Australian Government

International Air Services Commission

DECISION

Decision:	**[2006] IASC 218**
Variation of :	**[2002] IASC 104, [2002] IASC 108, [2004] IASC 120, [2005] IASC 123 and [2005] IASC 126**
The route:	**Japan**
The applicant:	**Qantas Airways Limited (ACN 009 661 901) (Qantas)**
Public Register:	**IASC/APP/200607**

1 The application

1.1 Qantas applied to the Commission on 4 May 2006 seeking an extension until 30 June 2009 of authorisation for Japan Airlines (JAL) to code share on Qantas' services between Tokyo and Cairns and between Tokyo and Melbourne. The Commission's current approval of the code share arrangements expires on 30 June 2006.

1.2 The Commission published a notice on 12 May 2006 inviting submissions about the application. A submission was received on 5 June 2006 from the Australian Competition and Consumer Commission (ACCC). Submissions in responses to the ACCC submission were received from Qantas on 7 June 2006 and from Tourism Australia on 9 June 2006.

1.3 Material supplied by the applicant and submissions are filed on the Register of Public Documents. Commercial-in-confidence data provided quarterly to the Commission is filed on the Commission's Confidential Register.

2 Current Services

2.1 Qantas operates the following weekly services, effective for the Northern Summer 2006 scheduling period:

- 7xB767-300 Melbourne-Tokyo and vv (JAL code shares – 53 seats per flight);
- 7xB767-300 Sydney-Cairns-Tokyo* and vv;
- 7xB767-300 Brisbane-Cairns-Tokyo* and vv;

  *JAL code shares with 191 seats on seven services per week on the Cairns – Tokyo and vv sector

- 3xA330-300 Perth-Tokyo and vv;

- 7xB747 Sydney-Tokyo and vv;
- 7xB767-300 Cairns–Nagoya and vv (effective 1 July 2006); and
- 7xB7767-300 Cairns-Osaka and vv (effective 1 July 2006).

2.2 JAL operates the following weekly services:

- 7xB747 Brisbane-Tokyo and vv (Qantas code shares – 191 seats per flight);
- 7xB747 Sydney-Tokyo and vv; and
- 7xB747 Brisbane-Osaka-Brisbane-Sydney (Qantas code shares – 110 seats per flight).

2.3 A number of other international carriers offer connections between Australia and Japan via intermediate points.

3 Traffic Levels

3.1 The tables below show moving annual total data for Japanese visitors arriving in Australia, and for Australian residents travelling to Japan. According to these ABS figures, about 87 percent of the Origin Destination traffic on the route originates in Japan.

JAPANESE VISITOR ARRIVALS IN AUSTRALIA – MOVING ANNUAL TOTALS

	2003	CHG %	2004	CHG %	2005	CHG %	2006	CHG %
YE JAN	743,563	8.4%	644,136	-13.4%	725,879	12.7%	693,353	-4.5%
YE FEB	746,024	10.2%	647,428	-13.2%	724,966	12.0%	693,694	-4.3%
YE MAR	736,050	8.8%	650,886	-11.6%	728,584	11.9%	690,528	-5.2%
YE APR	721,368	6.7%	662,566	-8.2%	722,891	9.1%	684,705	-5.3%
YE MAY	699,811	3.2%	684,380	-2.2%	714,264	4.4%		
YE JUN	678,930	-0.2%	700,413	3.2%	710,352	1.4%		
YE JUL	662,222	-2.5%	711,369	7.4%	709,241	-0.3%		
YE AUG	650,094	-3.6%	719,664	10.7%	705,863	-1.9%		
YE SEP	649,545	-4.1%	724,551	11.5%	704,787	-2.7%		
YE OCT	643,321	-8.0%	729,320	13.4%	697,950	-4.3%		
YE NOV	641,917	-11.1%	732,188	14.1%	696,300	-4.9%		
YE DEC	643,742	-12.7%	721,642	12.1%	694,438	-3.8%		

AUSTRALIA RESIDENT DEPARTURES TO JAPAN – MOVING ANNUAL TOTALS

	2003	CHG %	2004	CHG %	2005	CHG %	2006	CHG %
YE JAN	76,266	0.7%	79,502	4.2%	94,576	19.0%	104,401	10.4%
YE FEB	77,394	0.9%	79,511	2.7%	96,311	21.1%	106,359	10.4%
YE MAR	77,808	2.1%	79,603	2.3%	98,761	24.1%	105,966	7.3%
YE APR	77,139	1.7%	81,360	5.5%	99,053	21.7%	105,815	6.8%
YE MAY	76,569	1.3%	82,680	8.0%	99,881	20.8%		
YE JUN	76,551	1.0%	83,188	8.7%	100,267	20.5%		
YE JUL	75,807	0.5%	85,630	13.0%	100,201	17.0%		
YE AUG	77,364	4.3%	87,237	12.8%	98,723	13.2%		
YE SEP	77,231	3.0%	88,836	15.0%	100,840	13.5%		
YE OCT	78,065	3.5%	90,208	15.6%	100,157	11.0%		
YE NOV	78,700	3.5%	90,955	15.6%	100,499	10.5%		
YE DEC	79,618	5.3%	92,696	16.4%	101,736	9.8%		

