to Australia.

6.9 More directly related to the current case, the collapse of Ansett International has also meant the loss of future competition between Australia and Tokyo. Ansett International had held an allocation of capacity from the Commission to add a daily B767-300 service between Tokyo and Australia, once the new runway at Narita airport opened. This would have represented an important new competitive presence on the Tokyo route, which is serviced solely by Qantas and Japan Airlines.

6.10 Due to payload restrictions associated with the operation of services from the Narita B runway, it was likely that Ansett International would have operated its services to a point in Queensland. This would have made it a direct competitor for the Qantas/Japan Airlines services between Tokyo and Queensland.

6.11 In view of these very significant changes to the market structure, relative to when the code sharing was originally approved, the Commission considered it reasonable to invite Qantas to make fresh arguments in support of a continuation of its code share arrangement with Japan Airlines.

6.12 The Commission’s assessment relates to the public benefits associated with the code sharing by each of the carriers on the services of the other, as that is the nature of the arrangement between the two. However, ultimately, the Commission's decision is whether to authorise continued code sharing by Japan Airlines on Qantas' services to Cairns, in accordance with the Memorandum of Understanding of Co-operation between the two airlines. Following changes to the air services arrangements between Australia and Japan, Qantas is able to code share on Japan Airlines' services without requiring the approval of the Commission. It would be a commercial matter between the two carriers whether Qantas continued to code share on Japan Airlines, in the event the Commission did not authorise Japan Airlines code sharing on Qantas' Cairns services.

6.13 In relation to the paragraph 5 criteria, the Commission's task is to decide whether a continuation of code sharing would be of benefit to the public. If a reduced level of public benefits would result from continued code sharing, then code sharing should no longer be authorised.

6.14 The Commission is relatively well placed to assess whether code sharing thus far has acted to the public benefit, because there is historical information available to assist in that task. More difficulty arises in assessing the likely situation in the future. This difficulty arises for two main reasons. Firstly, as noted, the extent of actual and potential competition for Qantas and Japan Airlines has declined with the departure of Ansett International and All Nippon. Secondly, the state of demand in the Japanese market has been dramatically influenced by the events of September 11 2001 and the Commission needs to take a longer term perspective on the likely state of the market.

6.15 In making its assessment in respect of the future, the Commission has the difficult task of assessing the likely operational outcomes if code sharing was no longer permitted. The Commission must endeavour to assess what the actual outcome is likely to be so as to be able to come to an appropriate assessment of the public benefits that would be associated with the new pattern of operations and interaction between the carriers. It needs to do this with a high degree of certainty because different sets of public benefits would arise under alternative scenarios.

6.16 Both carriers would have a number of options if code sharing was not authorised. These options range from one or both carriers operating services to/from Brisbane and Cairns in their own right, one or both operating to/from Brisbane via Cairns (as was the case prior to code sharing), to various combinations of reduced services.

6.17 The submissions from both Qantas and Japan Airlines point to the likelihood that Qantas would not maintain increased frequency of services to Cairns as currently proposed (either terminating or with a Brisbane extension), and Japan Airlines would not re-enter the Cairns market in its own right. This is clearly also the expectation of other parties that have made submissions in this case. In relation to Brisbane – Tokyo, it seems likely that there would be no change to the level of operations by Japan Airlines at Brisbane. It is unclear whether code sharing by Qantas on Japan Airlines would continue. This would be a commercial matter between the two carriers. Of more significance from a public benefit point of view is whether Qantas would introduce its own services to Brisbane. Qantas has inferred that it would not.

6.18 Qantas has presented two alternative scenarios to its planned double daily B767 services to Cairns with Japan Airlines code sharing. Under scenario 1, Qantas would operate initially as now proposed (double daily services to Cairns), but without Japan Airlines code sharing. Qantas says attracting traffic to Cairns would be more difficult in the absence of Japan Airlines and the Cairns market would contract (this assumes Japan Airlines does not return to serving Cairns in its own right). Qantas says it would be unable to sustain double daily services to Cairns.

6.19 Under the second Qantas scenario, Qantas would return to daily B747 service to Brisbane and operate a second (B767) service to Brisbane via Cairns. This scenario is seen by Qantas as the least commercially attractive.

6.20 Based on this information, the most likely outcome, in the absence of authorised code sharing, is that Qantas would return to a daily B747 service to Cairns (rather than operate double daily B767s) and would not introduce services to Brisbane. Japan Airlines seems likely to maintain direct Brisbane services but to not introduce services to Cairns either terminating or extending to Cairns.

