Australian Government

International Air Services Commission

DECISION

Decision:	**[2008] IASC 225**
Variation of:	**[2004] IASC 119, [2005] IASC 125, [2006] IASC 130, [2008] IASC 105 and [2008] IASC 109**
The route:	**South Africa**
The applicant:	**Qantas Airways Limited (ACN 009 661 901) (Qantas)**
Public Register File:	**IASC/APP/200827**

1 Brief summary of the application

1.1 Qantas applied to the Commission on 3 October 2008 to vary Determinations [2004] IASC 119, [2005] IASC 125, [2006] IASC 130, [2008] IASC 105 and [2008] IASC 109 to permit South African Airways (SAA) to continue code sharing on Qantas' services between Australia and South Africa until 31 December 2010. The Commission first authorised code sharing between Qantas and SAA in December 2000 and has granted a series of approvals since that time. The current authorisation is provided by Decision [2007] IASC 216 of 16 November 2007 for the period ending 31 December 2008.

1.2 The Commission wrote on 2 October 2008 to the Australian Competition and Consumer Commission (ACCC), inviting its views on the Qantas proposal. The Minister's policy statement requires consultation with the ACCC when the IASC has concerns that a code share proposal may not be of benefit to the public. The ACCC provided a submission on 31 October 2008. Qantas responded by letter to the ACCC submission on 26 November 2008.

1.3 On 3 October 2008, the Commission published a notice inviting submissions from other interested parties about the Qantas application. No other submissions were received.

1.4 All non-confidential material supplied by the applicant is filed on the Register of Public Documents. Confidential information attached to Qantas' public application is filed on the Commission's confidential register.

2 Current services

2.1 Qantas operates five B747-400 return services per week between Sydney and Johannesburg. Four of these are operated by a four-class aircraft, which includes a

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Premium Economy class added in May 2008. The fifth weekly service is flown by a two-class aircraft. Both aircraft types have "Skybed" sleeper seats in the business cabin. The premium economy class seats are not included in the code share agreement because SAA does not offer an equivalent product. SAA operates five A340 two-class return services per week between Johannesburg and Perth.

2.2 Under the code share agreement between the two carriers, Qantas purchases blocks of 10 business class and 90 economy class seats on each SAA service. SAA buys average blocks of two first class, 24 business class and 126 economy class seats on each three-class Qantas service. It buys 22 business class and 138 economy class seats on each two-class service.

2.3 Qantas advised that a number of changes are proposed by both Qantas and SAA to service levels and associated code share seat purchases. Most significant is the introduction by Qantas of a sixth service between Sydney and Johannesburg in December 2008 with a seventh service planned for mid-2009. Further details are in Section 5 below.

2.4 A number of third-country airlines provided services between Australia and South Africa via their home countries. These airlines include Singapore Airlines, Emirates, Etihad, Thai Airways, Malaysian Airlines, Cathay Pacific and Air Mauritius.

3 Characteristics of the Australia – South Africa route

3.1 In the year ended 30 September 2008, total traffic on the Australia – South Africa route totalled just over 346,000 passenger movements. Traffic growth continued strongly, with total traffic rising by 8.6% over the previous year, after increases of 9.9% and 6.8% in the two prior years.

3.2 Of the total passenger movements, 54.3% were passengers with a destination of either Australia or South Africa travelling directly between the countries (direct traffic). Direct traffic increased by 10.1% in the year ending September 2008, following an increase of 8.9% in the previous 12 months.

3.3 About 26.4% of passengers travelled between the two countries via a third point (indirect traffic). This market segment continues to see slightly stronger growth than the direct component, averaging nearly 12% annual expansion for the past three years compared with just over 9% for direct traffic. This has meant that the share of the market comprised of indirect traffic has been rising steadily over recent years, although there was only a small increase in the most recent year.

3.4 The remaining 19.3% of passengers on the route originated in or were destined for countries beyond South Africa or Australia (beyond traffic). This market segment showed modest growth over the previous year after a solid increase in the year preceding that.

