Australian Government

International Air Services Commission

DECISION

Decision:	**[2005] IASC 204**
Variation of:	**Determinations 2000/107, 2001/114, 2002/117, 2003/108 and 2004/119**
The Route:	**South Africa**
The Applicant:	**Qantas Airways Ltd (ACN 009 661 901) (Qantas)**
Public Register File:	**IASC/APP/200506**

1 The application

1.1 Qantas applied to the Commission on 31 March 2005 to vary IASC Determinations 2000/107, 2001/114, 2002/117, 2003/108 and 2004/119 to permit South African Airways (SAA) to continue code sharing on Qantas services between Australia and South Africa for a further two years from 1 July 2005 until 30 June 2007. The Commission first authorised code sharing pursuant to these determinations in Decision [2000] IASC 217 of 11 December 2000. The current authorisation, which extends until 30 June 2005, was given in Decision [2003] IASC 204 of 30 May 2003.

1.2 A detailed confidential submission was received from Qantas in a letter dated 29 April 2005. The submission was made in response to a written request by the Commission for additional information relating to the economic and financial performance of operations on the South Africa route.

1.3 On 8 April 2005, the Commission published a notice inviting submissions from interested parties about the application. A submission was received from the West Australian Government on 10 May 2005. The Commission also wrote on 6 April 2005 to the Australian Competition and Consumer Commission (ACCC) inviting its views on the Qantas proposal. The ACCC provided a submission on 29 April 2005. Qantas responded to the ACCC's submission by letter on 10 May 2005.

1.4 All non-confidential material supplied by the applicant and submitters is filed on the Register of Public Documents. All confidential material from Qantas is filed on the Commission's confidential register.

2 Current services

2.1 Qantas currently operates four B747-400 three-class return services per week between Sydney and Johannesburg. Over summer periods, Qantas has added a fifth weekly service. SAA operates five A340-200 two-class return services per week between Johannesburg and Perth. Under the code share agreement between the two carriers, Qantas purchases 17 business class and 77 economy class seats on each SAA service. SAA buys an average of two first class, 26 business class and 118 economy class seats on each Qantas service.

2.2 Indirect services between Australia and South Africa are provided by several third country carriers, principally Singapore Airlines (via Singapore), Malaysian Airlines (via Kuala Lumpur), Cathay Pacific (via Hong Kong), Air Mauritius (via Mauritius) and Emirates (via Dubai).

3 Provisions of relevant air services arrangements

3.1 The Australia-South Africa air services arrangements allow the designated airlines of each country to code share on each other's services. Qantas does not require the Commission's approval to code share on SAA's services as the marketing carrier's seats do not involve the use of bilateral capacity entitlements.

4 Applicant's arguments in support of its proposal

4.1 Qantas advised that all of the conditions specific to the Commission's authorisation of code sharing had been met by itself and SAA, the conditions cause no problems at present and Qantas is not seeking any change to them. Central amongst these conditions are that:

- Qantas and SAA must operate at least 2,680 seats per week between them, although they are able to reduce capacity temporarily in the event of unforeseen circumstances or in periods of low demand;
- the two airlines are to withdraw from all IATA tariff co-ordination activities relating to fare levels between Australia and South Africa; and
- Qantas is required to price and sell its capacity independently of SAA.

4.2 Qantas said that it has suffered a reduced share of the origin-destination market over the past two years despite overall growth in the market. Qantas attributed this to increased competition from third-country carriers, particularly Singapore Airlines, Emirates and Air Mauritius.

4.3 Qantas advised that it understands SAA plans to continue indefinitely with five services per week but plans to upgrade its aircraft to an A340-300, which would increase the number of seats per service by 30. Qantas plans to continue its four weekly services until the end of October 2005, and will review the situation at that time with a view to introducing a fifth weekly service year-round.

