Australian Government

International Air Services Commission

DECISION

Decision:	**[2007] IASC 213**
Variation of:	**[2006] IASC 129**
The route:	**Papua New Guinea (PNG)**
The applicant	**Qantas Airways Limited (ACN 009 661 901) (Qantas)**
Public Register File:	**IASC/APP/200710**

1 The application

1.1 On 14 May 2007, Qantas applied for a variation to Determination [2006] IASC 129 (the Determination), which allocates 1,000 seats of capacity per week on the PNG route, to permit it to continue code sharing on Air Niugini services between Sydney/Brisbane and Port Moresby and between Cairns and Port Moresby and vice versa. Authority was sought to code share for the duration of the determination, that is, until 30 June 2012.

1.2 The proposed arrangement involves Qantas purchasing a hard block of seats on all Air Niugini services between Australia and PNG. Qantas also has an option to purchase seats from a further soft block of seats on each flight. The agreed number of seats in the blocks varies from flight to flight. The code sharing will be conducted pursuant to the existing code share agreement between the airlines and any subsequent agreement which replaces it, subject to Commission approval. Qantas stated in its application that it had yet to receive a code share proposal from Air Niugini to replace the current agreement which expires on 12 August 2007. However, Qantas advised subsequently that the existing agreement had been extended to the end of October 2007.

1.3 The Commission published a notice on 18 May 2007 inviting submissions about the application. A submission was received from the Australian Competition and Consumer Commission (ACCC) on 15 June 2007. All public material supplied by the applicant and submitter is filed on the Register of Public Documents. Supporting confidential material supplied by Qantas is filed on the Commission’s confidential register.

1.4 Concurrently with this application, Qantas applied for interim approval for the code sharing arrangements to continue until 29 February 2008. The Commission authorised this short term extension in Decision [2007] IASC 208 of 30 May 2007.

2 Provisions of relevant air services arrangements

2.1 Operation of the capacity in code share services as proposed in the application is consistent with the provisions of the Australia - PNG air services arrangements. Capacity purchased by a marketing carrier (in this case, Qantas) on the services of the operating

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carrier (Air Niugini) counts as the exercise of capacity entitlements under the air service arrangements.

3 Current services

3.1 Air Niugini operates six two-class B767-300 return services per week between Port Moresby and Brisbane. Two of these services extend to and from Sydney. In addition, Air Niugini operates a weekly two-class Fokker F-100 jet service between Port Moresby and Brisbane. Qantas code shares in relation to the carriage of passengers on all of these services. Qantas also buys freight capacity on the B767 services. Airlines of PNG flies three return services per week on the Brisbane – Port Moresby sector, using two-class B737-200 aircraft.

3.2 On the Cairns – Port Moresby sector, Air Niugini operates nine two-class F-100 jet return services per week, on which Qantas code shares. Airlines of PNG also flies on this sector seven times per week using de Havilland Dash 8-100 turbo prop aircraft in an all-economy seat configuration. HeavyLift Cargo Airlines operates scheduled all-freight services up to twice per week using a B727 aircraft. Queensland Regional Airlines has an allocation of capacity from the Commission and plans to operate six weekly return flight using Dash 8-100 aircraft on the Cairns – Port Moresby sector from late 2007.

3.3 There are also various charter services operated between points in Australia and mining operations in PNG.

4 Characteristics of the Australia – PNG route

Australia – Papua New Guinea Traffic Growth

Traffic category	Year ended May 2004	2005	2006	2007		Compound annual growth rate 04-07
Direct traffic	116,900	119,600	130,300	146,800	(80.5%)	7.9%
(Annual % change)		(+2.3%)	(+8.9%)	(+12.7%)		
Indirect traffic	9,200	8,700	9,300	10,000	(5.5%)	2.8%
(Annual % change)		(-5.4%)	(+6.9%)	(+7.5%)		
Beyond traffic	21,600	22,200	21,400	25,600	(14.0%)	5.8%
(Annual % change)		(+2.8%)	(-3.6%)	(+19.6%)		
Total traffic	147,600	150,500	161,000	182,400	(100.0%)	7.3%
(Annual % change)		(+2.0%)	(+7.0%)	(+13.3%)		

4.1 The Australia – PNG route has shown solid growth over the past few years and the past two years in particular. The average annual growth rate for the three years ending May 2007 was 7.3%. The growth rate for the most recent year ended May 2007 was 13.3%. The growth in recent years represents a recovery in traffic levels, which declined significantly in the four years after 1999. Current traffic numbers are still below 1999 levels.

4.2 In the year ended May 2007, a total of 182,400 passengers were carried on the route. Most of this traffic (80%) travelled directly between the two countries with an origin and destination of PNG and Australia. A small proportion, about six percent, travelled between Australia and PNG via other countries. A further 14% of passengers on the route flew from or on to destinations beyond Australia or PNG.

4.3 Focusing on the traffic with an origin and destination in Australia or PNG, there were about 156,800 passengers on the route in the year ending May 2007. This comprises the direct plus indirect traffic from the table above. In other words, an average of about 1,510 passengers travelled each way each week between the two countries. Of this traffic, about 59% is made up of Australian residents, with PNG residents accounting for 41% of the end-to-end market.

5 Applicant's supporting arguments

5.1 Qantas provided detailed arguments in support of its application for continued authorisation of the code share arrangements until 30 June 2012. These are summarised below. Qantas also provided confidential data requested by the IASC.

Introductory remarks

5.2 In overview remarks, Qantas stated that the code share arrangements have delivered substantial benefits, including to consumers. They had enabled the PNG route to remain profitable for both Qantas and Air Niugini by providing for an efficient use of capacity, against a background of rising fuel prices and increasing competition on the route, which had resulted in lower market share. Qantas considered that the code share arrangement offered the best prospect for maximising public benefits and underpinning continued viable operations by both carriers. In Air Niugini's case, this was of vital importance to the PNG economy.

