Australian Government

International Air Services Commission

DECISION

Decision:	**[2007] IASC 204**
Variation of :	**[2002] IASC 116, [2004] IASC 120, [2006] IASC 103 and [2006] IASC 124**
The route:	**Japan**
The applicant:	**Qantas Airways Limited (ACN 009 661 901) (Qantas)**
Public Register:	**IASC/APP/200704**

1 The application

1.1 Qantas applied to the Commission on 20 February 2007 for variations of four determinations to enable code sharing by Japan Airlines (JAL) on Jetstar services between Osaka and Brisbane/Sydney from 25 March 2007. The determinations are [2002] IASC 116, [2004] IASC 120, [2006] IASC 103 and [2006] IASC 124.

1.2 The Commission published a notice on 26 February 2007 inviting submissions about the application. Submissions were received from:

- the Tourism Industry Council of NSW (dated 28 February 2007)
- the Tourism Attractions Association (28 February)
- Tourism Australia (2 March)
- Gold Coast Tourism Corporation (2 March)
- the Queensland Department of Tourism, Fair Trading and Wine Industry Development (5 March)
- the Commonwealth Department of Industry, Tourism and Resources (5 March)
- the Tourism and Transport Forum (5 March)
- Wasabi (8 March)
- the Queensland Tourism Industry Council (9 March)
- Australian Tourism Export Council (13 March)
- Tourism New South Wales (14 March).

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

2 Provisions of the relevant air services arrangements

2.1 The air services arrangements between Australia and Japan allow code sharing between the designated airlines of Australia and Japan. Under changes agreed in December 2000, 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 required for Japan Airlines to code shares on Jetstar's flights, Jetstar being the operating carrier. Commission approval has not been needed since December 2000 for Qantas, as the marketing carrier, to code share on Japan Airlines' services.

3 Summary of application and submissions received

Qantas

3.1 Qantas explained that Jetstar would be the only airline linking Osaka, Japan's second largest population centre, with Australia, once Japan Airlines had ceased its Osaka services. Japan Airlines was restructuring its operations, including reducing flying on unprofitable routes. Qantas understood that Japan Airlines was incurring losses on the Australia – Osaka route and there was little prospect of it re-entering it in the medium to longer term.

3.2 Qantas stated that the Jetstar/Japan Airlines code share represented a reversal of the Japan Airlines/Qantas arrangements, although there were differences in the capacity operated and the structure of the commercial relationships. Jetstar would operate daily A330-200 services, replacing Japan Airlines' daily B747s. Japan Airlines was only prepared to enter into a free-sale arrangement and would not commit to a fixed number of seats per service. The Japan Airlines/Qantas code share is a block space arrangement, with Qantas purchasing up to six business class and 104 economy class seats on each Japan Airlines flight.

3.3 Qantas considered that the code share arrangement with Japan Airlines would be a critical factor in supporting successful operations by Jetstar and the level of visitor numbers to Australia. The presence of Japan Airlines as a code share partner would assist Jetstar to overcome the challenges of being a new carrier in the Osaka market. Qantas noted that Australian Airlines had faced difficulty in gaining recognition in the Japan market which is dominated by travel agency wholesaler groups.

3.4 Qantas explained that the code share arrangement needed to be seen in the context of continued weakness in the Australia – Japan market, with total origindestination traffic falling by nearly four percent in the 2006 calendar year compared with 2005. In particular, the Japanese visitor market fell by nearly five percent in the year to 31 December 2006. Japanese visitors continue to be the dominant market segment, making up 86 percent of passenger numbers on the route.

3.5 The weakness in the market had led to falling average load factors. Combined with rising costs and declining market share, this had made Qantas' current commercial performance unsatisfactory.

Tourism Industry Council NSW

3.6 The Tourism Industry Council advised that it is the peak tourism body in NSW. The Council supported the Qantas application for Japan Airlines to code share with Jetstar on its services between Sydney and Osaka. The Western Japan market was important for Sydney and NSW and it was unfortunate that Japan Airlines would no longer serve the region. The continued participation of the Japan Airlines sales team in Western Japan in selling services to Sydney was regarded as vital to the success of the Jetstar services. This support was particularly applicable to travel by groups, which had historically required intensive sales management.