4.4 Qantas wishes to continue indefinitely its code share arrangements with SAA. Qantas stated that if the code share was not re-authorised, it would not be commercially viable for Qantas to return to operating via Perth to Sydney, nor to introduce Johannesburg service terminating at Perth. Qantas understands that SAA has no plans to introduce services to Sydney, but wishes to continue to code share on Qantas' Sydney services.

4.5 Qantas noted that the South African Competition Commission's authorisation of the code share arrangement is valid to 18 December 2005. Qantas will seek an extension of this authorisation later in 2005.

4.6 Qantas outlined what it considers to be the benefits from the code share arrangement. The code share has placed operations by both carriers onto a firmer financial footing, mainly as a result of the lower operating costs achieved and despite rising fuel costs and increased competition. As a result, Qantas argued, the public has benefited in a range of ways. These include maintenance of dedicated services to both Perth (with SAA maintaining services) and Sydney with competition between Qantas and SAA on both the Perth – Johannesburg and Sydney – Johannesburg city pairs; an attractive frequency of non-stop services to Sydney with reduced travel times; improved quality of product with the introduction of SAA's A340 aircraft and new Skybeds in Qantas' business class; convenient flight times and connections for New Zealand and domestic transfer passengers. The product offering will improve further when SAA introduces its A340-300 aircraft type, which has flat beds in its business class cabin.

4.7 Qantas considered that the code share arrangements are delivering a better market outcome than would occur in their absence. Services levels were likely to fall without the code share.

4.8 In its supplementary confidential submission, Qantas provided detailed information on a range of matters. These included load factors, market shares, third-country passenger carriage, forward bookings, revenue yields, costs and Qantas' profits on the route.

5 Summary of submissions

5.1 The ACCC restated concerns from its submissions to previous reviews about the competition implications where the code share partners are operating on the same route and have relatively high market shares. The ACCC argued that there was little prospect of direct competition from a new entrant, and that the only indirect route competition was from carriers with much longer flying times. The ACCC also considered that fare levels in the South African market may be consistent with a lack of competition, noting that Qantas and SAA's fares are much higher than those of Singapore Airlines, despite the latter's longer flying time. The ACCC contrasted the situation with the United Kingdom route, where fares are lower than for South Africa at certain times of the year. The ACCC also provided estimates of Qantas' revenue per kilometre on the South Africa route compared with several other routes, finding that yields were generally higher on the South Africa route.

5.2 The ACCC suggested that Qantas and SAA would probably maintain current operations in the absence of code share approval. Fares were unlikely to increase beyond current levels because of the presence of indirect operators. There was a possibility that competition between Qantas and SAA may develop and that market stimulants such as the Commonwealth Games and the new Perth-based Rugby team may assist this.

5.3 The ACCC argued that there would be little impact from the Commission's condition of code share approval which requires Qantas and SAA not to participate in IATA fare setting processes. Other IATA airlines operating to the African continent could do so, including those with a commercial relationship with Qantas and SAA.

5.4 Qantas responded to the ACCC submission, arguing that Qantas and SAA were in no better position at this point than in 2003 to take advantage of the characteristics of the South Africa route. Qantas argued that market conditions had moved slightly against the code share partners, with an increase in competition from indirect operators leading to a decline in Qantas/SAA market share. Qantas claimed that the indirect operators were not dependant upon end-to-end traffic, rather using it to build frequencies on the legs of its connecting services.

5.5 The West Australian Government supported extension of the code share arrangements for a further two years, arguing that the code share provides the best means of developing financially sustainable direct services. The WA Government would not want to see regulatory action which created uncertainty. It stated concern about the possible impact on services to Perth in the absence of code share approval, arguing that the most likely outcome in the absence of Qantas' presence in the market was a reduction in frequency levels to probably three services per week and reduced tourism to Western Australia. The WA Government stated that it was working with SAA to develop the level of services to Perth, with the aim of seeing a daily service within two to five years. The absence of Qantas on the route would create instability and risk the development of a monopoly in the Perth – Johannesburg market.

