Australian Government

International Air Services Commission

DECISION

Decision:	**[2008] IASC 212**
Variation of :	**[2004] IASC 120, [2005] IASC 123, [2005] IASC 126, [2006] IASC 113 and [2006] IASC 117**
The route:	**Japan**
The applicant:	**Qantas Airways Limited (ACN 009 661 901) (Qantas)**
Public Register:	**IASC/APP/200808**

1 The application

1.1 Qantas applied to the Commission on 6 May 2008 for a variation of a number of determinations (see above) to extend until 30 June 2010 authorisation for Japan Airlines (JAL) to code share on Qantas' services between Tokyo and Cairns and between Tokyo and Melbourne. The current Commission authorisation of the code share arrangements expires on 30 June 2008. A more detailed summary of the application is at section five of this Decision.

1.2 The Commission published a notice on 13 May 2008 inviting submissions about the application. No submissions were received. Material supplied by the applicant is filed on the Register of Public Documents.

1.3 On 11 June 2008, Qantas announced major international schedule changes, including significant alterations to Qantas Group services to Japan. These changes included the withdrawal of Qantas' three times per week Melbourne – Tokyo A330 services from September 2008. Qantas also announced the replacement of Qantas' fourteen weekly B767 Cairns – Tokyo services with daily Jetstar A330 services from December 2008. This meant that authorisation for code sharing between Qantas and JAL on the two sectors would be required only for the period from 1 July 2008 until the ending of the services. Accordingly, Qantas wrote to the Commission on 11 June 2008 advising that it required approval to continue code sharing with Japan Airlines only until 31 December 2008. This would allow sufficient time for the carriers involved – Qantas, Jetstar and JAL – to reach suitable new code share arrangements and prepare for the implementation of the new operating pattern. Qantas advised that it would apply to the Commission for the necessary approvals for arrangements beyond 31 December 2008.

2 Current Services

2.1 Qantas is operating the following weekly services during the Northern Summer 2008 scheduling period:

- 3xA330-300 Melbourne-Tokyo and vv (JAL code shares – 36 seats per flight of which 20 are “hard-block” and 16 “soft-block”);
- 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

- 3xB767-300 Perth-Tokyo and vv;
- 6xA330-300 and 1xA330-200 Sydney-Tokyo and vv;
- 2xA330-300 Sydney-Tokyo-Sydney-Melbourne;

2.2 Jetstar operates:

- 7xA330-200 Sydney-Osaka-Brisbane-Sydney;
- 3xA330-200 Cairns-Osaka and vv;
- 3xA330-200 Cairns-Nagoya and vv; and
- 2xA330-200 Cairns-Osaka-Nagoya-Cairns.

2.3 JALways (JAL subsidiary) operates the following weekly services:

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

2.4 As noted above, Qantas’ pattern of operations on the Japan route will change substantially in the latter part of 2008.

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

3 Traffic Levels

3.1 The table below provides a summary of traffic levels on the Japan route for the year ending March 2008, compared with the previous year. It shows that overall traffic on the route in the March 2008 year fell by over seven percent from the year before.

This overall figure disguises markedly different results for Japanese visitor traffic compared with Australian resident travel.

3.2 Historically, the market has been dominated by the inbound market from Japan. While it still makes up by far the major part, the proportion of Japanese visitors compared with that for Australian residents has been declining for several years now.

3.3 The fall in visitor numbers in the year to March 2008 over the previous year was particularly sharp - visitor traffic fell by over thirteen percent. In terms of numbers, there were over 85,000 fewer Japanese visitors to Australia than in the previous twelve months period.

3.4 In clear contrast, the number of Australian resident travellers rose sharply - by more than thirty percent for the year. An extra 61,000 Australian residents visited Japan in the March 2008 year compared with the year before. The result of these changes is that Australian resident travel now makes up over twenty percent of traffic on the route.

AUSTRALIA - JAPAN
MONTHLY OD TRAFFIC SUMMARY

LATEST YEAR ENDING DATA	MAR 2007 PAX	MAR 2008 PAX	PAX EWEW or OW*		% CHG
TOTAL OD TRAFFIC	1,492,108	1,386,219	13,329	EWEW	-7.10%
TOTAL VISITORS (ARR & DEP)	1,272,682	1,100,268	10,580	EWEW	-13.55%
(Proportion of total OD traffic)	85.29%	79.37%			
TOTAL RESIDENTS (ARR & DEP)	219,427	285,955	2,750	EWEW	30.32%
(Proportion of total OD traffic)	14.71%	20.63%			
TOTAL ARRIVALS (VIS & RES)	743,706	691,982	13,307	OW	-6.95%
TOTAL DEPARTURES (VIS & RES)	748,402	694,237	13,351	OW	-7.24%
TOTAL VISITOR ARRIVALS	636,135	550,789	10,592	OW	-13.42%
TOTAL RESIDENT DEPARTURES	111,857	144,762	2,784	OW	29.42%
SHORT TERM VISITOR ARRIVALS	626,668	541,547	10,414	OW	-13.58%
SHORT TERM RESIDENT DEPARTURES	107,644	140,688	2,706	OW	30.70%