Tourism Attractions Association (TAA)

3.7 The TAA is the peak body for attractions in NSW. It also supported the Qantas application, in similar terms to the Tourism Industry Council NSW.

Tourism Australia

3.8 Tourism Australia also supported the Qantas application. Tourism Australia stated that the inbound tourism market from Japan posed unique challenges, both economic and structural, for airlines. Economic factors had worked against the development of Japanese tourism to Australia. Strong appreciation of the Australian dollar against the Yen since 2000 and a positive inflation rate in Australia compared with a negative rate in Japan had combined to nearly double the real cost of a holiday in Australia for Japanese visitors. Australia had also lost price competitiveness with alternative destinations for Japanese travellers.

3.9 Australian airlines had encountered declining profitability as their costs are incurred in Australian dollars, while revenues are primarily in Yen. Tourism Australia saw this as the main reason for Qantas seeking to introduce Jetstar services to the lower yielding Western Japan market.

3.10 Japan Airlines' influence in the market was considered by Tourism Australia to be a strong reason for allowing Japan Airlines to sell seats on Jetstar's services.

3.11 Tourism Australia noted that Jetstar was focussed on sale of air-only tickets to independent travellers, a departure from the traditional Japanese model, with package and group sales the dominant segment in travel from Western Japan to Australia. However, Tourism Australia considered that the active involvement of the traditional Japanese distribution system was necessary to prevent a decline in inbound tourism from Western Japan and this would be best achieved by allowing Japan Airlines to sell seats on Jetstar’s services.

3.12 Tourism Australia noted that Japan Airlines was in a major restructuring phase and was withdrawing from low yielding routes. It was not likely to compete more aggressively with the Qantas group on services to Australia. Tourism Australia also considered it unlikely that another Japanese or Australian carrier would be able to offer services from Western Japan for at least two years. Accordingly, any anti-competitive impact of allowing the code share should not be a consideration for that period at least.

3.13 Tourism Australia considered that if the code share was not authorised, promotion of south-east Queensland and Sydney would be reduced, adversely affecting inbound tourism and making it difficult for Jetstar’s services to succeed.

Gold Coast Tourism Corporation

3.14 Gold Coast Tourism emphasised strongly the importance of ensuring a continuation of air services from Western Japan to south-east Queensland. The code share would ensure that Jetstar would be able to maintain this link. In the current tourism climate, with the softness in the Japanese visitor market to Australia, a low cost carrier service would have a much greater likelihood of sustainability than other services.

3.15 Gold Coast Tourism noted that, after March 2007, the Jetstar services would be the only non-stop air services between Western Japan and the south-east Queensland corner, that Japan Airlines participation was vital because of its comprehensive distribution channels and that approval of the code share should allow both parties to the joint service to secure profitability thus ensuring that the Jetstar services are sustainable.

Queensland Government

3.16 The Queensland Department of Tourism, Fair Trading and Wine Industry Development supported the application. It noted that Japan was the largest international source market for Cairns and the Gold Coast as well as a major inbound market for Queensland as a whole, with two out of every three Japanese tourists to Australia visiting Queensland. This produced 5,900 tourism jobs and $478 million in direct visitor expenditure.

3.17 Japan is also an important export market for Queensland. Many exports are time sensitive and therefore reliant on regular air services.

3.18 The reduction in capacity between Brisbane and Japan following the collapse of Ansett in September 2001 had not been fully replaced. Since that time, up to

85,000 visitors annually to south east Queensland from western Japan had been lost. Japan Airlines was departing the Osaka – Brisbane/Sydney market from April 2007 and the Queensland Government had successfully negotiated for Jetstar to enter that market. The code share arrangements with Japan Airlines would facilitate a smooth transition between the two services, and provide Jetstar with access to Japan Airlines' distribution system. Without this support, Jetstar may struggle to make its services sustainable.