6 The draft decision

6.1 On 27 May 2005 the Commission issued Draft Decision [2005] IASC 204, proposing to continue authorisation of code sharing between Qantas and SAA until 18 December 2005. This would bring the period of authorisation into line with that given to the arrangement by the South African authorities. The Commission proposed to include an amended condition of approval which would require the carriers to operate a minimum of ten weekly services between them from 1 November 2005. In view of the fact that the Commission was proposing conditions of approval which differed from that sought by Qantas, the Commission wrote to Qantas inviting it to amend its application in line with the terms proposed.

6.2 Qantas responded to the draft decision in a letter of 23 June 2005. Qantas agreed with the proposed requirement to operate a minimum of ten weekly services, advising its intention to add a fifth weekly service on a permanent basis. In Qantas' most recent review of the route, it found that improved results on the South Africa route and other factors had supported the decision to add the extra service. However, due to aircraft availability constraints, Qantas sought an extension of time to introduce the additional weekly service. Qantas asked that the new schedule be permitted to commence from 3 December 2005. The service would operate via Perth in each direction because of range limitations with the

B747-300 aircraft. Qantas expected that in the second half of the Northern Winter 2005 season a B747-400 aircraft would become available and services would then operate non-stop between Sydney and Johannesburg. Qantas advised that SAA had advised that it was keen to take up a 40 percent block of seats on the fifth weekly Qantas service.

6.3 Qantas also responded to comments contained in the draft decision about competitive conditions on the route. Qantas was particularly concerned about what it considered was insufficient recognition of the hard block space nature of the code share arrangement between Qantas and SAA (this involves the sale at an agreed price of a group of seats on each flight by the operating airline to the marketing airline, which the marketing airline is responsible for marketing and selling. The marketing airline cannot hand back any unsold seats from its block to the operating airline). While acknowledging that Qantas and SAA together have a relatively high market share, Qantas argued that the code share arrangements provided the basis for vigorous competition between the two carriers because they pay a fixed amount for their seat block, with no hand-back provision for unsold seats, exposing the carriers to losses if seat block costs are not covered. The two airlines also priced and sold seats independently of one another.

6.4 Qantas considered that the draft decision appeared to accept the ACCC’s argument that indirect services did not provide meaningful competition for the Qantas and SAA services. It argued that there was evidence to the contrary. Qantas pointed to data it had provided previously which showed an increasing number of leisure travellers flying with third-country carriers via their hubs. Qantas also argued that these carriers generally undercut the direct carriers’ fares and are able to price on a marginal cost basis. Qantas argued that indirect services sufficiently constrain direct services, even for time sensitive passengers.

6.5 Qantas argued that recent increases in prices for business class travellers were well justified by the improvement in facilities with the introduction of Skybed seats which take up 27 percent more space than conventional business class seats and the equivalent of over 3.5 economy class seats. Qantas submitted that the differential between business and economy class fares was equal to or less than warranted by the seat space ratio.

6.6 Qantas stated that the vast majority of its flights were not full, with almost 30,000 of its seats unfilled on its Sydney services and Perth seat blocks over the year to May 2005. Qantas therefore disagreed with the assertion in the draft decision that aircraft are nearly full on many flights.

6.7 Qantas concluded by stating that its improved fortunes on the South Africa route are recent and the returns within reasonable bounds. Profitability could be weakened without significant adjustment in loads and costs. Qantas did not accept that just because there had been productivity gains, fare levels should be lower, arguing that account also needs to be taken of product improvements which tend to come at a higher cost.

7 Commission’s assessment

7.1 Under section 15(2)(e) of the Act, a carrier cannot use allocated capacity to provide joint services with any other carrier without the prior approval of the Commission.

Qantas therefore requires the Commission's authorisation to enable SAA to code share on Qantas' services. No approval is required by the Commission for Qantas to code share on SAA services.