6.21 While the Commission cannot be sure that this would be the outcome, it has accepted the advice of both carriers as to their likely commercial response to a Commission decision not to allow code sharing to continue. In this regard, the Commission notes that the Japan market has experienced a marked downturn following the events of 11 September 2001. Even discounting this as having a transient effect on the overall market, forecasts by the Tourism Forecasting Council suggest that growth in the market will be slow. The Commission has no reason to consider that these forecasts are pessimistic, particularly given the expected continued weakness in the Japanese economy. Given the weak growth outlook for the Japan market as a whole, there seems limited scope for profitable expansion of capacity on routes to Japan.

6.22 Although the task of the Commission is to determine the overall effect of code sharing in terms of public benefit, it is convenient and consistent with past practice to set out the Commission's consideration of public benefit using the structure of paragraph 5 of the Policy Statement. An overall conclusion can then be reached taking all of the elements of paragraph 5 into account.

Paragraph 5 assessment

Tourism benefits

> *The extent to which proposals will promote tourism to and within Australia. The Commission should have regard to:*
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> - *the level of promotion, market development and investment proposed by each of the applicants, and*
> - *route service possibilities to and from points beyond the Australian gateway(s) or beyond the foreign gateway(s)*

6.23 When first authorising code sharing in November 1996 (Decision IASC/DEC/9608), the Commission noted that each carrier would independently market its own capacity allocation. Information provided by Qantas shows that the airline has increased its Australian dollar expenditure on marketing, sales and support expenditure each year over the five year period in which the code share as been in effect. While the annual increases have not been dramatic, they have generally been at a rate greater than the rate of inflation. Qantas notes that Japan Airlines' marketing efforts heighten Japanese consumer awareness of Cairns as a destination and therefore complement Qantas' own efforts to attract traffic to its Cairns services.

6.24 Looking to the future, Qantas has not indicated what its intentions are in terms of marketing effort. However, Qantas is adding a second daily service to Cairns from the opening of the new runway at Narita B and will be keen to ensure this is profitable. The substitution of double daily B767-300 services for daily B747 flights represents about a 10% increase in overall capacity. Qantas clearly has a strong incentive to market these services strongly. This incentive, combined with Qantas' consistent expenditure history and established Japanese marketing presence, suggests that future marketing and promotional support for its Cairns services is likely to continue at least at current levels in real terms. Japan Airlines would appear to have an incentive to increase its marketing efforts to take advantage of the additional capacity only if the number of seats exchanged between the carriers was to increase. In this respect, currently the carriers are exchanging fewer seats per week (1,337) than the maximum number permitted (1,500) under the terms of the approval of the code share. In other words, some scope remains for expansion by Japan Airlines on Qantas services to Cairns (and for Qantas on Japan Airlines' Brisbane services).

6.25 Qantas has provided information about the historical pattern of its yields on the combined Brisbane-Cairns-Tokyo route. While the detail of this information is commercial in confidence, broadly it shows that yields from economy class passengers have fluctuated (largely on a seasonal basis) around a fairly stable long term trend during the period of the code share. Comparative yields provided by Qantas for the 18 month period prior to introduction of the code share suggests that fares did not rise in the wake of the introduction of the code share arrangement. A similar pattern is evident for yields from business class traffic, although there is somewhat more volatility. Yields appeared to fall, on average, over the period in which the code share arrangements have been in operation.

6.26 When approving the code share in November 1996, the Commission expressed its belief that the code share could have longer term impacts on fare levels. The Commission is satisfied that the introduction of the code share arrangements in fact appears not to have had a negative effect on fare levels compared with the situation prior to code sharing. Accordingly, public benefits in this area appear not to have been eroded. It is not possible to assess what the situation may have been in the absence of code sharing and therefore whether greater public benefits may have otherwise arisen. The Commission cannot be sure about what will happen to fare levels in the future, but the loss of Ansett International's future entry to the Queensland – Tokyo route has removed some incentive for Qantas to maintain downwards pressure on fare levels.

6.27 Information provided by the Cairns Port Authority in its submission, and available to the Commission from the Department of Transport and Regional Services, shows that the number of passengers carried to Cairns by both Qantas and Japan Airlines has increased over the period of the code share. Japan Airlines, in particular, has increased its passenger numbers at a rapid rate since 1998, to the point where it now carries similar numbers to Qantas. The combined carriage of the two airlines in 2001 was significantly higher (about 22% up) than in 1996, the last year prior to implementation of the code share. At that time, both airlines operated direct services to Cairns. The Commission is unable to assess whether the level of carriage to Cairns would have been higher now, had both Qantas and Japan Airlines maintained own-aircraft services to that city. However, it appears that the withdrawal of direct services by Japan Airlines to Cairns has not worked to the detriment of tourism development to Cairns.