Commonwealth Government

3.19 The Department of Industry, Tourism and Resources supported the code share application. It argued that code share arrangements promote travel between Australia and international markets, delivering tourism benefits and improving sustainability of air services.

3.20 Jetstar's entry to the Osaka – Brisbane/Sydney market is a welcome development and the proposed code share arrangements could be important towards ensuring the initial success and long term viability of these services.

3.21 The Department attached information about the importance of the Japanese market for the Australian tourism industry.

Tourism and Transport Forum (TTF)

3.22 The TTF strongly supported the Jetstar/Japan Airlines code share arrangements. While expressing disappointment at Japan Airlines' withdrawal of its Osaka services, the TTF said that maintaining Japan Airlines' presence was important in supporting the sustainability of services on the route and inbound tourism to Australia. The TTF noted that Japanese visitor arrival numbers had fallen by 20 percent since 1996, but Japan remained Australia's second largest source of tourism expenditure, spending $2.7 billion in Australia in 2005.

3.23 Jetstar's proposed code share arrangements would support the Australian Government's *Action Plan for Japanese Tourism*, which was launched in January 2006. This is intended to address the fall in Japanese visitor numbers. Jetstar had already contributed to this task by announcing new services from Cairns to Osaka and Nagoya in 2007 and undertaking promotional activity in Osaka associated with its international launch.

Wasabi

3.24 Wasabi supported the application, arguing that the Jetstar operations could struggle without the co-operative arrangements proposed. The code share with Japan Airlines would provide access to that airline's powerful distribution system and assist in the growth of traffic on the route.

3.25 Wasabi said that Japan was a vital source of inbound tourism to Australia and the largest single international source market for Cairns. Wasabi explained that it had negotiated contracts in 2006 with Japanese travel agents worth $32 million to hotels and tour operators in Cairns. Japanese travellers were also now staying longer and spending more than previously.

Queensland Tourism Industry Council

3.26 The QTIC supported the application. QTIC said it was very supportive of any measure that would improve access to the Japanese market following the imminent withdrawal of Japan Airlines from the Australia-Osaka market.

3.27 QTIC advised that the most recent tourism data showed that arrivals from Japan in 2006 were 4.4 per cent lower than the previous year. QTIC's view is that the code –share arrangements between Jetstar and Japan Airlines will lower access costs and invigorate the tourism link between Australia and Japan. QTIC expressed concern that Japan Airlines may reduce its services to Australia further as part of its reviews of its leisure routes.

Australian Tourism Export Council (ATEC)

3.28 The ATEC is the peak national body representing the tourism export sector with 1100 members from across the tourism industry. Many of its members are active in the Japan market, including Japan Airlines and several important Japanese inbound tour operators. ATEC also supports industry advisory panels, including the Japan Policy Panel which is made up of representatives of the Japanese tourism industry in Australia.

3.29 ATEC noted that the Japanese market had been in decline, now ranking as Australia's third largest inbound market after New Zealand and the United Kingdom. Japanese visitor numbers and expenditure in Australia had fallen significantly in 2006 with regions such as the Gold Coast and Tropical North Queensland particularly affected.

3.30 ATEC summarised aspects of the Commonwealth Government's *Action Plan for Japanese Tourism*, highlighting the importance of aviation access issues in the market's recovery and growth. The emergence of low-cost carriers in Asia had increased competition for Japanese tourists, with China and Korea increasing their tourist numbers substantially.

3.31 The suspension of Japan Airlines' services between Osaka and Brisbane/Sydney from 24 March was considered by ATEC to have a significant impact on Japanese tourism to Sydney and the Gold Coast. ATEC therefore supported the Jetstar/Japan Airlines code share approval, considering this would deliver a range of benefits.

Tourism New South Wales (Tourism NSW)

3.32 Tourism NSW supported strongly the application for code sharing between Qantas and Japan Airlines. Although noting that the Commission would look closely at the arrangements due to the high relative market shares of the code share partners, Tourism NSW considered that there were sound reasons to allow the code share.