Australia – South Africa Passenger Movements
Years Ended September 2005 – September 2008

Traffic category	Year ended September 2005	2006	2007	2008		Compound annual growth rate 05-08
Direct traffic	144,844	156,860	170,796	188,008	(54.3%)	9.1%
(Annual % change)		(8.3%)	(+8.9%)	(+10.1%)		
Indirect traffic	65,619	74,852	82,713	91,578	(26.4%)	11.8%
(Annual % change)		(+14.1%)	(+10.5%)	(+10.7%)		
Beyond traffic	61,358	58,603	65,482	66,696	(19.3%)	2.8%
(Annual % change)		(-4.5%)	(11.7%)	(+1.9%)		
Total traffic	271,821	290,314	318,992	346,282	(100.0%)	8.4%
(Annual % change)		(6.8%)	(+9.9%)	(+8.6%)		

Source and note: Data in this table have been derived from information supplied by the Australian Bureau of Statistics and includes both scheduled and charter traffic. Figures may not add to totals due to rounding. Average annual growth records the compound annual growth rate.

3.5 In the year ended 31 August 2008, growth in the number of visitors from South Africa compared with the previous year was the most notable development in traffic levels. The visitor component recorded an increase of nearly 14% over the previous year, while the number of Australian residents on the route rose by just over four percent. This represented a reversal of the trend of the previous six years, when the growth rate in the number of Australian residents travelling on the route was higher than for South African visitors to Australia. The result is also somewhat surprising given that the Australian dollar has been generally stronger relative to the South African rand in 2008 compared with 2007.

3.6 In the August 2008 year, visitors from South Africa comprised 54.1% of the origin/destination traffic between Australia and South Africa. Nearly 150,000 South African visitor arrivals and departures were recorded, an average of 1,440 each way each week. This compared with Australian residents, who totalled about 127,000 arrivals and departures, or 1,220 each way each week.

3.7 The journey purpose profile of visitors from South Africa and Australian residents is much the same as a year ago. South Africans visiting Australia did so mainly to visit friends and relatives (30%) or to holiday (33%). Approximately 18% of South African visitors were in Australia for business reasons. Australians visiting South Africa showed holiday (38%) as the main reason for travel, with 31% visiting friends and relatives and 17% travelling for business. Smaller numbers of travellers cite conventions, education and employment as their reasons for travel.

4 Provisions of relevant air services arrangements

4.1 The air services arrangements between Australia and the Republic of South Africa allow the designated airlines of each country to code share on the services of the other. Under the arrangements, seats purchased by a marketing carrier do not count as a use of bilateral capacity entitlements. This means that Qantas does not require permission from the Commission to code share on SAA's services. However, Qantas, as the operating carrier between Sydney and Johannesburg, requires authorisation for SAA to code share on Qantas' services.

5 Detailed summary of application

5.1 Qantas summarised the history of the Commission's authorisation of the code share arrangements between Qantas and SAA. The airline referred to remarks in the Commission's most recent decision on the code share ([2007] IASC 216) about the capacity limitations under the air services arrangements at that time. Qantas noted the Commission's suggestion that, if capacity entitlements were expanded, Qantas should apply as soon as possible should it wish to continue code sharing beyond the end of 2008. Qantas observed that revised capacity entitlements were agreed in June 2008, resulting in an immediate increase in capacity from five to 10 frequencies per week, increasing to 14 frequencies in October 2009 and 21 frequencies in October 2010.

5.2 Given the increased opportunities now available under the air services arrangements, Qantas will increase its Sydney–Johannesburg services from five per week to daily flights. A sixth service is to be introduced in December 2008, with a seventh weekly flight to commence in mid-2009. As A380 aircraft are delivered to Qantas, this will free up B747 aircraft to operate the extra services to South Africa.

5.3 Qantas noted that the new services constitute a 40% increase in its current capacity levels, a significant development given growing competition on the route. The daily frequency would provide improved convenience and choice for passengers, especially business travellers and passengers connecting to or from other ports who may currently be unable to make same-day connections. The daily flights would also increase Qantas' ability to compete with third-country airlines, especially those offering high frequency services in the South African market. Qantas regarded the continuation of the code share arrangements as an important factor in Qantas and SAA maintaining 12 direct services between them over the medium term.