7.2 At its reviews in April 2002 (Decision [2002] IASC 212) and May 2003 (Decision [2003] IASC 2004) the Commission analysed detailed economic and financial data associated with the operation of the code share. Assessments were made of the impact of the code share on factors such as operating patterns to Perth and Sydney, traffic carried, load factors, revenue yields, costs and fares, and of the impact of third-country carrier competition. The analyses provided the Commission with an in-depth insight into the commercial viability of the services on the route for Qantas, relative to the situation before the code share commenced, as well as its impact on consumers in terms of factors such as fares, choice of carrier, frequency levels and demand levels. The Commission found on each occasion that the public benefits from authorisation were likely to marginally outweigh the detrimental effects that might arise. An important factor in deciding to allow code sharing was the Commission's concern that discontinuing authorisation may have a detrimental impact on the level of services between Perth and Johannesburg.

7.3 However, both of the previous reviews were complicated by the impact of major international events - 11 September 2001, the Iraq war and the SARS virus on consumer travels decisions during the period under review. Although the effect of those events on demand on the South Africa route was probably less than on many other routes, the Commission considered that they may have influenced the supply, pricing and marketing behaviour of Qantas, SAA and its third-country competitors (most of which fly through Asian ports to South Africa), relative to the situation in more normal circumstances. In turn this may have significantly affected the level of public benefits associated with the code share.

7.4 The Commission has again carried out a detailed analysis of the economics of the route, using the commercial in confidence information provided by Qantas and information available to the Commission from other sources. The analysis was conducted on a comparable basis with the Commission's previous reviews in 2002 and 2003.

7.5 The Commission stated at its review in April 2003 that it was hopeful more normal operating conditions would prevail over the period until the review in 2005. The Commission also commented at the time that the introduction of new A340 aircraft by SAA may improve the cost structure of operations on the Perth sector and may therefore improve the profitability of the route for both carriers. The period since mid-2003 has in fact proved to be one of comparative industry stability, although rising fuel costs have placed cost pressures on all airlines. SAA did introduce its A340 aircraft in the second half of 2003. This has indeed improved the underlying cost structure of the Perth operations, notwithstanding the fuel cost rises.

7.6 The Commission has found that the financial results for Qantas (and, it could be expected, SAA) have improved substantially since the time of the last review in April 2003. The profitability of Sydney services is strong. Sydney continues to perform financially significantly better than the Perth services, but the situation in the Perth market has turned around substantially for the better since the time of the previous review. The cost reductions associated with the replacement of the inefficient B747-200s by the A340 have underpinned the improvement for Perth in particular. Higher load factors, exchange rate influences and other factors have also contributed to the better results for both Sydney and Perth. The financial situation for Qantas on the South Africa route as a whole, over 2004 in particular, was much stronger than previously, despite relatively flat traffic levels.

7.7 In terms of benefits to the travelling public, the Commission finds that there have been some gains to consumers since the previous review. The introduction of SAA's A340s has resulted in benefits to passengers through better on-board facilities and comfort and a rise in frequency from four to five services per week providing additional choice of travel times. The addition of Skybeds in Qantas business class has added a higher level of service for business passengers on Sydney services.

7.8 However, the Commission continues to have concerns about the high prices facing travellers, particularly business class passengers, but leisure travellers as well. Fares have generally continued to trend upwards, despite the stated concerns by Qantas about the effectiveness of competition from third-country carriers in capturing market share from Qantas and SAA. Business class fares, which were already high, increased sharply when Qantas introduced its Skybeds to the business class cabin, although this increase applied also to other routes on which the beds were introduced.

7.9 Qantas and SAA, the only direct carriers, continue to enjoy a major advantage over indirect carriers because of the much shorter travel times of the direct services, especially in relation to time-sensitive business travellers. Even the significantly lower fares offered by most indirect carriers are unlikely to provide sufficient incentive for significant numbers of business travellers to prefer a carrier operating on an indirect routing. Some leisure travellers opt to travel on the third-country carriers because of generally lower fares, the opportunity to stopover at an intermediate point, and possibly because of difficulty in obtaining seats on the direct carriers on preferred travel days at some times of the year. However, the long travelling time of indirect services is likely to limit the ability of third-country carriers to greatly increase their market share even of leisure travellers.