Development of the code share

5.3 Qantas canvassed the historical development of its long-standing code share relationship with Air Niugini, which extends from 1987. Initially encompassing code sharing by Qantas on Air Niugini services between Cairns and Port Moresby, the arrangement has been varied for a number of reasons from October 2001. In March 2002, the PNG government invited Qantas to consider options for ensuring the viability of Air Niugini's operations, following growing financial losses being experienced by that airline. This led to development of the current structural arrangements between the airlines, which were implemented from September 2002. They involved Qantas ceasing its own flying on the Sydney/Brisbane – Port Moresby sectors but maintaining its presence in the market by code sharing on all Air Niugini's services. The arrangements also enabled Air Niugini to enter into a lease arrangement for a B767-300 aircraft which provided improved service standards.

5.4 The specifics of the code share arrangements have developed over time. Currently, Qantas code shares on Air Niugini’s seven services per week between Brisbane and Port Moresby – two of which extend to Sydney, and its nine weekly services between Cairns and Port Moresby. Currently, Qantas purchases a hard block of seats on all Air Niugini flights and has the option to purchase a further number of seats if market conditions warrant. The hard block component exposes Qantas to the full commercial risk of selling these seats. The additional seat option is a soft block arrangement.

5.5 Qantas also purchases about half of the belly-hold cargo space on the B767 services between Sydney/Brisbane and Port Moresby. This is also a hard block arrangement, with an option of taking additional space on a soft block basis. Qantas does not purchase cargo space on Air Niugini’s Cairns – Port Moresby services.

Route characteristics

5.6 Qantas pointed out characteristics of the Australia – PNG passenger market which made the route unique amongst those served by the airline. In overall terms, the origin-destination (O/D) market had grown by nine percent in 2006, compared with the previous year, to 1,426 passengers each way each week. About 60% of this traffic was made up of Australian origin travellers. There is very little traffic travelling beyond Australia or PNG to third countries.

5.7 The route is unusual for the high proportion of passengers travelling for business purposes. Business travellers make up to 60% of the Australian origin/destination passengers on the route. This large business component leads to another related unique feature of the route, which is the variation in demand according to the day of the week. Peak demand is for southbound services on Fridays and Sundays. Northbound travel peaks on Sundays and Mondays, although this is less pronounced than for southbound travel.

Yields

5.8 The high business component has also led to an unusual passenger mix within the business and economy cabins. Passenger mix refers to the distribution of passengers travelling on different fare types within the same class of travel. A substantial proportion of travellers within the economy cabin pay full economy fares rather than lower discount fares. The result is that Qantas has achieved strong yields on the route. The non-business component is comprised mainly of Visiting Friends and Relatives (VFR) traffic, some expatriate leisure traffic, students returning home in vacation periods and a small soft-adventure market.

Competition

5.9 Qantas’ performance on the route had been affected by the entry of Airlines of PNG in November 2005 and its expansion of services since that time. This airline now operates daily de Havilland Dash 8-100 services between Cairns and Port Moresby, and three weekly B737-200 services between Brisbane and Port Moresby. In total, Airlines of PNG now operates 507 seats per week across all of its services, compared with 165 when it entered the route in late 2005.

5.10 The participation of Airlines of PNG has seen a decline in the market share of Qantas and Air Niugini. In the last two months of calendar year 2006, the combined Qantas/Air Niugini market share fell below 80% as the impact of Airlines of PNG services between Brisbane and Port Moresby began to be felt. Qantas stated that although Airlines of PNG's market share was still modest, it had grown quickly. The Australian Competition Tribunal was cited by Qantas as recognising the role of small but aggressive competitors in constraining the behaviour of larger competitors.

5.11 Similarly, the increasing capacity operated by Airlines of PNG had seen a fall in Qantas' seat factors, despite growth in the overall market. Between 2005 and 2006, its average seat factor on the Australia – PNG route fell by six percentage points to 65%. This effect was expected to continue into the future, with Qantas reporting its forward bookings for the period May to August 2007 to be 11% lower than for the previous year's bookings at the same point in time. On a related point, Qantas explained that the PNG route was characterised by late booking to a greater degree than its other international routes. The entry of Airlines of PNG has accentuated this pattern, with the period between the time of booking and travel date decreasing significantly over the past eight months.

5.12 Qantas cited statistics from the Bureau of Transport and Regional Economics which showed that total market seat factor in the 12 months to November 2006 was 50%. Qantas argued that this demonstrated that the market was not capacity constrained.

Pricing

5.13 In relation to pricing, Qantas and Air Niugini act independently of each other. They separately set prices, fares and associated rules, operate their own yield management systems and sell through their respective sales networks.

5.14 Qantas claimed that the hard block element of the code share provides a significant incentive to compete with Air Niugini. The PNG carrier's fares are sometimes below the hard block seat price that Qantas pays Air Niugini for its code share seats. Qantas said that it had offered a number of special fare initiatives since February 2005, from both Australia and PNG. Qantas also introduced a simplified economy class fare structure in December 2006, responding to concerns over losing market share to Air Niugini and Airlines of PNG.

Freight market

5.15 Arrangements between Qantas and Air Niugini in relation to freight apply to six B767 services per week between Brisbane and Port Moresby, with two services connecting to and from Sydney each week. All space is sold under an Air Niugini flight designator, but Qantas actively sells freight space on these services. Although Qantas freight revenues had fallen for some time, there was a significant increase in 2006 as higher volumes were carried. Cargo rates had remained relatively stable since 2002, although fuel surcharges had been imposed consistent with passenger surcharges.

5.16 Qantas stressed the importance of the wide-bodied aircraft for carrying palletised and containerised freight. The B767-300 aircraft carries up to seven tonnes of freight per flight. By contrast, B737 aircraft have no container or pallet capability, so can carry only loose cargo. Specialised and higher value freight, such as seafood, could not be carried on a B737.

Situation without the code share arrangements

5.17 Qantas stated that ending the code share arrangements would increase average cost for Qantas and Air Niugini and result in an erosion of public benefits. Qantas indicated that it would be likely to return to operating to PNG in its own right and has a range of suitable aircraft types which would enable an attractive high frequency service to be offered.

5.18 Qantas considered that its own-operated services would be profitable, but expressed concern about the likely impact its re-entry to the route would have on the viability of Air Niugini's international services. Air Niugini would almost certainly have to reduce frequency if Qantas resumed services. As the B767-300 is Air Niugini's only wide-bodied aircraft and is used for all of its other international services, except Cairns, reduced flying hours could undermine the economic viability of the aircraft.