*EWEW = each way each week; OW =one way

Source: Australian Bureau of Statistics

4 Provisions of the relevant air services arrangements

4.1 The air services arrangements between Australia and Japan permit code sharing between the designated airlines of Australia and Japan. Where airlines of the two countries code share with each other, capacity is counted as being exercised only by the operating carrier. Accordingly, the Commission's approval is required for JAL to code share on Qantas-operated flights, but is not needed for Qantas to code share on JAL's services.

5 Summary of original application

5.1 Qantas outlined the history of the code share arrangements, noting that they have covered the Queensland - Tokyo services since 1996 and the Melbourne - Tokyo services from 2002. The Commission's most recent approval in June 2006 approved both sets of arrangements for a further two years until 30 June 2008. Qantas advised that it and JAL continued to comply with all of the conditions of the Commission's authorisation.

5.2 Qantas advised that since the Commission's previous review, conditions on the route had continued to deteriorate, evidenced by declining overall passenger numbers and weak yields. The inbound visitor market declined by five percent in 2006 over 2005 levels, and a further twelve percent in 2007 over 2006. This situation resulted from a combination of factors – market maturity, competition from other destinations and the appreciation of the Australian dollar relative to the Japanese yen.

5.3 Looked at over a longer time frame, inbound numbers in 2007 were twenty-nine percent below the record high numbers recorded in 1997. Qantas said that relative exchange rates had influenced strongly Japanese leisure travel patterns, as Australia has become more expensive for Japanese visitors, nearly doubling holiday costs between October 2000 and October 2007. By comparison, the US dollar to yen exchange rate has been relatively stable, so that US dollar destinations such as Korea and China have become more competitive relative to Australia.

5.4 By contrast, the exchange rate movement has been a factor in strong growth in Australian resident departures, which rose by twenty-eight percent in 2007 compared with 2006. However, even with this strong growth, the outbound market remains much smaller than the visitor market, constituting nineteen percent of total traffic in 2007.

5.5 Qantas stated that the outlook for inbound travel continued to be weak. It cited the Tourism Forecasting Council's most recent forecast Japanese visitor arrival average growth rate of 0.6 percent per annum for the ten years to 2016, down from its forecast of 2.9 percent per year made in 2006.

5.6 Qantas summarised its changes to Group flying as a result of ongoing weakness in the Japan market. A significant change was the commencement of flying in March 2007 of Jetstar on the Japan route. Over the course of 2007, Jetstar introduced services between Osaka and Sydney via Brisbane, and between Cairns and Nagoya and Osaka. Qantas also reduced its frequency of operation on the Melbourne – Tokyo sector from daily to three services per week in 2006, and dropped two weekly frequencies between Sydney and Tokyo in early 2008. However, Qantas stressed that Group capacity on the Japan route had decreased by less than one percent since the Northern Summer 2006 scheduling period.

5.7 Qantas also noted that JAL withdrew its daily Osaka-Brisbane-Sydney services in March 2007. JAL also entered into a code share arrangement with Jetstar in May 2007 (approved by the Commission) and since October 2007 had been operating its daily Tokyo - Sydney and Tokyo - Brisbane services with JALways, its low cost subsidiary.

5.8 Qantas suggested that there was ample competition on the route. It noted that load factors for Qantas and JAL were reasonable, in the low to mid-seventy percent range. Several third-country airlines provide competition for the direct airlines, accounting for about fourteen percent of Australia – Japan market in 2007. Singapore Airlines, Cathay Pacific and Korean Air are the main carriers.

5.9 Competition from rival destinations such as Korea and China was likely to intensify, according to Qantas. The recent and likely future proliferation of low cost carriers in the region was a major factor in this development. The increased interest of these carriers in serving Japan is due in part to the very recent removal of Japanese regulations limiting the discounting of international. Additionally, there will be an increase in international slots at Tokyo’s Haneda airport when the new runway is completed in 2010.

5.10 Qantas said that it was incurring significant financial losses on the Japan route. Yields overall have continued to decline, remaining below 2003 levels. The devaluation of the Japanese yen relative to the Australian dollar was adversely affecting yields. Yields on the Cairns services had shown some recovery, but those on the Melbourne and Brisbane sectors had fallen. Qantas said that its airfares to Japan had declined by 5.3 percent between 2005 and 2007 in an endeavour to stimulate demand. On the cost side, fuel price increases of twenty-eight percent between 2005 and 2007 had particularly damaged route financial performance, with total costs rising by 10.5 percent since mid-2006.