5.4 Qantas pointed to a more challenging operating environment, with increased fuel expenses and the global economic slowdown resulting in the Qantas Group announcing job cuts, reducing planned capacity growth and retiring older aircraft. The airline also noted the Commission's allocation in August 2008 of capacity to V Australia with that airline planning to commence five weekly 361 seat B777-300ER services between Sydney and Johannesburg from October 2009. This airline's entry to the route, together with Qantas' two extra weekly services would increase available seats by 82%, in Qantas' view greatly exceeding recent and forecast growth in the market.

5.5 Qantas outlined details of the code share arrangements with SAA. No changes were proposed to the broad structure of the arrangements with SAA operating Perth–Johannesburg, Qantas between Sydney and Johannesburg, and with each airline continuing to code share on all services operated by the other.

5.6 Qantas operates four of its five weekly services with a four class B747 aircraft. SAA purchases blocks averaging two first class, 24 business class and 115 economy seats. On the once weekly two-class B747 service, SAA purchases average 22 business class and 139 premium economy seats. The Qantas four-class aircraft include a premium economy class section, launched in March 2008, but as SAA does not have an equivalent product, premium economy is not included in the code share agreement.

5.7 Qantas advised that SAA operates five weekly A340 two-class services between Perth and Johannesburg. Qantas purchases 10/15 business and 90/86 economy seats respectively on the two aircraft types.

5.8 Qantas referred to the competition from third-country carriers such as Singapore Airlines, Malaysia Airlines, Emirates, Cathay Pacific and Air Mauritius; established airlines operating one-stop services between Australia and South Africa. Qantas said that the combined market share of Qantas and SAA has risen only slightly (to 70%), despite traffic growth of 9.4%. The Qantas/SAA share remained below what it was in 2000 when the code share commenced and was due to the strong competition from the third-country carriers. Qantas also argued that the indirect carriers capture a relatively greater share of the overall Australia–Africa market. Qantas set out the role of each of the third-country carriers in the Australia – South Africa market, noting that Singapore Airlines was the largest participant with over 12% of the market and outlining the planned growth in services of the other third-country airlines.

5.9 Qantas set out what it sees as the benefits of the code share services. Broadly, the arrangements provide stability and improved profitability, enabling Qantas to increase its capacity on the route in 2008/09 to daily flights and for SAA to introduce higher capacity A340 series aircraft.

5.10 A number of specific benefits to travellers were identified including:

- operation of dedicated capacity to each of Perth and Sydney, with the non-stop flights to Sydney reducing travel times for east coast passengers;
- increased choice though the presence of both airlines in the Perth and Sydney markets;
- improved product with both airlines have introduced flat-bed business class seats and Qantas adding premium economy on some services
- convenient connections and timings for New Zealand and domestic transfer passengers;
- price competition between Qantas and SAA on the Perth and Sydney sectors, associated with the block space code share arrangements; and

- maintenance of a Qantas presence in the Western Australia – South Africa market and SAA in the east-coast – South Africa market.

5.11 Qantas submitted that its expansion to daily services would generate increased public benefits and create greater competition. However, the continuation of the code share services was fundamental to achieving this, particularly due to the commencement of V Australia services in October 2009 and continuing third-country carrier competition which would ensure fares remained competitive and consumers had broad choice. Qantas noted that the route had been loss-making prior immediately prior to the commencement of the code share operations even though the operating environment was more favourable than now prevails. In light of past and forthcoming capacity expansion exceeding past and forecast growth, the code share arrangements were important to sustaining capacity levels by carriers of each side.

5.12 Qantas considered that a two-year period of authorisation was a suitable time frame in light of Qantas expansion plans, V Australia's entry and a challenging operating environment.

5.13 In the confidential part of its application, Qantas provided detailed information on matter such as load factors, market shares, third-country passenger carriage, forward bookings, revenue yields, costs and Qantas' profits on the route.

6 Summary of submissions

6.1 The ACCC welcomed the doubling of capacity available to carriers in the South Africa route which has occurred since the last review and the introduction of a new competitor, V Australia, as a result of the IASC allocating five services per week to V Australia. However, the ACCC remained of the view that there were a number of competition concerns associated with fundamental issues on the route. Principal among these issues is that there is still no competition from other direct carriers. The only competition continues to be from third-country carriers - Singapore Airlines being the major one - all with longer travel times. The ACCC instanced examples of additional travel time for those carriers ranging from seven to 16 hours.