5.19 Qantas did not consider that it would be viable for Air Niugini to increase frequencies on its other routes served by the B767. The likely result would be that Air Niugini would have to cease operating the wide-body aircraft and replace it with a narrow bodied aircraft. This would enable Air Niugini to continue to compete with Qantas on frequency on the PNG route, but would have consequences for Air Niugini's other international routes.

5.20 Should both airlines operate narrow-bodied aircraft on the route, this would result in greatly reduced belly-hold freight capacity with significant implications for the carriage of cargo.

Summary of claims against the paragraph 5 criteria

5.21 Qantas claims against the paragraph 5 criteria in the Minister's policy statement are as follows:

<u>Competition benefits</u>

5.22 Qantas stated that the predominantly hard block nature of the code share arrangements meant that competition was retained between Qantas and Air Niugini, including incentives for price discounting. The maintenance of separate seat inventories means that the effect is as if two smaller aircraft were flying instead of one larger aircraft. As noted above, each airline sets its fares independently of the other and sells its products through its respective sales networks.

5.23 Qantas said that the code share arrangements do not represent a barrier to entry by prospective competitors. Airlines of PNG had increased its market share by seven percentage points from November 2005 to December 2006. Queensland Regional Airlines had also received a capacity allocation from the Commission to enable it to operate six weekly de Havilland Dash-8 services between Cairns and Port Moresby, but was yet to commence services.

5.24 There was also scope for other new entrants, with almost 70% of the capacity available to Australian airlines under the air services arrangements unused. Virgin Blue, for example, would be in a position to take up PNG capacity if it wished. There was greater scope for new entry by other Australian carriers on the PNG route compared with other international routes because of the short distance involved in flying to Cairns and Brisbane from Port Moresby. Domestic aircraft types would be suitable for these services.

Tourism benefits

5.25 Qantas stated that there was limited scope for the promotion of inbound tourism to Australia because of the characteristics of the PNG economy and the relatively small PNG population. Qantas suggested that data on the number of holiday makers visiting Australia need to be treated with caution, due to the particular characteristics of the market. A large number of expatriate Australians resident in PNG make multiple visits to Australia and are likely to categorise their journey purpose as holiday. The underlying true tourism component of PNG residents visiting Australia is therefore small and Qantas does not anticipate strong growth. However, the code share arrangements do provide the best means of encouraging PNG nationals to holiday in Australia.

Consumer benefits

5.26 Consumers have benefited from the code share through improved frequency and schedule choice through the presence of both airlines in linking Sydney/Brisbane and Cairns with Port Moresby. The number of weekly seats operated by Air Niugini overall had risen from 1,594 to 2,349 over the period of the code share, although the weekly frequency had risen only from 15 to 16. Seats and frequencies available to Cairns had fallen slightly, while there had been an increase in seats and frequency to Brisbane (the latter coinciding with the withdrawal of Qantas' operated services).

5.27 Qantas said that convenient connections were offered for domestic transfer passengers and for passengers travelling beyond or behind Australia, particularly New Zealand and the United States. The daily schedule offered under both airlines' flight designators was attractive to connecting traffic and to Qantas frequent flyers. Qantas noted that Air Niugini's schedules were limited to daylight hours because of concerns about security and landing lighting facilities.

5.28 The code share arrangement had enabled Air Niugini to lease a B767-300, which provided better levels of passenger comfort than the previously operated A310 aircraft.

5.29 Qantas re-emphasised earlier comments about pricing initiatives and fare restructuring to remain competitive against Air Niugini and Airlines of PNG. A new economy class fares structure implemented in December 2006 had given passengers more flexibility and options than previously, including the ability to buy half-round-trip fares and to book online. A lower entry-level economy fare for Cairns – Port Moresby of A$535 replaced the previous fare of A$595. Qantas now offered five year-round fares, compared with two prior to December 2006.

5.30 Qantas pointed out difficulties in PNG which limited the scope for attracting the leisure market, particularly law and order issues, but also health and infrastructure concerns.

Trade benefits

5.31 Qantas again stressed the importance of the wide-bodied B767-300 aircraft in facilitating the carriage of palletised and containerised freight, compared with alternative aircraft types such as the B737 which have no such facility. The six services per week between Brisbane and Port Moresby with twice weekly connections to Sydney provide Australian exporters with a choice of day and schedule stability. Qantas said that no other carriers currently provided reliable services in the Australia – PNG scheduled freight market. Other carriers had been allocated scheduled capacity but had not sustained effective regular services.

5.32 Qantas also provided freight forwarders with the ability to tranship product to wider markets in Asia, particularly Japan, on a reliable and regular basis. Qantas noted the availability of a global network of 135 countries covered by the oneworld alliance, as well as its arrangements with Australia Post and Australian Air Express.

5.33 Qantas said that its base cargo rates had remained fairly stable since 2002, although fuel surcharges had been imposed in line with those applied to passenger fares. Qantas also highlighted other benefits of the code share, including reduced risk and cost to the airlines through their joint contribution towards operating costs. Qantas actively sells space on the wide-bodied aircraft as part of its commitment under the code share arrangements.

Expected outcomes in the absence of the code share

5.34 Qantas argued that there would probably be a restructure of operations in the absence of code share approval, with the most likely adverse outcomes being for Air Niugini's future operations. Qantas indicated that it would most likely return to the route with own-aircraft operations. Qantas had aircraft suitable for operations on the route, and considered that its own operations would be profitable, but this could be to the detriment of Air Niugini's international service viability. The withdrawal of Qantas' brand would remove marketing and promotional support for Air Niugini's services.

5.35 While there could be some short-term capacity increases with both airlines operating on the route, but this would not be sustainable in the longer term. Reduced Air Niugini schedules would be an almost certain consequence. Unless alternative flying could be found for Air Niugini's B767, this would be likely to undermine its economic viability. Qantas considered that it was unlikely Air Niugini could sustain expansion of its other international services to Asian points. It was likely that Air Niugini would need to cease operating the wide-bodied aircraft and replace it with a narrow-bodied one. This in turn would have consequences for Air Niugini's other international routes.