Source: Australian Bureau of Statistics

4 Provisions of the relevant air services arrangements

4.1 The air services arrangements between Australia and Japan allow code sharing between the designated airlines of Australia and Japan. Where the designated airlines code share with each other, capacity is counted as being exercised only by the operating carrier. As a consequence, the Commission's approval is not required for Qantas to code share on Japan Airlines' services, but is for services where Japan Airlines code shares on Qantas flights.

5 Summary of submissions received

Qantas

5.1 Qantas advised that it was complying with all of the conditions of the Commission's authorisation of code sharing between Qantas and Japan Airlines. These conditions require the airlines to price and sell services independently of each and not share revenues, to limit the number of code share seats, to operate a minimum of 3,200 seats per week between Cairns and Tokyo, and to report quarterly on seats sold and yields achieved.

5.2 Traffic levels in the Japan market continue to be subdued. The size of the inbound visitor market, which amounts to about 88 percent of traffic has been relatively steady for five years, although there have been fluctuations over that period. Visitor numbers in 2005 were five percent below 2004 levels. A 45 percent appreciation of the Australian dollar against the Japanese yen since 2001 had increased the cost for Japanese visitors to Australia. At the same time, the US dollar to Yen exchange rate had remained relatively stable. As a result, the United States and US dollar-linked destinations have gained a competitive advantage over Australia. The Japanese economy had also been weak, dampening Japanese outbound tourism generally.

5.3 Although exchange rate movements had assisted growth in resident departures to Japan, the outbound market made up only 12% of the total market traffic.

5.4 Qantas noted that it is involved in implementing the recommendations of the report of the Action Plan for Japanese Tourism Committee. It also quoted the Tourism Forecasting Council's visitor arrivals forecast of 2.9 percent per annum until 2014.

5.5 Qantas advised that market capacity had remained steady at about 22,000 direct seats per week over the past two years. This was despite the downward trend in traffic numbers. Qantas argued that the continuation of the code share arrangements with Japan Airlines were vital to Qantas being able to maintain current service levels.

5.6 Qantas stated that its commercial performance on the route had deteriorated dramatically over the past two years and the company is now incurring losses. Discounting had been necessary to stimulate demand in a weak market with stable capacity levels. This, together with the appreciation of the Australian dollar relative to the Yen, had caused a decline in yields. Yields fell by 11.9 percent (or 12.6 percent including Australian Airlines) between 2003 and 2005. Although yields rose marginally on the Melbourne – Tokyo sector in 2005, they fell on the Cairns and Brisbane services. Qantas and Japan Airlines also suffered a fall in market share, with their combined share falling from 69.1% in 2003 to 65.6% in 2005.

5.7 Qantas stated that its cost base on the Japan route was high, noting the rapid rise in the price of fuel to over US$70 per barrel currently from less than US$40 per barrel in March 2004. Fuel surcharges had only partially compensated for the higher fuel bill.

5.8 Qantas noted that the proposed introduction in 2005 of A330-300 aircraft on the Tokyo – Cairns and Tokyo – Melbourne had been postponed in light of poorer than expected market performance. It also confirmed earlier advice that services on the Tokyo – Cairns route would be provided by Qantas using wet-leased Australian Airlines aircraft from July 2006. Jetstar would enter the Japan route from March 2007 but would not serve Tokyo.

5.9 Qantas advised that it and Japan Airlines propose to retain their current pattern of services for the foreseeable future and to continue code sharing in accordance with their current agreement. The agreement involves a fixed block seat swap on the Cairns – Tokyo services and a block space arrangement on the Melbourne – Tokyo services with a partial hand-back facility.

5.10 Qantas submitted that the code share arrangement continued to deliver a range of benefits including:

- the maintenance of own-operated services by both Japan Airlines and Qantas in the Australia – Tokyo market;

- the continuation of dedicated non-stop capacity from Tokyo to Brisbane, Cairns and Melbourne, including competition on these sectors through the block-space nature of the code share;

- increased likelihood of long-term sustainability of routes;

- frequency and schedule choice between Tokyo and Queensland, and provision of direct access to Melbourne, benefiting travellers and exporters

- a two-fold promotional effort in marketing Brisbane, Cairns and Melbourne in Japan;

- the distribution capacity of Japan Airlines including its wholesale and retail presence, which contributes significantly to inbound tourism to Australia; and

- protection of valuable slots at Narita Airport.