6.28 If Japan Airlines withdrew altogether from Cairns, if code sharing was not permitted, Qantas would have no competitor on the Cairns route. However, Qantas would have to market and sell a substantial number of additional seats in its own right. The loss of Japan Airlines' marketing presence on the Cairns route is unlikely to make Qantas' efforts to develop the route easier, nor to contribute to the growth of tourism.

6.29 If, as a consequence of the code share no longer being authorised, Qantas did pull back from its double daily service, travellers to Cairns would lose the benefit which greater choice of departure and arrival times bring. Qantas would not have the incentive to develop the market to sell the ten percent increase in capacity that double daily B767 services would bring compared with daily B747s. The absence of Japan Airlines in a marketing capacity on the Cairns route would be likely to mean the loss of pressure on Qantas to maintain competitive fare levels. None of this would be desirable from a tourism viewpoint.

6.30 If Qantas and Japan Airlines did not maintain code sharing on Japan Airlines' Brisbane services, then Japan Airlines would have no competitor on this route, even a marketing one as at present. This would also be detrimental to tourism.

6.31 The Commission concludes that retention of code sharing is likely to offer greater scope for the development of tourism, particularly to Cairns, than would be likely if the code sharing was not permitted.

Consumer Benefits

> *The extent to which proposals will maximise benefits to Australian consumers. The Commission should have regard to:*
>
> - *the degree of choice (including, for example, choice of airport(s), seat availability, range of product);*
> - *efficiencies achieved as reflected in lower tariffs and improved standard of services;*
> - *the stimulation of innovation on the part of incumbent carriers; and*

- *route service possibilities to and from points beyond the Australian gateway(s) or beyond the foreign gateway(s).*

6.32 The outbound component of traffic on the Japan route is small, comprising less than 10% of total traffic. The level of public benefits associated with this criteria is therefore likely to be smaller than in relation to the tourism criteria.

6.33 A significant element of Australian consumer traffic travels for business purposes. Issues of frequency of service are therefore relatively more important to this market segment than to leisure travellers. The addition of a second daily service by Qantas to Cairns would offer public benefits to business travellers in particular. As noted above, the additional daily Qantas service is only likely to be operated if code sharing is maintained and there is unlikely to be a change in frequencies at Brisbane by either Japan Airlines or Qantas. As for the tourism criteria, the absence of Japan Airlines as a marketing competitor to Qantas on the Cairns route is likely to mean pressure on Qantas to maintain competitive fare levels would be lost. Similar consequences would follow if Qantas did not continue to code share on Japan Airlines services to Brisbane.

6.34 The Commission concludes that a greater level of public benefit would be associated with a continuation of code sharing, compared with a situation where frequency did not increase because code sharing was not permitted.

Trade Benefits

> *The extent to which proposals will promote international trade. The Commission should have regard to:*
>
> - *the availability of frequent, low cost, reliable freight services for Australian exporters and importers.*

6.35 The introduction of double daily services at Cairns would improve freight access to Australian exporters and importers. However, both importers and exporters continue to be captive to Japan Airlines at Brisbane and to Qantas at Cairns. The two carriers do not code share freight space, so there is no scope for price competition between the two. However, as noted above, non-approval of code sharing for passenger traffic is likely to result in no change to the points served by Qantas and Japan Airlines, so there would be no gains to exporters and importers by preventing code sharing for passengers.

6.36 The Commission concludes that the additional daily frequency to be offered at Cairns would offer exporters and importers increased public benefits.

Competition Benefits

> *The extent to which proposals will contribute to the development of a competitive environment for the provision of international air services. The Commission should have regard to:*

- *the need to develop strong Australian carriers capable of competing effectively with one another and the airlines of foreign countries;*

- *the number of Australian carriers using capacity on a particular route and the existing distribution of capacity.*

- *the extent to which applications are proposing to provide capacity on aircraft they will operate themselves as, in the long term, operation of capacity on own aircraft is likely to result in more competitive outcomes;*

- *the provisions of any commercial agreement between an applicant and another airline affecting services on the route but only to the extent of determining comparative competition benefit between competing proposals;*

- *any determinations made by the Australian Competition and Consumer Commission or the Australian Competition Tribunal in relation to a carrier operating or proposing to operate on all or part of the route; and*

- *any decisions on notifications made by the Australian Competition and Consumer Commission in relation to a carrier operating or proposing to operate on all or part of the route.*

6.37 This criteria is one on which the Commission has placed considerable emphasis in its decisions in relation to the Australia – Japan market over the past year in particular. The Commission has consistently expressed its concern about the high proportion of capacity in the hands of Qantas and Japan Airlines (eg. [2001] IASC 210).