5.36 The loss of the wide body aircraft would substantially reduce belly-hold freight capacity and it was unlikely that other freight operators would be able to provide the regular schedules currently in place under the Qantas/Air Niugini partnership.

6 Summary of submissions

6.1 The Australian Competition and Consumer Commission (ACCC) made a submission on 15 June 2007. The ACCC noted that the changes to the code share arrangements in 2002 involved Air Niugini assuming responsibility for flying on the Australia – PNG route. The ACCC said that it was generally likely to have concerns about code share proposals which involved an operating carrier withdrawing services from the affected routes. It noted that Air Niugini's financial situation was considered by the IASC to be critical at the time of the 2002 decision and that continued operations would be jeopardised without the code share.

6.2 The ACCC noted that the block space nature of the code share provided some commercial incentives for the marketing carrier to sell seats, but that the code share partners maintained an interest in the financial position of the other airline. Airlines of PNG provided some competition on the route, having gathered 13% and 15% of the economy and business markets respectively. The ACCC would be concerned if the code share arrangements limited the further expansion of an efficient operator.

6.3 The ACCC stated that the likely re-entry by Qantas to the route, in the absence of code share approval, meant that the financial impact Air Niugini would need to be carefully re-examined in the light of different possible scenarios.

7 Commission's assessment

<u>Assessment framework</u>

7.1 Under section 15(2)(e) of the *International Air Services Commission Act (1992)* (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 it to code share on Air Niugini's services.

7.2 Under the Minister's policy statement, the Commission is normally expected to authorise applications for use of capacity to code share where this is provided for under the relevant air services arrangements. However, where the Commission is concerned that a code share application may not be of benefit to the public, it may subject the application to detailed assessment against the paragraph 5 public benefit criteria in the policy statement. The Commission must consult with the ACCC before doing so and has done so in this case.

7.3 In authorising a short-term extension of the code share arrangements until end-February 2008 (Decision [2007] IASC 2008), the Commission set out its concerns about the possible impact on competition of continuation of the code share over the longer term. Accordingly, the Commission has indicated to Qantas that it would assess the airline's application for extended authorisation against the public benefit criteria in paragraph 5 of the Minister's policy statement.

7.4 The Commission's review has been undertaken concurrently with consideration by PNG's Independent Consumer and Competition Commission (ICCC) of an Air Niugini application to that body for authorisation of the conduct under the code share arrangements between the two airlines. The two authorities agreed in December 2006 to co-ordinate their respective review processes. As part of this process, they have exchanged data relating to the operation of air services on the route, including confidential information provided by Qantas and Air Niugini, with the prior agreement of the airlines. The two Commissions have discussed their analysis of the data in relation to the public benefit frameworks under their respective legislative frameworks. While there are differences between these frameworks, there are broad similarities in terms of assessing competition impacts and public benefits associated with the code share arrangements. However, each Commission has reached its own conclusions, consistent with its particular legislative requirements.

The draft decision

7.5 On 7 September 2007, the Commission issued Draft Decision [2007] IASC 211 proposing to authorise a continuation of code sharing until 31 December 2009 subject to a number of conditions. On 21 September 2007, Qantas made a submission in response to the draft decision. Qantas' views on the Commission's draft decision are discussed in the Commission's assessment below. Qantas also commented on two proposed conditions in the ICCC's draft decision which were not included in the Commission's draft decision. The Commission anticipates that the ICCC will address these particular concerns in its final decision.

7.6 Air Niugini also made a confidential submission on 3 October 2007. This was a copy of a submission to the ICCC. The thrust of the submission as far as it applied to the Commission's draft decision was that Air Niugini sought a longer period of authorisation than the 31 December 2009 date proposed by the Commission.

Detailed assessment

7.7 The Commission's assessment of the Qantas code share proposal against the paragraph 5 criteria in the Minister's policy statement is as follows:

Competition Benefits

(a) In assessing the extent to which applications will contribute to the development of a competitive environment for the provision of international air services, the Commission should have regard to:
- the need for Australian carriers to be able to compete effectively with one another and the carriers of foreign countries;
- the number of carriers on a particular route and the existing distribution of capacity between Australian carriers;
- prospects for lower tariffs, increased choice and frequency of service and innovative product differentiation;
- the extent to which applicants are proposing to provide capacity on aircraft they will operate themselves;
- the provisions of any commercial agreements between an applicant and another carrier affecting services on the route but only to the extent of determining comparative benefits between competing applications;
- any determinations made by the Australian Competition and Consumer Commission or the Australian Competition Tribunal in relation to a carrier using Australian entitlements under a bilateral arrangement on all or part of the route; and

- any decisions or notifications made by the Australian Competition and Consumer Commission in relation to a carrier using Australian entitlements under a bilateral arrangement on all or part of the route.

7.8 The Commission has authorised code sharing by Qantas on Air Niugini's services on the Cairns – Port Moresby sector since 1992. The Commission has not previously had concerns about the competition impact of these particular arrangements, However, it is reviewing this element of the code share arrangements at this time as they form part of the broader set of code share agreements for which Qantas has sought authorisation.

7.9 Of more concern for the Commission is the impact on competition on the PNG route which has occurred since the code share arrangements were expanded in mid-2002 to include the Sydney/Brisbane – Port Moresby sectors. When granting approval to the expanded code share arrangements in August 2002, the Commission expressed concern about the possible implications for competition on the route. There were then and still are no third-country carriers operating on the route which could provide competition for Qantas and Air Niugini.

7.10 The changes in September 2002 saw an ending to flying by Qantas on the PNG route, leaving Air Niugini as the sole operator with Qantas participating in the route only by code sharing on Air Niugini's services. The changes meant that Sydney and Brisbane travellers no longer had a choice of carrier and Sydney passengers had weekly frequencies reduced from six to two.

7.11 Although the hard block nature of the code share arrangement created some incentive for price competition between Qantas and Air Niugini, this was greatly reduced from the situation which had prevailed when both airlines operated their own services in direct competition with each other. There were some offsetting benefits through additional weekly services to Brisbane and Cairns and the introduction of the wide-body B767 aircraft, which provided improved on-board service levels compared with the A310 aircraft it replaced.