5.11 The outlook for the route is weak, with Qantas’ forward bookings low and down on 2007 levels. With low prospects for growth and no sign of significant fuel price falls, Qantas was pessimistic about the likelihood of the route returning to profitability for some time.

5.12 Qantas submitted that the code share arrangements continued to deliver a range of benefits, despite the financial deterioration of the route. These include:

- continuation of own-operated services by both JAL and Qantas in the Queensland - Tokyo market;

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

- a two-fold promotional effort by Qantas and JAL in marketing Brisbane, Cairns and Melbourne in Japan, complemented by the distribution capacity of JAL, both wholesale and retail, which contributes significantly to inbound tourism to Australia; and

- good frequency and choice of schedules for travellers and exporters based in Queensland.

5.13 Qantas stated that the code share arrangements had improved the commercial performance of the route. Although services were not profitable, the situation would have been worse without the code share. Despite the benefits of the code share, Qantas noted that market conditions had deteriorated to the point where daily direct Melbourne - Tokyo services were no longer sustainable.

6 Commission's consideration

6.1 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, including to use Australian capacity in a code share arrangement with a foreign carrier, 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.

6.2 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.

6.3 The Commission has for some years now subjected to careful examination applications from Qantas for code sharing with JAL on the Japan route. This is because the Japan market is a large one and Qantas, its wholly-owned subsidiary Jetstar, and JAL are the only direct operators on the route. There have been no other airlines serving the route directly since 2001. In such circumstances, there is the possibility that code sharing between the only two direct airlines groups could inhibit competition between them and lead to reduced public benefits.

6.4 However, in its previous decisions over the past several years, the Commission has particularly taken account of visitor demand weakness in extending approvals for code sharing between Qantas and JAL. More recently, in March 2007, the Commission also authorised code sharing by JAL on Jetstar's Sydney/Brisbane – Osaka services. The introduction of this code share arrangement coincided with the withdrawal of JAL's services between Australia and Osaka. The Commission found in that case that the code share arrangements were likely to assist the viability and maintenance of frequency of the relevant services in the prevailing difficult market circumstances, without leading to adverse public benefit outcomes.

6.5 Nevertheless, because of the dominant market position of the code share partners and little likelihood of new direct competitors in the foreseeable future, risks to public benefits from the code share arrangements could resurface in the event of significant overall recovery of the Japan market. 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 and Jetstar to provide data on aspects of their market performance, relating to traffic carried and passenger revenue yields. This information assists the Commission to review the impact of the code share on public benefits when extensions of the arrangements are sought.

6.6 On this occasion, the Commission has reviewed the traffic data demonstrating a continuing fall in Japanese visitor demand and the confidential market data provided by Qantas. The Commission has also noted the changes to Japan operations from September 2008 announced by Qantas in early June 2008. In light of this information, the Commission considers that the code share arrangements do not currently raise the serious competition concerns necessary to provide a basis for subjecting the application to the paragraph 5 criteria. A summary of the Commission's review is set out as follows.

6.7 As noted above, the Commission assessed the state of the Australia - Japan aviation market, most recently in March 2007 (the Jetstar/JAL code share arrangements) and prior to that in June 2006 (the Qantas/JAL arrangements). On both of those occasions, weakness in the Japanese visitor market to Australia was apparent, with visitor numbers showing a declining trend and Australia capturing a relatively smaller share of overall Japanese outbound travel. This was despite more stable international circumstances than prevailed during the early years of the decade when incidents such as the September 11 attacks and the SARS virus affected demand.

6.8 The situation on the route has not improved over the past year or so. In fact it has worsened. As noted in section 3 above, the Japanese visitor component of the market experienced a major decline in numbers, amounting to 85,000 fewer visitors in the March 2008 year compared with the previous twelve months period.

6.9 The ongoing weakness in the visitor market continues to be offset to an extent by increasing numbers of Australian residents visiting Japan. Historically, the

Australian resident segment has comprised a small part of the overall market, but that proportion has been increasing strongly in recent years. The number of Australian residents travelling to Japan increased by nearly thirty percent in the March 2008 year, compared with the previous year. As noted above, the Australian resident market now comprises over twenty percent of total travel on the Japan route. Only four years ago, the proportion was about ten percent.[1]

6.10 As the Commission has noted in its previous decisions concerning code sharing on the Japan route, the contrasting trends in the visitor and resident segments appear to be being driven significantly by the continuing strength of the Australian dollar relative to the Japanese yen. In mid-2004, the Australian dollar exchange rate was below 80 yen to the dollar. It has traded above 90 yen since late 2006, reaching nearly 105 yen per dollar at various times through 2007. In late May 2008, the rate was just below 100 yen per dollar.