3.33 In noting the ending of Japan Airlines Osaka – Brisbane – Sydney services, Tourism NSW stressed the importance of the new Jetstar services in maintaining links with Japan. Without these services, 27% of NSW's inbound tourism capacity would be lost.

3.34 Tourism NSW observed that the proposed new code share arrangement was a reversal of the existing Qantas/Japan Airlines code share situation and therefore an appropriate arrangement. As Jetstar would find it challenging to achieve access to the Japanese market, especially in the early years, the maintenance of Japan Airlines' presence through code sharing was warranted to support inbound tourism. Visitor arrivals to NSW from Japan had fallen by 29% since 1999. Several factors had contributed to this fall, including the strength of the Australian dollar relative to the Yen and competition from intra-Asian destinations.

3.35 The characteristics of the Japanese regulatory and product distribution system posed unique challenges for new entrants. Jetstar was not permitted to market itself directly in Japan, nor could it offer online ticket sales. Sales were only possible through agents and the majority of visitors to NSW were on a package tour. Without the code share arrangement, Jetstar would find it challenging to gain access to the market.

4 Commission's consideration

4.1 When considering applications to vary determinations, the Commission must decide whether the determinations, as varied, would be of benefit to the public. Under section 6.3 of the Minister's policy statement, where a carrier requests a variation of a determination to allow it flexibility in operating its capacity and no submission is received about the application, only the criteria in paragraph 4 of the policy statement are applicable. Under paragraph 4, the use of entitlements by an Australian carrier that is reasonably capable of obtaining the necessary approvals and of implementing its proposals is of benefit to the public.

4.2 Under Section 15(2)(e) of the Act, the Commission must include a condition in determinations stating the extent to which the carrier may use that capacity in joint services with another carrier. The Minister's policy statement indicates that the Commission would generally be expected to authorise code sharing but where it has serious competition concerns about a particular proposal is able to subject it to detailed consideration against the public benefit criteria contained in paragraph 5 of the policy statement.

4.3 The Commission has consistently subjected to careful scrutiny applications for code sharing between Australian and Japanese carriers on the Japan route. This is because of concerns about the potential impact of such arrangements on competition in this large market. The scope for code sharing to reduce competition has increased since 2001, when the Qantas-group airlines and Japan Airlines have been the only direct operators on the route and seek to code share with each other.

4.4 After careful consideration, the Commission has authorised Qantas to code share with Japan Airlines on Qantas' services between Cairns and Tokyo and between Melbourne and Tokyo. (Qantas code shares on Japan Airlines' Brisbane – Tokyo services but, as the marketing carrier, does not require the Commission's approval to do so). In recent decisions extending authorisation for these arrangements, the Commission has been well aware of the continuing demand weakness on the Japan route. The Commission has found that the code share arrangements have assisted the viability and maintenance of frequency of the relevant services in these difficult circumstances and have not led to adverse public benefit outcomes.

4.5 However, the dominant position of the code share partners in the market, with little foreseeable prospect of new direct competitors, is unlikely to be an ideal situation from a public benefit viewpoint should the market recover significantly. For this reason, the Commission has continued to limit the duration of its code share approvals on the Japan route to two year periods and has required Qantas to provide data regularly on important aspects of its market performance. This information assists the Commission to review the impact of the code share on public benefits.

4.6 In this case, the Commission does not have sufficient concerns about the proposal to warrant subjecting it to detailed assessment against the paragraph 5 criteria in the Minister's policy statement. Accordingly, the Commission has not directly invited the views of the Australian Competition and Consumer Commission (ACCC) about the proposal, as is required by the Ministers' policy statement when the IASC invokes the paragraph 5 criteria.

4.7 There are several reasons for the Commission's position. Most significantly, the application is made against continuing weakness in the Australia - Japan market. The Commission notes in particular the material fall in Japanese visitor numbers in 2006 compared with 2005. The state of this major market is a matter of serious concern for the tourism industry and the bodies which represent it, as has been expressed in the many submissions strongly supporting approval of the Qantas application.