7.12 However, the overriding consideration in the Commission's August 2002 decision was concern about Air Niugini's poor financial circumstances. The Commission considered that there would be sharply reduced public benefits if Air Niugini was unable to continue to operate on the Australia – PNG route. Competition would be greatly reduced, with only Qantas operating on the route, and there would be a risk of monopoly pricing as a result. There was likely to be a greater public benefit detriment from such an outcome than might be associated with the situation under the expanded code share.

7.13 Confidential data provided by Qantas and Air Niugini shows that both airlines enjoy attractive passenger revenue yields on the PNG route. An important contributor to this situation is the unusually high proportion of business traffic on the route. Well over half of Australian resident travellers (who comprise nearly 60% of the total market) travel for business purposes, as do over a quarter of PNG residents. Qantas stated that its services on the PNG route attract a greater percentage of business travellers than on any of its other routes, both domestic and international.

7.14 The uniquely large proportion of business travellers accounts in significant part for the high revenue yields on the route. Business travel demand is far less sensitive to fare levels than the leisure market. The necessity to travel for work purposes means that business passengers will generally not change their frequency of flying despite high fares. This is the case even for business passengers travelling in the economy cabin, who will generally prefer fully flexible fares including the ability to book or cancel fares at short notice.

7.15 The Commission considers that, as it anticipated might occur, the expansion of the code share arrangements did little to facilitate competition between Qantas and Air Niugini. For some time after the new arrangements were implemented, air fare levels were generally higher than might have prevailed in a more competitive market, even given the fare inelasticity of much of the market. However, the competitive situation improved noticeably with the entry of Airlines of PNG onto the route. This airline, while small, has offered important competition on both the Cairns (since late 2005) and Brisbane (since late 2006) to Port Moresby sectors.

7.16 The data available to the Commission suggests that air fares have fallen significantly for passengers travelling on economy fares since Airlines of PNG entered the Cairns and Brisbane sectors. There is a considerably larger range of fares and fare types in economy class available from day to day, compared with the situation prior to the entry of Airlines of PNG. These developments suggest an improved level of competition in the market over the past one to two years.

7.17 There is some evidence that business class travellers have also benefited from slightly lower fares, particularly when travelling on Air Niugini tickets. There is less evidence that Qantas business class passengers have enjoyed similar improvements. However, the Commission notes that consumers do have a choice as to whether to purchase an Air Niugini or Qantas fare. Many are clearly willing to pay the typically higher Qantas fare despite the availability of lower Air Niugini and Airlines of PNG fares. This suggests that there are non-fare related factors which influence the preference of some travellers to fly with Qantas rather than Air Niugini despite a sometimes substantial price differential. These factors might include ease of baggage transfer for Australian passengers connecting with Qantas domestic flights to points behind the Brisbane and Sydney gateways.

7.18 An issue which can potentially influence fare levels is the level of aircraft load factors. Where load factors are high, airlines are under little pressure to compete with each other via discounting to fill seats which might otherwise be left empty.

7.19 The Commission is generally encouraged by the fact that overall load factors are not especially high on the Australia – PNG sectors. Indeed, on the Sydney sector they are low, due mainly to the intermediate stop at Brisbane where many passengers leave the aircraft on southbound journeys and join it on northbound services. However, the broad picture disguises some differences between Qantas and Air Niugini. Qantas enjoys slightly higher load factors than Air Niugini. Under the agreed hard/soft block arrangements, Qantas generally purchases less than half of the seats available on Air Niugini's services, sometimes much less than half. It is therefore able to achieve a higher load factor for the same number of seats sold as Air Niugini and so is often under less pressure than Air Niugini to sell seats on any particular flight. This may be a further factor in the price differential between Qantas and its competitors.

7.20 Looking at this issue in more detail, Qantas has argued in its submission that the hard block component of the code share provides incentive for it to price competitively, as it must sell sufficient seats to at least cover the seat block charge it pays to Air Niugini. However, under the code share arrangements the number of seats in the Qantas hard block varies from day to day, with smaller blocks purchased by Qantas on days of lower demand. The number of seats in the hard block on some flights is small. This means that the arrangements work to Qantas' advantage in matching its supply of seats to the considerable demand variations on the route on different days in the week. For example, many more passengers travel ex-Australia on Sunday and Monday compared with other days. By contrast, Air Niugini is left to sell the balance of seats on all flights, with a higher number of seats to sell on days of weaker demand.

7.21 The Commission considers that the block arrangements inherently favour Qantas relative to Air Niugini. Of the two partners, Air Niugini is likely to be placed under more pressure to price competitively to sell its seats than Qantas, particularly on days of low demand when Qantas buys from Air Niugini a smaller proportion of the seats on the aircraft.

7.22 A reinforcing feature of the code share is that Qantas has the option to purchase further seats up to an agreed limit on each Air Niugini flight within a soft block of seats. This means that Qantas has considerable flexibility in managing the supply of seats it has available for sale. It can purchase more seats if its hard block is likely to be fully sold, or not do so if the hard block is only partially sold. Given this flexibility in supply, and the overall matching of hard seat block sizes to day to day demand, the Commission considers that Qantas is in a position to generate strong returns without intensive marketing effort or the need to discount significantly.

7.23 The Commission considers that the arrangements would be more competitive if the Qantas hard block seat numbers were larger and more uniform across flights on different days, with smaller or no soft block components. The Commission understands that the current code share arrangements are due to expire in late October 2007 and will therefore require renegotiation by the airlines prior to that time.

7.24 In responding to this issue in the draft decision, Qantas stated that it was no different from any other carrier in seeking to enter into arrangements that enhanced its competitive position. Qantas said that it was not unusual for the operating carrier to carry greater risk than the marketing carrier. However, Qantas advised that it would take the Commission's views on this issue into account in the forthcoming renegotiation of the block arrangements with All Niugini, while aiming to achieve an outcome which was in Qantas' commercial interests.