7.10 The Commission considers that the increasingly high load factors on Qantas' Sydney services in particular are an impediment to effective price competition between Qantas and SAA. The Commission acknowledges the Qantas view that the block-space code share arrangement offers better scope for competition between the partners than would a free-sale type of arrangement. However, code share arrangements even of the block-space type are likely to promote less competition compared with no code sharing. This is particularly the case as load factors rise under code sharing, as the incentive for the code share partners to compete diminishes. Further, the current high load factors, particularly to and from Sydney, are being achieved despite high fare levels. The Commission maintains that there is little or no incentive for the two carriers to compete more vigorously on price because the aircraft are heavily loaded on many flights over most of the year. Further, the high load factors are probably limiting choice of travel date for consumers at certain times of the year, as seats may be unavailable on preferred days, or if they are, lower fare types may be unavailable.

7.11 Despite the high load factors on the Sydney services, Qantas has thus far not moved to operate a fifth weekly frequency on a year-round basis. If demand for travel on the route is price sensitive, as Qantas has suggested in its submission, there should be scope for the carriers to add capacity and attempt to stimulate additional demand through price initiatives. The Commission is therefore pleased that Qantas has indicated in its response to the draft decision that it will introduce a fifth service on an all-year round basis from 3 December 2005.

7.12 The Commission has observed in its previous decisions that the cost efficiencies associated with the rationalisation of services since the start of the code share has provided a basis for the continuation of services to both Perth and Sydney.

7.13 Since the most recent review in 2003, the airlines have been able to generate significant additional cost savings, despite the rising cost of fuel. The Commission considers that there is now a genuine question about whether the code share continues to be necessary to support commercially viable operations, in view of the improved cost base, particularly on Perth services which have been commercially not as strong as the Sydney services.

7.14 The profits generated by those extra savings appear to have been retained by the airlines and the efficiency gains do not appear to have benefited consumers through the form of lower fares, although there have been service quality improvements. The Commission considers that the benefits from the code share have begun to swing more heavily in favour of the producers of the air services than towards the public.

7.15 The apparent lack of significant competitive tension between Qantas and SAA and the limited scope for additional competition from other carriers is of concern to the Commission. Currently there is no capacity available for allocation to other Australian carriers which may wish to operate on the route. Third country carriers provide only limited competitive pressure, particularly in the business travel market.

7.16 However, the Commission needs to have regard to the possible market consequences of withdrawal of the code share, in case this might lead to reduced public benefits. Qantas has indicated that it would not introduce any services to Perth, either direct or enroute to and from Sydney, in the absence of the codeshare. The Commission considers that SAA would be unlikely to extend its services beyond Perth to Sydney because it is permitted to carry only own-stopover traffic on the long trans-continental leg between Perth and Sydney. This means its aircraft could be half-empty on the Perth – Sydney leg. SAA could continue to operate only to Perth, but there is a question mark about whether SAA service levels might be reduced in the absence of Perth market participation by Qantas, and given that SAA's overall profits on the South African route could be expected to decline in the absence of its participation in the Sydney market through the code share with Qantas.

7.17 The Commission considers that a possible outcome of withdrawal of code share approval could be the development of monopolies on the Perth sector (by SAA) and the Sydney sector (by Qantas). The result may be that such limited competitive tension that exists between the two code share partners would be lost and consumers may be no better off than currently.

7.18 The Commission is also aware of the expiry in mid-December 2005 of the current authorisation by the South African authorities of the code share.

8 Conclusion

8.1 The growing evidence of the impact of a lack of competition between Qantas and SAA is a concern for the Commission, with continuing high fares and increasingly high load factors on the very profitable Sydney services of particular concern. On the other hand, some new benefits to consumers have arisen since the previous review in the form of a regular fifth weekly frequency by SAA to Perth, with better service levels associated with the more modern A340 aircraft. Business class passengers on Qantas' Sydney services have also experienced additional service improvements with the addition of Skybeds. The improved cost base for operations to Perth from the A340 appears to be greatly assisting the financial viability of Perth services.