6.38 With the departure of Ansett International and All Nippon from the Australia - Japan market, the concentration of direct capacity has now intensified to the point where it is 100% in the hands of Qantas and Japan Airlines. The only competitive presence in the market is third country carriers operating via intermediate points. As noted above, these airlines carry a relatively small share of total market traffic. The Commission has no doubt that the competitive pressures on Qantas and Japan Airlines have been significantly weakened by the loss of other direct market participants. The pressures that would have been applied to Qantas from the entry of Ansett International in the Tokyo market would have benefited consumers and the tourism industry. There would have been additional marketing effort by Ansett International (and possibly by Qantas), greater choice of travel times and product, and more incentive to be efficient and maintain downward pressure on price. Travellers in the time sensitive business segment of the market now have little choice other than to accept fares offered to them by Qantas and Japan Airlines. However, the Cairns market is predominantly comprised of tourist traffic so this latter issue is not of great weight in public benefit terms in this case.

6.39 Qantas points out that Australia competes with other destinations in the region for Japanese traffic and this creates pressure for Qantas to operate efficiently and to maintain fares at rates competitive with alternative destinations. Japanese carriers also have the option of operating to other destinations in preference to Australia. The Commission sees some validity in this argument. Cairns is essentially one leisure market amongst a number in the Asia-Pacific region available to Japanese travellers. If

Cairns as a destination is not competitive on price, other things being equal, then travellers may choose to go elsewhere. On the other hand, from a carrier perspective, if prices are too low to maintain acceptable yields, then the airline may choose to operate on alternative higher yielding routes. This is particularly the case for Japanese carriers where the total Japanese outbound market is likely to be weak while the Japanese economy remains subdued. All Nippon has already exercised this option. In these circumstances, the code share maintains the ability of Qantas and Japan Airlines to achieve cost efficiencies from not having to service both Cairns and Brisbane, thereby improving their ability to offer more competitive fares and holiday packages to travellers.

6.40 The Commission has allowed the code sharing thus far on certain terms, designed to ensure at least some degree of competition between Qantas and Japan Airlines. These measures have included ensuring that the carriers price and sell seats independently, and not pool revenue. The seat exchange mechanism in the code share arrangement also creates an incentive for the carriers to market and sell their seats, as there is no scope for retrieving revenue through the hand back of unsold seats.

6.41 As noted above, the Commission observes that fares have not increased following implementation of the code share arrangements. This may be due in part to the efficiencies Qantas has claimed arise as a results. However, downward pressure on fares has probably been maintained as much by market softness during the Asian economic crisis, the continuing weakness of the Japanese economy, and more recently the events of September 11 2001. Had the underlying market demand been more robust, fare levels may not have remained so subdued.

6.42 However, as observed above, the Commission sees the expected continuing weakness of the Japan market, the additional capacity and frequency Qantas is bringing to Cairns and the availability of competing destinations as acting to maintain downward pressure on fares. These factors also create an incentive for efficiency on the part of the carriers. The Commission therefore sees reasonable grounds for allowing a continuation of code sharing. If the alternative to allowing code sharing is a reduction in the level of services provided, then competition gains cannot be achieved by denying the code share. However, in the event that the market was to perform more strongly than expected, then continuation of the code share arrangement may prove to be to the longer term detriment of the public benefit.

6.43 The Commission is inclined to limit the duration of its approval of the code share until the effects of September 11 have dissipated and the actual impact of the withdrawal of Ansett International and All Nippon from the route can be assessed. If Qantas can demonstrate after a period of operation under the new circumstances that fares have continued to be managed responsibly and that traffic levels have not been suppressed, then the Commission will be likely to allow the code share to continue for the full duration of the determination.

Industry Structure

The extent to which proposals will impact positively on the Australian aviation industry.

6.44 The Commission considers that maintenance of the code share arrangement is likely to have a positive impact on the Australian aviation industry, by comparison with a situation where reduced levels of operation occur if the code share is denied.

Conclusion

6.45 The evidence for the duration of the code share so far suggests that fare levels have not risen and that traffic levels have continued to rise. However, it is unclear whether these results have been achieved despite the code share as much as because of it. The difficulty in making an accurate assessment is due to the confounding influences of substantial weakness in the Japanese market during much of the code share period, compared with more robust conditions prior to that. In particular, the extreme impact of the events of September 11 2001 obscures the picture significantly.