7.25 The Commission maintains its view that the imbalances in the seat hard block sizes, and the flexibility afforded to Qantas by the soft block arrangements, work to the advantage of Qantas relative to Air Niugini and reduce the level of competitiveness between the code share carriers. The Commission is pleased to note Qantas' advice in its submission on the draft decision that it will take the Commission's view into account when renegotiating the seat block arrangements.

7.26 The Commission notes that there is little competition from third country carriers in the Australia – PNG market. This reflects the close proximity of the two countries, with no intermediate countries with potential competitor airlines. Only about six percent of the traffic on the route travels via third countries. All passengers travelling in this way would have longer journey times involving a change of aircraft. They presumably follow such a routing to visit third countries enroute to Australia or PNG.

7.27 The absence of third country carriers means that the importance for competition on the route of locally-based carriers, such as Airlines of PNG, is amplified. There has always been the threat of new competition on the route because the air services arrangements allow for multiple national carriers and there is ample capacity available. However, there is little, if any, evidence that this potential for competition constrained the pricing behaviour of the code share partners. It appears that only the imminent and then actual entry of Airlines of PNG prompted more competitive pricing by the code share partners.

7.28 In this respect, the Commission notes the planned entry of Queensland Regional Airlines to the Cairns – Port Moresby sector from late 2007. This should add a further important competitive stimulus to that sector. As noted earlier, the Commission has had few concerns about the long-standing code share arrangements on the Cairns sector. The presence of two competitors for Qantas and Air Niugini on that sector alleviates further those modest concerns.

7.29 The Sydney/Brisbane – Port Moresby sectors continue to be the area of concern for the Commission from a competition viewpoint. Airlines of PNG has been operating on this sector for less than a year. Although this airline has established a meaningful presence, with its B737 aircraft now operating three times per week, the Commission would need to see ongoing evidence of improved fare levels before it was satisfied that there are no longer significant competition concerns associated with the code share arrangements.

7.30 Should another new entrant with the ability to operate jet services take up the opportunities available under the air services arrangements, this would no doubt have a substantial effect on competition on the route and improve the level of public benefits.

7.31 An issue the Commission must consider is the likely competitive framework in the absence of code share approval. The Commission would authorise continuation of the code share if it assesses that there could be the same or fewer public benefits in the absence of the code share. As mentioned above, the Commission had serious concerns in 2002 that Air Niugini could exit the Australian market if the code share arrangements were not authorised. This raised the possibility that Qantas would be left as a monopoly provider on the route and public benefits could be lessened as a result. An important objective in approving the expanded code share was to avoid this outcome.

7.32 Air Niugini's published financial statements indicate that the carrier has recovered its financial state since 2002, when it was in a serious situation. The Commission's assessment is that the airline is now in a sound financial position, having strengthened its finances consistently over the four years to the end of 2006. Improved profitability on the Brisbane sector in particular has contributed to the stronger situation.

The Sydney sector is comparatively weak, reflecting the low load factors achieved on the twice-weekly Brisbane extension.

7.33 The introduction of competition from Airlines of PNG has led to a moderation in Air Niugini's profit levels in the past two years, as Air Niugini has responded with reduced fare levels. In the Commission's view, this restored the balance between consumers and airlines from the code share which had previously been flowing to Air Niugini (and Qantas) at the expense of the travelling public. Along with lower fares, mainly for economy passengers, is increased choice of carrier, higher frequency of services and choice of time of travel.

7.34 The Commission considers that, if code share approval is not continued, Qantas would almost certainly re-enter the Sydney/Brisbane – Port Moresby sectors, but is unlikely to operate to and from Cairns. The larger city pairs generate more traffic and are attractive because of the high business component and the attractive revenue yields which accompany it. Qantas has never operated between Cairns and Port Moresby in its own right, but served Sydney/Brisbane until the 2002 code share changes were implemented.

7.35 To achieve the frequency needed to serve the business market, Qantas would probably offer daily or near daily services to and from Brisbane/Sydney. It would be likely to use a narrow-body B737 aircraft, because a wide-body aircraft would add excessive amounts of capacity to the route. However, even the introduction of the B737 could see about a 60% increase in capacity.

7.36 The introduction of services by Qantas would dramatically alter the market's dynamics. All carriers would need to compete aggressively for market share and prices would be likely to fall as a result. This would result in improved benefits to the public. However, the characteristics of the Australia – PNG market, with its small leisure component and limited scope for rapid growth in the short to medium term, is likely to mean that traffic levels would not be stimulated sufficiently to enable any carriers to operate profitably. Airlines of PNG and Air Niugini, with their relatively high dependency on this route compared with Qantas, would be the most vulnerable to a prolonged period of losses.

7.37 There is likely to be a rapid readjustment of operations on the route by PNG carriers in response to Qantas' entry. This could mean Airlines of PNG withdrawing and Air Niugini reducing frequencies. Even with less flying, Air Niugini's operations on the Sydney/Brisbane – Port Moresby sectors would be unlikely to be profitable. In time, perhaps over a period of as little as one to two years, Air Niugini may be forced to withdraw from the Sydney/Brisbane sector, with the prospect that Qantas may have a monopoly position on the route. Essentially this is the scenario which the Commission was concerned could develop in the absence of code share approval when considering the situation in 2002.

7.38 As noted above, there could be a period of improved public benefits in the short term, but the loss of PNG carriers or reduced flying would erode public benefits as choice of carrier and frequency diminished. The longer term public benefit outcome is likely to be worse than under the code share.

7.39 The broader financial impact on Air Niugini could be serious, as there is limited scope to deploy its large B767 into its other international markets, which are all fairly small. In this respect, the Commission observes that the B767 may not be an ideal size for the small Australia – PNG passenger market, although it plays an important role in the freight market, as discussed below. The aircraft is large for what is a comparatively thin passenger route and provides little flexibility to match frequency to changing demand. The Commission understands that Air Niugini will be replacing its existing B767 with a newer B767 aircraft and that this is configured with fewer seats than the current aircraft. This might assist somewhat in better matching seats available to demand and allow for slightly improved economics of operation.

7.40 However, even with a new B767, there would be a significant issue for Air Niugini to manage if the code share approval was discontinued. Air Niugini's other international routes are not large and the addition of extra services to these with the B767 instead of on Australian sectors may not be profitable. Over time, the risk is that Air Niugini's financial situation might deteriorate to the point where financial support from its owner, the PNG Government, was required.