6.2 The ACCC set out estimated market shares of the code share carriers and third-country carriers over a period of years, with the current share of the code share partners at 71.2%. The ACCC considered that the additional capacity to be operated by Qantas would result in that carrier increasing its market share.

6.3 In summary, the ACCC remained of the view that the code share arrangements reduce price and service competition incentives on Qantas and SAA on a route where there are no directly competing services and Qantas will increase its capacity before V Australia enters the route.

6.4 In responding to the ACCC, Qantas argued that the code share carriers have a clear incentive to compete on price. Qantas detailed the mechanisms by which hard block code share arrangements operate, including independent fare setting by Qantas and SAA.

6.5 Qantas also submitted that the ACCC did not give adequate recognition to the competition provided by third-country airlines. Qantas instanced sale fares offered by Singapore Airlines at various times, showing these to be lower than Qantas regular fares and also its sale fares. Qantas argued that the growth in indirect carrier market share suggests that many passengers are willing to take longer journeys, pointing to meaningful competition for Qantas and SAA. Qantas pointed to the high frequency of services offered by some third country carriers to South Africa from their home countries. Qantas also noted in this context that the share of the broader Australia–Africa market held by Qantas and SAA was lower than its share of the Australia–South Africa route. Qantas said that sufficient capacity would be available in the near future for V Australia to expand services on the route if it chose to do so, noting the phased increases in capacity available under the air services arrangements. Ample capacity was also available for South African carriers or a new entrant to provide further direct competition on the route.

7 Commission's assessment

<u>Assessment framework</u>

7.1 Under section 15(2)(e) of the Act, a carrier cannot use allocated capacity to provide joint services with any other carrier without the prior approval of the Commission. As noted in Part 4 above, Qantas therefore requires the Commission's authorisation for SAA to code share on Qantas' services between Sydney and Johannesburg. No approval is required from the Commission for Qantas to code share on SAA services. Under the air services arrangements, Qantas is not considered to be exercising capacity entitlements by code sharing on SAA's flights.

7.2 Under the Minister's policy statement, the Commission is normally expected to authorise applications for use of capacity to code share where use of capacity in this way 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, as it is in this case, it may subject the application to detailed assessment using the paragraph 5 public benefit criteria of the policy statement. The Commission must consult with the ACCC before doing so and has done so in this case. The ACCC's views on the Qantas application are summarised above. Having assessed the application, the Commission must either confirm the original determination (thereby rejecting the code share request), or amend the determination as requested by the applicant airline. The Commission must not vary a determination unless it is satisfied that it would be of benefit to the public to do so.

<u>Background</u>

7.3 At its previous reviews the Commission has conducted in-depth assessments of data and other information associated with the many facets of the operation of the code share. This information provides the basis for the in-depth assessment called for by the paragraph 5 criteria. The material covers matters such as:

- the specific details of the code share agreement between Qantas and SAA such as seats exchanged;
- capacity entitlements available under the air services arrangements and capacity and frequency operated by Qantas and SAA including aircraft types used, seating configurations and service standards;
- trends in traffic numbers including seasonal patterns and journey purpose of travellers;
- load factors;
- forward bookings;
- confidential financial information including trends in Qantas' revenue yields (which act as a detailed pricing proxy) and Qantas' route costs and profits; and
- the extent of third-country carrier participation and its effect on competition in the market.

7.4 Broadly speaking, at each of its previous reviews, while finding that there were some adverse public benefit impacts of the code share arrangements, the Commission identified sufficient offsetting benefits for it to authorise the arrangements on each occasion. However, the Commission has maintained short-duration periods of approval in the event that changing circumstances led to that balance of public benefits shifting adversely. These approval periods have not exceeded two years and the current approval is for one year, ending on 31 December 2008. The Commission has also maintained various conditions associated with its authorisations, to ensure as much competition as possible between the code share partners and within the constraints imposed by the capacity available under the air services arrangements. Currently these include requirements for Qantas and SAA to independently price and to operate a combined total of at least ten return services per week on the South Africa route.