6.46 The Commission is unable at this early stage to assess the impact on the route of the loss of Ansett International and All Nippon from the Japan market, particularly with the effects of September 11 clouding the situation. The outlook for the route is likely to be influenced by dramatically reduced competition. In the absence of Ansett International and All Nippon, there will be a reduced marketing effort, less downward pressure on air fares, reduced choice of product and travel time options. The Commission is concerned that there will less incentive for Qantas and Japan Airlines to offer competitive air fares to consumers on the route and to market the route as aggressively as they may otherwise have done.

6.47 Nevertheless, the evidence is that, without code share approval, services to Queensland, particularly Cairns, may be reduced. This is likely to lead to a reduced level of public benefits compared with allowing the code share to continue. The Commission is conscious of the fact that Qantas is making use of new slots at Narita runway B with the introduction of its double daily B767-300 services. Ensuring the retention of these slots for Australia is important from a long term tourism viewpoint.

6.48 Taking all of these factors into account, the Commission considers that it should continue to authorise a continuation of the code share arrangement. However, the Commission will limit the duration of that authorisation to the end of June 2004, at this stage. The Commission wishes to review the situation further once the effects of September 11 can be seen in a longer term context, and the impact of the withdrawal of Ansett International and All Nippon is clearer.

6.49 In the interim period, the Commission will monitor Qantas' yields on its Cairns and Brisbane services and the level of seats sold by Japan Airlines on Qantas' Cairns services. The authorisation will also remain effective only while Qantas maintains at least double daily B767-300 services between Cairns and Tokyo.

7 Determination for renewal of Determination IASC/DET/9701 allocating capacity on the Japan route to Qantas ([2002] IASC 108)

7.1 The Commission makes a fresh determination in favour of Qantas Airways Limited, allocating 45.6 B767-200 units of capacity per week in each direction between Australia and Japan.

7.2 The determination is for five years from 1 July 2002.

7.3 The determination is subject to the following conditions:

- Qantas is required to fully utilise the capacity;
- only Qantas or another Australian carrier which is a wholly owned subsidiary of Qantas is permitted to utilise the capacity;
- neither Qantas nor another Australian carrier which is a wholly owned subsidiary of Qantas is permitted to utilise the capacity to provide services jointly with another Australian carrier or any other person without the approval of the Commission;
- Qantas may use the capacity to provide services jointly with Japan Airlines until end June 2004 in accordance with:
  - the Codeshare Services Agreement between Qantas and Japan Airlines, or as varied except in relation to:
    - the number of seats to be exchanged exceeding 1500 per week in each direction; or
    - the city pairs served; or
    - any financial adjustment;
  - variations to the Codeshare Services Agreement which relate to any of the excepted matters referred to above, subject to the prior approval of the Commission; or
  - any new joint service arrangements between Qantas and Japan Airlines for operations on the Australia - Japan route, whether or not it replaces the existing agreement, with the prior approval of the Commission;
- under the code share agreement with Japan Airlines:
  - Qantas must price and sell its services on the route independently of Japan Airlines;

- Qantas must not share or pool revenues under any such agreement; and

- the approval to operate joint services with Japan Airlines will be effective only while Qantas maintains at least double daily B767-300 services between Cairns and Tokyo. The Commission will allow Qantas some flexibility in respect of this requirement to account for short term operational or commercial factors which may arise from time to time;

- Qantas must submit to the Commission reports each quarter on (a) the number of code share seats sold by Japan Airlines on Qantas' operated services between Cairns and Tokyo; and (b) Qantas' yields per revenue passenger kilometre on the Brisbane – Tokyo and Cairns – Tokyo routes for all passenger classes;

- to the extent that the capacity is used to provide joint services on the route, Qantas must take all reasonable steps to ensure that passengers are informed of the carrier actually operating the flight at the time of booking;

- changes in relation to the ownership and control of Qantas are permitted except to the extent that any change:

  - results in the designation of the airline as an Australian carrier under the Australia - Japan air services arrangements being withdrawn; or

  - has the effect that another Australian carrier, or a person (or group of persons) having substantial ownership or effective control of another Australian carrier, would take substantial ownership of Qantas or be in a position to exercise effective control of Qantas, without the prior consent of the Commission, and

- changes in relation to the management, status or location of operations and Head Office of Qantas are permitted except to the extent that any change would result in the airline ceasing to be an airline designated by the Australian Government for the purposes of the Australia – Japan air services arrangements.

Dated: 22 April 2002

Ross Jones Chairman	Michael Lawriwsky Member	Stephen Lonergan Member