4.8 In addition to the general market circumstances, there are several other factors which are important in the Commission's consideration of the application. Some of these have been identified by submitters. Japan Airlines is withdrawing its Osaka services from late March, leaving the Jetstar flights as the only service linking Osaka to Sydney and Brisbane. Without these services, access to the major western Japan tourist market would be significantly impaired, as passengers would have to travel via Tokyo. This would have flow-on consequences for the tourism industry in south-east Queensland and New South

Wales. All submitters have stressed the importance of Japan Airlines' participation in the service on a code share basis for the commercial sustainability of the Jetstar services. This is because of the prominent position of Japan Airlines in the product distribution system in Japan.

4.9 The Commission notes that the Qantas/Japan Airlines code share arrangements, and public benefits associated with them, will end with the withdrawal of Japan Airlines' flights, independently of any Commission decision concerning the Jetstar/Japan Airlines proposal. It is therefore inappropriate to compare the public benefits arising from the current Japan Airlines/Qantas arrangement with the public benefits likely to be associated with the Jetstar/Japan Airlines proposal.

4.10 Under the new arrangements, there will be a reduction in the number of seats being operated. However, the Commission recognises this has been driven by the weakness in the market and Japan Airlines' decision to cease serving the market except through its participation in a free sale code share arrangement with Jetstar.

4.11 Free-sale arrangements, by their nature, are likely to stimulate a lesser degree of competition than block space arrangements.

4.12 The appropriate assessment for the Commission to undertake is of the public benefits likely to arise through approving the code share compared with the public benefits situation which would otherwise prevail. In this case, the situation without the code share would involve Jetstar operating in its own right without code share support.

4.13 The Commission is satisfied that there would be no lessening of public benefits by allowing code sharing in this case. The Commission considers that against the background of weak market conditions, with Jetstar being a new carrier to Japan attempting to establish itself, it is important to the success of the services that Japan Airlines assist in the marketing and sales for these services. There is little prospect of anti-competitive behaviour arising from the arrangement in these circumstances.

4.14 However, as noted above, the Commission has maintained short-term approvals of other code sharing arrangements (between Qantas and Japan Airlines) on the Japan route because of concerns about the potential longer term impact of the arrangements on competition if the market recovers unexpectedly strongly. The Osaka – Brisbane/Sydney sector represents a major segment of the Japan – Australia market and therefore it is important that anti-competitive outcomes do not develop over time as a result of code sharing arrangements. The Commission notes that it had previously approved code sharing on the Osaka – Brisbane/Sydney sector only on a short-term basis, until the changes to the air services arrangements removed them from the Commission's scope in December 2000.

4.15 For these reasons, the Commission will limit the duration of its approval in this case to 30 June 2009, or a little over two years. To assist the Commission's analysis should Qantas seek an extension in due course, Qantas will be required to report six-monthly on traffic carried and yields for the services, as it does for the Melbourne – Tokyo and Cairns – Tokyo code share sectors.

5 Decision [2007] IASC 204

5.1 In accordance with section 24 of the Act, the Commission varies Determinations [2002] IASC 116, [2004] IASC 120, [2006] IASC 103 and [2006] IASC 124, as requested by Qantas, by adding:

- "Jetstar may use the capacity to provide services jointly with Japan Airlines until 30 June 2009 in accordance with:
  - the codeshare agreement of 9 February 2007, signed by Jetstar and Japan Airlines, with such additional conditions (if any) as the Commission may require, prior to code share services commencing, or as varied except in relation to:
    - Sydney/Brisbane – Osaka being the city pair served; or
    - any financial adjustment; or
  - any subsequent code share agreement between Jetstar 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:
  - Jetstar must price and sell its services on the route independently of Japan Airlines;
  - Jetstar must not share or pool revenues under any such agreement; and
  - Jetstar must take all reasonable steps to ensure that passengers are informed of the carrier actually operating the flight at the time of booking
- Jetstar must submit to the Commission reports six-monthly on the number of code share seats sold by Japan Airlines on Jetstar-operated services between Sydney/Brisbane - Osaka; and its yields per revenue passenger kilometre for all passenger classes on these services".

Dated: 14 March 2007

John Martin
Chairman

Vanessa Fanning
Member