7.5 Since the time of its June 2005 review, the Commission has been increasingly concerned about the high air fares and rising load factors on the route. There have been two main drivers of that situation over recent years. These are a lack of capacity available to Qantas and SAA to expand, or for new direct operators to introduce services; and, partly related to that, the limited extent of competition on the route, either from other direct or indirect carriers, or between the code share partners.

7.6 There has never been direct competition for Qantas and SAA. However, prior to the code share commencing, Qantas and SAA both operated on a Sydney/Perth – Johannesburg routing, providing motivation for them to compete more strongly with each other than is currently the case. Subsequent to the code share, with Qantas and SAA flying solely to Sydney and Perth respectively, the only competition between them has been via the hard block code share arrangements. By their nature, such arrangements create a situation where neither carrier would wish to compete with the other in ways which might threaten the viability of either service. Further, strongly rising passenger demand on the route combined with an absence of extra operated capacity since Qantas introduced its fifth weekly Sydney service three years ago has diminished any imperative for Qantas and SAA to compete meaningfully with each other.

7.7 Third-country airlines have provided the only competition for the direct carriers. While the indirect operators maintain a market share around 30%, much of this is achieved as a result of traffic "spilling" from the heavily-booked direct carriers during the seasonal peaks from the end of the year extending into the early months of the following year.

7.8 The long journey times associated with travel on most of the indirect carriers places them at a competitive disadvantage. This means that their ability to increase market share, especially in the more time sensitive business market, is likely to be limited, despite offering attractive air fares. The market share of the third-country airlines has remained fairly steady over the past few years.

7.9 Although there had been some public benefit improvements resulting from the introduction of more efficient A340 aircraft by SAA and the addition in late 2005 of a fifth weekly service by Qantas to Sydney, there was increasing evidence in recent reviews that public benefits were being eroded by a lack of competition on the route.

7.10 The Commission's reason for maintaining the code share, despite growing concerns about the public benefits from air services on the route, was because there were risks that public benefits would be lower if the code share approval was removed.

7.11 In earlier reviews, the Commission was concerned about the possible tourism and consumer consequences if SAA withdrew its Perth services or lessened frequencies in response to the withdrawal of code share approval, although it saw this as a low probability outcome. However, in the more recent reviews, a primary concern for the Commission was the absence of additional capacity under the air services arrangements. This meant that Qantas and SAA could not introduce new services on the route. In order to serve any new point, they would either have to move services from the point presently served, or operate via Perth to and from Sydney. The Commission assessed both options to be unattractive to the carriers for a number of reasons. Neither carrier had incentive to price more aggressively to expand the market in a situation where many flights were operated at extremely high load factors. There was a significant risk that, if Qantas and SAA maintained their existing pattern of operations, separate monopolies would develop on the Perth and Sydney sectors. Such small competition benefits as the code share arrangements offered would then be lost.

7.12 The Commission was therefore pleased when expanded capacity entitlements were negotiated between the Australian and South African aeronautical authorities in mid-2008. There was an immediate doubling of entitlements from five to ten frequencies per week for carriers of each side, with a further four weekly frequencies available from October 2009. Another seven weekly frequencies are provided from October 2010.

7.13 Shortly thereafter, Qantas applied for and was allocated two additional weekly frequencies in July 2008. Qantas will add an extra weekly flight from mid-December 2008 and plans to move to daily services from mid-2009. V Australia sought and was allocated five weekly frequencies in August 2008. The allocation was made up of the three remaining immediately available weekly services and two weekly services from the four available from October 2009. V Australia plans to introduce five B777 services per week between Johannesburg and Sydney from October 2009.

7.14 As a result of these recent allocations, there are two weekly frequencies remaining available to Australian carriers for operation from October 2009. A further seven frequencies per week can be used from October 2010.

7.15 In its current review, the Commission has again carried out a detailed analysis of economic and financial route factors, using the commercial-in-confidence information provided by Qantas and information available to the Commission from other sources, to assess the public benefits associated with the code share arrangements. The recent allocations of new capacity to Qantas and V Australia, and the capacity still available for allocation, are important developments in the competitive framework on the route. They are therefore highly significant in the Commission's assessment of the Qantas application to continue to code share with SAA.

Detailed assessment

7.16 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.

7.17 The Commission notes the requirement of the Minister's policy statement that, in considering all of the paragraph 5 criteria, the competition criterion is to be the Commission's pre-eminent consideration.