5.11 Qantas stated that if the code share arrangements were not re-authorised, it would not be commercially feasible to maintain its existing frequency of services to Cairns and Melbourne. Qantas also suggested that Japan Airlines may not maintain its current level of operations if the code share arrangements did not continue, noting that Japan Airlines has foreshadowed the possible withdrawal of its daily service between Osaka and Brisbane/Sydney.

Australian Competition and Consumer Commission (ACCC)

5.12 The ACCC reaffirmed the view from its April 2004 submission that the code share arrangements will continue to raise competition concerns while there is not competition from other direct operators on the Australia – Japan route. The ACCC suggested that there was no sign that any other airline, other than Qantas subsidiaries, will enter the route in the short to medium term. Carriers operating via indirect routes were not regarded as providing an effective competitive constraint, as their services involved longer flight times and they offered similar fares to the direct operators. The ACCC estimated that the Qantas/Japan Airlines share of origin – destination traffic had fallen only by 1.6 percent from 2003 to 2005.

5.13 The ACCC was not convinced that Qantas' claims of significant losses were consistent with its behaviour in seeking to retain its existing capacity allocation on the Japan route. The ACCC also referred to Bureau of Transport Economics data indicating that Melbourne – Tokyo passenger numbers had increased significantly in recent years, particularly outbound departures, and that on the Cairns – Tokyo sector, passenger levels had remained relatively steady. The ACCC considered that fuel price rises referred to by Qantas as affecting route profitability would be having an impact on profitability of all carriers across all routes.

5.14 The ACCC was of the view that Japan Airlines would not withdraw from the Cairns – Tokyo sector if the code share was not re-authorised, noting that its share of seats under the code share was significant. This would be likely to increase competition, particularly on routes both airlines service. While the code share exists, the partners are less likely to engage in behaviour which might adversely affect their partner.

5.15 In concluding, the ACCC considered that the code share arrangements were likely to be reducing competition in the Australia – Japan market and that if the authorisation was not renewed, competition was likely to increase. This would be likely to lead to lower fares, increasing the attractiveness of Australia as a destination.

Qantas response to ACCC submission

5.16 Qantas contended that the indirect carriers do provide a competitive check on the direct airlines. Qantas noted that third-country carrier market share had risen, despite a seven percent increase in total capacity operated by Qantas and Japan Airlines over the two years from December 2003.

5.17 Turning to commercial performance on the route, Qantas pointed out that it had retained some unused capacity for the purpose of supporting the entry of Jetstar into the Japan market from March 2007. In relation to the increases in operated capacity to Cairns and Melbourne, Qantas submitted that considerable price discounting had been necessary to maintain passenger numbers. This discounting, together with the impact of the appreciation of the Australian dollar, had led to a significant decline in yields. Combined with rising costs, the Cairns and Melbourne code share sectors were loss-making.

5.18 Qantas reiterated its initial position that it would not be commercially viable to continue the current level of services on the Tokyo route in the absence of re-authorisation of the code share arrangements. Qantas also considered it likely that Japan Airlines would reduce capacity if the code share was not allowed to continue.

Tourism Australia response to ACCC submission

5.19 Tourism Australia said that it had not originally made a submission because it believed the IASC would extend code share approval in light of the current commercial and marketing challenges on the Japan – Australia route. It stated that it had some concerns with the ACCC advice.

5.20 Tourism Australia restated advice from its previous submission to the Commission, to the effect that the Japanese inbound tourism market is challenging for airlines wishing to provide services. The Japanese distribution system remained controlled by Japan Airlines and the desirability of it being involved in this system needed to be taken into account in assessing whether or not the code sharing authorisation should be extended.

5.21 Japan Airlines faced restructuring challenges and its continuation of Australian services was being examined as part of a new corporate strategy which included withdrawing from low yielding leisure routes. Tourism Australia said that Japan Airlines' public statements did not suggest it would compete more aggressively with Qantas, or seek to enter the Melbourne or Cairns markets in its own right, should the code share approval be withdrawn. Further, it was unlikely that another Japanese or Australian carrier would be in a position to enter the route for at least another two years.

5.22 Tourism Australia expressed concern about the reaction of the Japanese distribution system to the entry of Jetstar in 2007 in the event that the code share was not extended. In the absence of code share approval, consideration of Australia by the Japanese distribution system may be reduced, making it more difficult for Jetstar to be successful in its Japanese services.

6 Commission's consideration

6.1 At its previous reviews in 2002 and 2004, the Commission was unable to establish with certainty the impacts of the code share in the Australia – Japan market. This was due to difficulties in isolating the effects of the code share from major international events which had affected traffic patterns and market factors on the route.

6.2 Nevertheless, the Commission was able to conclude that there were likely to have been positive impacts from the operation of the code share, including the maintenance of service levels to Cairns and Melbourne. The preservation of runway slots at the capacity constrained Narita airport was an important by-product of preserving frequency levels. However, the Commission was concerned at the absence of competition from other carriers on the route and that this created the potential for anti-competitive outcomes from the code share if market conditions were to improve.