6.11 Other factors are also likely to have influenced the differing performance of the two market segment over recent years. For example, as Qantas noted in its application, other destinations competing with Australia for Japanese tourists have become relatively cheaper due to exchange rate movements. Qantas has also highlighted the growth of low cost carriers in the region, which compete vigorously for market share. The relative strength of the two economies may also have played a part, with Japanese per capita GDP falling slightly between 2004 and 2007, while Australia's GDP per capita rose over the same period. Air fare and holiday package promotions in Australia may also have had an impact in stimulating Australian resident travel to Japan, particularly associated with the introduction of Jetstar's services in 2007.

6.12 In terms of the visitor market, the result is that Australia's share of the Japanese outbound market has continued to decline, falling from about five percent in 2004, to a little over three percent in 2007. This is particularly concerning given that the size of the overall Japanese market has not increased in that time.

6.13 Confidential data reported by Qantas for the Cairns - Tokyo, Brisbane - Tokyo and Melbourne - Tokyo routes indicate that revenue yields from economy passengers have continued a long term downward trend. While yields for the business segment have improved slightly on a couple of sectors, business travel makes up a small proportion of the market around ten percent of the market. The overall effect has been a deterioration of yields since the Commission previous review of these code share arrangements. This data suggests that the code share partners are not exploiting their dominant market share on the route, but rather are having to discount economy fares in particular in an effort to combat weak demand.

6.14 Capacity management has been a challenge for the airlines in the face of weak demand, with Qantas decreasing Melbourne – Tokyo frequencies, JAL withdrawing its Osaka services and Jetstar introducing services on several sectors in 2007. Seat factors for both carriers have continued at moderate levels, with some rises at peak times, but nothing to suggest that there is any shortage of capacity on the route.

[1] Source: Australian Bureau of Statistics

6.15 Operating costs for the airlines have risen since the previous reviews primarily because of the rapidly rising cost of fuel. Announcements by Qantas in late May and early June 2008 highlighted the ongoing impact of increasing fuel prices on Qantas' operations. The combined effect of weakening yields, falling traffic levels and rising costs means that the code share sectors are currently unprofitable for Qantas.

6.16 The Commission notes that the Tourism Forecasting Council's forecast annual growth rates for visitor arrivals for the period to 2016, cited by Qantas, is 0.6 percent per annum. This is a reduction from an annual forecast rate of 2.9 percent made in 2006 for the same period. To achieve even the revised modest growth forecast, a major turn around would be needed from the declines in visitor numbers of the past several years. The Commission also notes that Qantas' forward bookings are quite weak.

6.17 The Commission's concerns about operation of the code share have been based on the potential implications of a recovery in the Australia - Japan market because significant market recovery could increase the scope for the code share partners to take advantage of the lack of direct competition on the route. As noted above, the recent performance of the visitor market has been very poor and the outlook remains weak. Although growth in the Australian resident market has been encouraging, overall the market is weakening and seems likely to continue in that vein for the foreseeable future. The recent announcements by Qantas of reduced services later in 2008 reflect that state of affairs.

6.18 At its previous reviews, the Commission accepted that the code share arrangements, and the capacity rationalisation associated with them, have assisted in the maintenance of current service levels on the code share routes. Unfortunately, even with the code share authorisation continuing, Qantas has assessed that its existing service levels are not commercially sustainable.

6.19 The Commission sees no potential for adverse competitive outcomes to develop from the code share arrangements continuing for the further short period (to the end of 2008) now sought by Qantas. Accordingly, 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 JAL until 31 December 2008. The Commission will grant authorisation for this period as sought by Qantas.

6.20 The Commission notes that Qantas would need to seek authorisation from the Commission in the normal way, should new code share arrangements between Jetstar and JAL be proposed associated with the introduction of new Jetstar services on the Japan route.

7 Decision ([2008] IASC 212)

7.1 In accordance with section 24 of the Act, the Commission varies Determinations [2004] IASC 120, [2005] IASC 123, [2005] IASC 126, [2006] IASC 113 and [2006] IASC 117 as requested by Qantas, by:

7.2 *deleting* “Qantas may use the capacity to provide services jointly with JAL until end June 2008 in accordance with:”

7.3 *adding* “Qantas may use the capacity to provide services jointly with JAL until end December 2008 in accordance with:”

Dated: 16 June 2008

John Martin Chairman	Philippa Stone Member	Ian Smith Member