7.18 At its previous review in November 2007, the Commission recorded in detail its growing concerns about the lack of competition on the route. An over-arching difficulty was the lack of available capacity on the route, which meant that the existing operators could not add more services, even as demand on the route had grown strongly, and there was no prospect of new entry. This situation had created an environment not conducive to competition, regardless of whether or not the code share arrangements were operating.

7.19 In the year to August 2008, total origin-destination traffic rose by 9.2% over the previous year. This is a large rise. It follows on from over a 10% annual increase in the preceding 12 months period. These rises are particularly significant for competition in a market where the supply of seats over the past two years has increased only slightly. Regular frequencies have remain fixed since late 2005 with modest supply growth since then coming through operation of supplementary services (December, January) and minor aircraft type changes (substitution of larger capacity A340 series aircraft for smaller series types).

7.20 There have been several consequences of this situation. One clear effect has been rising load factors. In the year since the Commission's previous assessment that effect has strengthened, with high load factors from peak times a year ago rising to around 90% or more for Qantas over several months of the year. SAA's load factors have lifted by similar proportions. Load factors have also risen strongly over traditionally quieter months such as May and June. This may have occurred because more passengers have been unable to find seats during the seasonal peak months (which now extend over the five months from December to April).

7.21 These high load factors have a related consequence. Some passengers who are unable to find seats on the direct carriers on desired days appear to opt in some cases to travel with third-country carriers, despite the longer travel times involved. As the Commission observed in its November 2007 decision, during the summer peak the market share of third-country carriers tends to rise. The Commission has noted previously that the travel time differential of a minimum of nine hours would generally be a significant deterrent to passengers considering travelling via intermediate points, even if lower fares were available. This is particularly the case for business travellers, for which travel time is a significant issue but price generally less of a consideration than for leisure travellers. Overall, third-country market share declined very slightly in the year to June 2008, totalling about 30% of the market.

7.22 A second serious outcome of the capacity constraints has been the lack of incentive for the direct carriers to offer attractive fares to generate additional traffic or increase market share. Fare levels, reflected as averages through Qantas' passenger revenue yields reported confidentially to the Commission, have continued at high levels over the past twelve months. With aircraft already very full for many months of the year, Qantas and SAA would be simply unable to accommodate more traffic that might be stimulated by lower fares, except on supplementary flights which can be approved on a limited basis in addition to normal capacity entitlements. Thus, while the hard block nature of the code share theoretically provides a rationale for Qantas and SAA to compete with each other, the surfeit of demand relative to constrained capacity means there has been little necessity for them to do so in practice. However, this situation is likely to have prevailed in the absence of code share approval while capacity remained constrained. As the Commission discussed at its previous review without more capacity available to operate, removal of authorisation could have seen the development of separate monopolies with Qantas and SAA operating solely to Sydney and Perth respectively. This outcome would, if anything, have been less likely to create price competition than the hard-block code share arrangements.

7.23 Finally, the lack of competition has reflected itself in high profits for Qantas on the route. Although profits on the Sydney sector declined slightly from the previous year, this was more than offset by a solid rise in profit on the Perth sector. While there was some rise in the cost base for Qantas, overall this has been compensated for by rising revenue yields. The route as a whole continues to be strongly profitable for the airline. While the Commission does not have access to similar data for SAA, the Commission is confident that the financial performance of the route is strong for that airline also, noting in particular its higher load factors in the past year. The Commission understands that SAA commenced a major restructure in mid-2007, with Government financial support, and that the airline's poor financial situation has improved subsequently as a result. Public announcements by the airline early in 2008 indicate that the Perth sector is profitable for it.

7.24 The combination of scarce seats and high prices is almost certainly causing a suppression of underlying demand for travel on the South Africa route. However, the Commission anticipates that this situation will begin to alter as substantial extra capacity and a new operator, V Australia, come on to the route over the course of the next year. These imminent and near term developments, discussed in detail below, represent a sharp contrast with the circumstances prevailing for some years until now.