6.3 Despite a return to a relatively stable operating environment, the Australia - Japan market continues to be weak. Although there was some recovery in Japanese visitor numbers to Australia in 2004, after the poor year in 2003, the situation deteriorated in 2005. It has continued to be weak into the early part of 2006. Visitor numbers remain below 1999 levels. In 2005, Australia captured only about four percent of the total Japanese outbound market, now the lowest share for some years, having fallen from about five percent in 2003.

6.4 The weakness in the visitor market has been partially offset by steadily increasing Australian resident travel, with the contrasting performance of the two segments apparently driven in large part by a substantial strengthening of the Australian dollar relative to the Japanese yen. However, the Australian resident component of the market still makes up only about 13% of total travel.

6.5 Confidential data reported by Qantas for the Cairns-Tokyo, Brisbane-Tokyo and Melbourne-Tokyo routes indicate that revenue yields from economy passengers weakened throughout 2004 and 2005. Yields for the business segment improved in 2005, leading to modest overall yield improvement for the Melbourne services which have the highest proportion of business traffic of the three routes. However, there is a relatively small percentage of business traffic on the other two sectors, particularly Cairns, so the overall yield performance across the code share sectors worsened relative to two years ago.

6.6 In addition, seat factors for both carriers were somewhat lower over the two-year period since the previous review, reflecting weakness in Japanese tourist numbers. Although Qantas made some brief seasonal adjustments to operated capacity on some sectors, this did not offset the weaker traffic conditions sufficiently to raise overall load factors.

6.7 Yield weakness and soft demand, combined with cost increases to the carriers associated with the rapid and significant rise in the price of fuel, have reduced returns from the route. Qantas states that all of the code share sectors were loss-making for the company in 2005.

6.8 Qantas quotes forecasts of visitor arrivals from Japan of an average growth rate of 2.9 percent per annum to 2014. This is a fairly slow rate, although it would represent a recovery based on performance over the past decade. The Commission also notes that Qantas' forward bookings are down on comparative levels in 2005.

6.9 The Commission concludes that the commercial situation on the route has deteriorated significantly since the Commission last reviewed the code share arrangements in April 2004. There is no evidence of exploitation of the route by the code share partners. Although some competitive pressure continues to be provided by indirect carriers, which have slightly increased their market share over the past two years, broader market factors seem to be providing considerable discipline on the direct operators.

6.10 The Commission's concerns about operation of the code share have been based on the implications of a strong recovery in the Australia - Japan market. This could increase the scope for the code share partners to take advantage of the lack of direct competition on the route. However, the market has remained in a generally weak state despite some improvement for a period after the serious world events of the early years of this decade. Factors such as unfavourable exchange rate movements and fuel price rises in particular appear to have contributed to a decline in the visitor travel market over the past 12 months. This is the dominant component of traffic on the route. High fuel costs seem likely to continue to add considerably to the airlines' operating cost base. As the ACCC points out, this is a factor for all routes, and is therefore neutral in competition terms, but it does not diminish the impact on operating margins on the code share routes.

6.11 At its previous reviews, the Commission accepted that the code share, and the capacity rationalisation associated with it, has assisted in the maintenance of current service levels on the code share routes. This continues to be the Commission's view. A loss of service frequencies is unlikely to serve the interests of consumers or the tourism industry in particular. The Commission considers it unlikely that frequency levels would be maintained in the event of the code share not being re-authorised, in the face of poor market conditions.

6.12 The Commission considers that there is likely to be no lessening of public benefit from allowing Qantas to continue to use the relevant capacity in code share services with Japan Airlines. Given the weak outlook for the route for the short to medium term, the Commission sees little potential for adverse competitive outcomes from continuing its authorisation of the code share arrangements for a further limited period. Although Qantas has sought a three-year extension on this occasion, the Commission considers that market circumstances could change significantly over this lengthy time frame and it will therefore limit the extension of approval for a further two years. This is consistent with the duration of the Commission's previous approvals. This means that authorisation will continue until 30 June 2008.

7 Decision ([2006] IASC 218)

7.1 In accordance with section 24 of the Act, the Commission varies Determinations [2002] IASC 104, [2002] IASC 108, [2004] IASC 120, [2005] IASC 123 and [2005] IASC 126, as requested by Qantas, by:

7.2 *deleting* "Qantas may use the capacity to provide services jointly with Japan Airlines until end June 2006 in accordance with:"

7.3 *adding* "Qantas may use the capacity to provide services jointly with Japan Airlines until end June 2008 in accordance with:"

Dated: 09 June 2006

John Martin Chairman	Michael Lawriwsky Member	Vanessa Fanning Member