<u>Other Benefits</u>

Tourism Benefits

(b) In assessing the extent to which applications will promote tourism to and within Australia, the Commission should have regard to:

- 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).

7.41 As noted above, traffic levels on the Australia – PNG market have been growing at a moderate rate over the past two years, but tourist traffic to Australia makes up only a small proportion of the market. PNG visitor traffic accounts for just over 40% of the total market and a large proportion of this is for non-tourism purposes including business, visiting friends and relatives, attending conventions and educational institutions. In 2006, fewer than 11,000 visits to Australia were for holiday purposes and much of this may have been by expatriate Australian citizens living in PNG. The small tourism element in the total market means that this criterion is of relatively minor significance in the overall consideration of public benefits associated with the code share arrangements.

7.42 The relatively low average income levels of PNG residents means that only a small proportion of the population is a realistic target market for tourism to Australia and for the foreseeable future. However, the presence of both code share partners in promoting travel to Australia is likely to have been a positive factor in the development of the small market that does exist. The added presence of Airlines of PNG to the market has increased the tourism marketing effort.

7.43 Withdrawal of code sharing approval may not improve the situation, particularly if there are reduced services to Australia, Brisbane in particular, in the wake of Qantas' re-entry to the market with lower promotional support for tourism from Air Niugini and Airlines of PNG as a consequence.

7.44 The code share arrangement facilitates some travel to and from points beyond gateways. For example, Qantas draws some tourist traffic via Brisbane and Sydney to and from other Australian cities, and some traffic flows behind Australia to and from third countries such as New Zealand and beyond PNG to other countries. However, these are small segments of the total market.

Consumer Benefits

(c) In assessing the extent to which the applications 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 standards of service;
- 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).

7.45 Consumers suffered a decline in certain respects when the expanded code share arrangements were introduced in September 2002. As noted above, Qantas withdrew from the route, leaving consumers with no choice of carrier. Service frequencies to Sydney also fell from six to two per week. There were some offsetting benefits. There was a small increase in frequencies to Brisbane and Sydney and Air Niugini introduced a B767 aircraft which had improved onboard service levels compared with the Airbus aircraft which it replaced.

7.46 Since that time, there has been little or no evidence of service innovation by the code share partners. Although there were no submissions to the Commission about service standards on the code share services, the Commission is aware that concerns about this issue have been raised in several submissions to the ICCC's review of the code share arrangements. However, as noted above, Air Niugini plans to replace the current B767 with a new version with fewer seats, which should improve the onboard amenity of passengers.

7.47 Until mid-2005 there was little evidence that efficiencies generated by the code share arrangements were passed on to consumers in the form of lower fares. Instead, the efficiency gains led to increased airline profits, although to the extent that this ensured the continued viability of Air Niugini, this was of benefit to consumers.

7.48 The most significant development for consumers has been the introduction by the code share partners of improved tariff structures, with more flexible fare types and lower fare levels mainly for economy class travellers following the entry of Airlines of PNG. Consumers now have a choice of direct carrier with alternative service arrangements, and increased options of days and times of travel particularly to/from Cairns but also to and from Brisbane.

7.49 As noted above under the Tourism criterion, there are possibilities for travel to and from points beyond gateways within Australia and PNG, as well as to countries beyond. However, only a small component of the market takes advantage of these options.

These possibilities would be broadly the same in the absence of code sharing provided frequency levels were maintained.

Trade Benefits

(d) In assessing the extent to which applications will promote international trade, the Commission should have regard to:

- the availability of frequent, low cost, reliable freight movement for Australian exporters and importers.

7.50 The code share arrangements do not formally extend to the carriage of freight. All freight is carried on Air Niugini flight designators. However, Qantas sells freight for carriage on Air Niugini's B767 aircraft. Qantas does not purchase freight space on Air Niugini's Cairns services.

7.51 The code share arrangements have been important in maintaining the presence of the wide-body B767 aircraft on the Brisbane/Sydney – Port Moresby sectors. Qantas has placed considerable emphasis in its application on the importance of this aircraft for the movement of freight between the two countries. It argued that much of the freight on the aircraft is carried on pallets and containers, including freight which is transhipped to third countries such as Japan. This cargo could not be carried on narrow-bodied aircraft such as the B737.

7.52 The Commission has analysed carefully the freight market. There is a considerable volume of freight carried on the PNG – Australia route, with higher volumes travelling northbound. Southbound, the main product carried by value is gold, although this appears to travel mainly on charter services. The dominant product by weight is fish, a time sensitive commodity. There is also a significant amount of coffee exported to Australia.

7.53 In the larger volume northbound market there is a considerable amount of fresh produce including dairy products, eggs and fruit and vegetables. These are essential to the food supply of PNG. There is also a large amount of industrial and office machinery and many other items. Much of this freight is only suitable for carriage on pallets or in containers.

7.54 The Commission considers that the presence of a wide-body aircraft has proved vital to accommodating the weekly volume of freight on the route. The aircraft facilitates the carriage of larger cargo items which could not be carried loose in the holds of smaller aircraft. The loss of wide-body services on the PNG route could potentially have serious implications for the freight market between the two countries and also trans-shipment of freight to third countries which currently moves in containers or on pallets. It is not clear to the Commission whether an alternative avenue for the carriage of freight might emerge, such as a dedicated regular jet all-cargo service. The current volume of freight on the route, including its directionality (most freight travelling north), may not be capable of sustaining a pure cargo service on the frequency currently available under the code share arrangements. However, existing freight operators might be able to take advantage of the situation to expand their presence.

Industry Structure

(e) The Commission should assess the extent to which applications will impact positively on the Australian aviation industry.

7.55 The code share arrangements have had a positive impact on the Australian aviation industry through the generation of profits for Qantas on the route. On the other hand, they have involved the loss of flying by Qantas, which has reduced the participation of Qantas staff on the route. However, there is unlikely to have been any significant impact on overall employment levels as a result of the code share arrangements.