8.2 In all the circumstances, the Commission will reauthorise the code share from 1 July 2005 until 18 December 2006. This is an additional one year from the date on which the current authorisation of the South African competition authority expires. Determinations 2000/107, 2001/114, 2002/117, 2003/108 and 2004/119 will be amended accordingly. The Commission expects that the South African authorities will review the code share arrangement later in 2005, and the Commission proposes to consult with them in that process.

8.3 In its earlier decisions, the Commission has imposed conditions designed to enhance public benefits as far as possible by ensuring some degree of price competition including through the maintenance of minimum frequency or seat levels. At its 2002 and 2003 reviews, the Commission progressively relaxed the condition because of the possible impact on demand of the major world events described above.

8.4 In view of the stronger financial situation on the route, and the high load factors evident over much of the year especially on Sydney services, the Commission considers that it is reasonable to increase the required minimum level of operations required by the carriers as a condition of continued approval of code sharing. This revised condition will require the operation of extra capacity and the Commission would expect that this would be achieved by an additional weekly service by Qantas from Sydney. Qantas has indicated its intention to introduce this extra service in early December 2005. The additional frequency will of itself be a public benefit through improved choice of date of travel, but more importantly the additional capacity should place some pressure on Qantas and SAA to compete to fill the extra seats, generating additional benefits to the travelling public.

8.5 The Commission will require Qantas and SAA to maintain the operation of a combined minimum of 10 services per week from 3 December 2005. The current minimum seat requirement will remain in effect in the interim period.

8.6 The Commission notes that the requirement to operate at least 10 services per week is the same condition as was imposed when code share authorisation was first given in late 2000. The airlines may be permitted temporary reductions from this level, depending upon circumstances and with the prior approval of the Commission. There are no other changes to the conditions of the existing authorisation.

9 Role of the ACCC

9.1 The Minister's Policy Statement and its associated Explanatory Memorandum make it clear that the ACCC retains primary responsibility for competition policy matters. Nothing in the Commission's decisions should be taken as indicating either approval or disapproval by the ACCC. The Commission's decisions are made without prejudicing, in any way, possible future consideration of code share operations by the ACCC.

10 Decision ([2005] IASC 204)

10.1 In accordance with section 24(1) of the Act, the Commission varies Determinations [2000] IASC 107, [2001] IASC 114, [2002] IASC 117, [2003] IASC 108 and [2004] IASC 119 to permit SAA to code share on Qantas flights operated to and from South Africa until 18 December 2006, consistent with the Qantas/SAA code share and commercial agreements provided to the Commission, subject to the following conditions:

- any amendments to the code share agreement (including to Annex 1), or to the commercial agreement in so far as it affects the former, must be approved by the Commission;

- any new code share agreement or commercial agreement in so far as it affects the former must be approved by the Commission;

- Qantas must price and sell its services on the route independently;

- Qantas and SAA must withdraw from all IATA tariff coordination activities in relation to air fare levels between Australia and South Africa;

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

- Qantas must take all reasonable steps to ensure that all passengers are informed, at the time of ticket reservation, of the carrier actually operating the flight;

- until 2 December 2005, the approval will remain in effect only while Qantas and SAA together operate at least 2,680 seats per week on the South Africa route, although the Commission will allow temporary reductions from this level during periods of low seasonal demand or for unforseen operational reasons, provided there is prior notification to the Commission

- from 3 December 2005, the approval will remain in effect only while Qantas and SAA together operate at least ten return services per week on the South Africa route. Temporary reductions from this level may be permitted depending on circumstances, but only with the prior approval of the Commission;

- Qantas must submit to the Commission reports each quarter on the number of code share seats available for sale and sold by it on each of SAA’s operated services and by SAA on each of Qantas’ operated services.

Dated: 30 June 2005

John Martin Chairman	Michael Lawriwsky Member