8 Conclusion

8.1 The Commission concludes that the expanded code share arrangements have achieved the important objective of restoring Air Niugini to sound financial health. In the first three years after those arrangements were implemented in 2002, the recovery in Air Niugini's finances appears to have come at the cost of reduced competition, with only one carrier on the route, and reduced frequency of service to Sydney. The combined hard-block/soft block nature of the code share arrangements provided only limited competition between Qantas and Air Niugini. The variable size of the Qantas hard blocks matched to daily demand patterns, has enabled Qantas to sell its seats without the need to discount fares significantly, especially in business class. Initially, the threat of entry by other carriers appears to have placed little or no price restraint on Qantas and Air Niugini. The absence of any significant presence of third country carriers taking passengers via other countries has also contributed to the lack of competitive pressure on the code share partners.

8.2 However, the entry of Airlines of PNG to the Cairns and Brisbane – Port Moresby sectors from late-2005 and late-2006 respectively changed the competitive dynamics of the route considerably for the better. There is clear evidence that fare levels particularly for economy passengers have fallen significantly, although the route has remained profitable for Air Niugini (and Qantas, the Commission believes), so not threatening the continued viability of Air Niugini's services on the route. There is now a much wider range of fare types and levels available within the market. The additional choice of carrier also provides consumers with a wider choice of times to travel and an alternative in-flight experience in different aircraft types from the incumbent operator. As noted above, Air Niugini is also to replace its ageing B767 with a newer version.

8.3 The Commission has also noted the prospective entry of Queensland Regional Airlines to the Cairns – Port Moresby sector, which will contribute to the competition already in place between those points.

8.4 The code share arrangements have also played an important role in maintaining the operation of wide-body services on the large Sydney/Brisbane sector. Wide-body services are generally preferred by consumers to narrow-body aircraft. However, perhaps the greatest public benefit has been to exporters and importers through the capacity of the B767 to move larger freight items and those in containers or on pallets. There is a substantial level of freight on the route, including time-sensitive products such as fish and other fresh food. The loss of wide-body capability would be likely to adversely affect the movement of this freight in the absence of an alternative option emerging.

8.5 The Commission notes that there is scope for additional entry by carriers of Australia or PNG, although it is unaware of any imminent plans by any operator to do so. Although the threat of entry did not seem to place any pricing discipline on the code share partners, the reality of the entry of two new airlines may have raised the awareness of Qantas and Air Niugini of the potential for further entry in future. This might act as a further incentive to moderate fare levels.

8.6 The Commission notes that Airlines of PNG has been on the Cairns sector for less than two years and on the Brisbane sector for less than one year. This is a limited period against which to assess data on the extent of the impact of that presence on competition. The impact of Queensland Regional Airlines is theoretical only at this stage.

8.7 The extent to which Airlines of PNG and Queensland Regional Airlines are able to sustain and expand their presence on the route is likely to have a large bearing on the impact of the code share arrangements over time. Should those carriers' presence diminish or disappear, there would be scope for the code share partners to again raise prices, to the detriment of public benefit. The Commission would therefore wish to see an extended period of evidence of the impacts of the new carriers on the overall competitive situation on the route, before being satisfied that the improvements in public benefits in the past two years are sustainable. For this reason also, the Commission would want to limit the period of continued code share authorisation against the possibility that less desirable public benefit outcomes develop over the next year or two.

8.8 The Commission considers that, as matters currently stand, removal of code share approval could potentially lead to a less competitive situation than now prevails. In the short-term, there could be higher public benefits as Qantas re-enters the market in its own right, increasing choice of carrier and frequency on the route. Air fares would be expected to fall as carriers fought for market share. However, within a relatively short time, there would probably be a rationalisation of operations, with the most likely scenario being the exit of small carriers and reduced frequencies by Air Niugini, at least in the large Sydney/Brisbane – Port Moresby sector. This could lead to higher fares and reduced public benefits.

8.9 In its draft decision, the Commission proposed to authorise the code share arrangements until 31 December 2009. In responding to the draft decision, Qantas argued that the proposed time frame was extremely limiting from a planning and operational perspective. Qantas noted that Air Niugini was intending to purchase a new wide-bodied aircraft and that uncertainty about continued authorisation beyond December 2009 was likely to have a significant bearing on whether to commit to such a large long-term investment. Air Niugini made similar representations about the period of authorisation in its submission.

8.10 As with any arrangements subject to time-limited regulatory approval, there is inevitably some uncertainty for affected parties about the situation that might prevail beyond the end of the period of approval. However, the Commission notes that the duration of its authorisation in this case is consistent with a number of decisions in other similar cases where the Commission has had concerns about the impact of code share arrangements on competition on a route. Qantas has maintained those other code share arrangements despite commercial uncertainty that might have been associated with shorter term periods of authorisation. It is a matter for Air Niugini to make appropriate aircraft investment decisions given the period of authorisation granted in this case.

8.11 In all of the circumstances, the Commission confirms that it will authorise the code share arrangements until 31 December 2009. The Commission will maintain its standard conditions of approval of the code share, together with requirements for Qantas to report its number of seat available and sold, as well as passenger revenue yields.

9 Decision [2007] IASC 213

9.1 In accordance with Section 24(1) of the Act, the Commission varies Determination [2006] IASC 129 by *deleting* the conditions inserted by Decision [2007] IASC 2008 and *adding* the following conditions:

- "the capacity may be used by Qantas to provide services jointly with Air Niugini until 31 December 2009 in accordance with:
  - the code share agreements dated 11 October 2001 and 30 August 2002;
  - or any subsequent code share agreement between Qantas and Air Niugini for operations on the Australia – PNG route with the prior approval of the Commission;
- under any code share agreement with Air Niugini:
  - Qantas must price and sell its services on the route independently of Air Niugini;
  - Qantas must not share or pool revenues on the route with Air Niugini;
- 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;
- Qantas must submit to the Commission reports each six months on the monthly number of code share seats available for sale and sold by it on each of Air Niugini's operated services on the Brisbane – Port Moresby, Sydney - Port Moresby and Cairns - Port Moresby sectors; and its yields per revenue passenger kilometre for all passenger classes on these services."

Dated: 16 November 2007

John Martin	Vanessa Fanning	Philippa Stone
Chairman	Member	Member