7.25 In mid-December, Qantas will add a sixth weekly B747 service between Sydney and Johannesburg. This is a 20% increase in available year-round capacity on that sector and has been introduced just in time to meet the extended summer–autumn peak period. However, Qantas has previously operated supplementary services over summer months, so there will be no net increase to the extent the new service merely replaces the supplementary flights for the months concerned. However, Qantas also plans to add a seventh weekly service in the first half of 2009. This will bring the total capacity increase on the Sydney–Johannesburg sector to 40% above the pre-December 2008 year-round level.

7.26 The advent of these extra services, particularly the seventh weekly flight in mid-2009, would be likely to result in an improvement in competitive tension between Qantas and SAA on the Sydney–Johannesburg sector. This could be expected to create competitive pricing between those airlines.

7.27 However, the much more significant development will come in October 2009 when V Australia introduces five weekly B777 Sydney–Johannesburg services. This will bring direct competition for Qantas and SAA on to that major part of the South Africa route for the first time. The combined impact of the two new Qantas services and the five extra B777 V Australia services represents about a 140% increase in operated capacity between Sydney and Johannesburg, and something over a 70% increase in direct capacity for the South Africa route as a whole. It also means an increase in frequencies on the Sydney sector from five per week to twelve per week, and a choice of operating carrier.

7.28 These developments should result in a transformation in the competitive framework and a major increase in competition benefits on the route. Benefits would be likely to rise with or without the code share arrangement in place but it is the Commission's task to determine whether there would be a relative lessening in public benefits from allowing the code share to continue.

7.29 The Commission therefore needs to assess what it considers to be the most likely competitive outcome in the absence of code share approval and associated public benefits, and compare these benefits with those expected if code share authorisation was granted. As noted above, the Commission has previously found there to be a strong possibility that two separate monopolies could form on the Perth and Sydney to Johannesburg sectors when capacity was constrained, if continued authorisation was not granted. However, the opening up of capacity entitlements and the entry of V Australia create a more complex set of possibilities than was previously the case.

7.30 Had there been no prospective entry by V Australia and code share authority was withdrawn then, in the Commission's assessment, SAA may well have entered the Sydney–Johannesburg market in its own right and Qantas the Perth–Johannesburg sector, given the extra capacity available under the air services arrangements which creates scope for additional services. SAA's new A340-600 series aircraft would have the range to operate non-stop to Sydney, although the airline could have chosen to operate via Perth as it has done in the past. There would be a number of considerations for both Qantas and SAA as to whether to operate discrete services to the two points, or combine them. These would include availability of suitable aircraft to operate new discrete services and a range of other commercial factors such as the extra costs associated with operating via Perth, including flying with part-empty aircraft between Perth and Sydney. This is particularly an issue for SAA which cannot carry Australian domestic passengers on the Perth–Sydney leg.

7.31 However, V Australia's entry creates more complications, both for Qantas and SAA and for the Commission in its public benefit assessment. The recent allocations of five services per week to V Australia and two per week to Qantas leave no frequencies available to Australian carriers for immediate operation. This means that Qantas could not serve Perth before October 2009 at the earliest, other than enroute to and from Sydney. A Sydney–Perth–Johannesburg operation would seem to place Qantas at a competitive disadvantage to V Australia which will operate Sydney–Johannesburg direct. It therefore seems highly unlikely that Qantas would consider seriously the indirect routing, given the lead time it would take to implement it and the fairly imminent entry of V Australia. Qantas could in any event continue code sharing with SAA on the Perth sector without Commission approval, if SAA was agreeable to such an arrangement in the absence of authority to code share on Qantas' Sydney services.

7.32 Only two frequencies are available for allocation to Australian carriers for operation from October 2009. This is unlikely to be a commercially attractive frequency for Qantas (or V Australia) to operate from Perth to Johannesburg as stand-alone frequencies. It is not until October 2010 that a further seven weekly frequencies become available to Australian carriers. This is at the outer end of the two year extension of the code share arrangement sought by Qantas on this occasion. While Qantas might seek additional frequencies from that tranche of capacity, it could also find itself in competition with V Australia for this extra capacity, and either or both might seek to expand Sydney services. By that time it is also possible that SAA would have increased frequencies to Perth. Growth in the Perth market has been strong, load factors have risen commensurately and there has been no increase in frequencies since SAA introduced its A340s in 2003. Accordingly, the Commission assesses there to be only a small possibility that Qantas would enter the Perth market in the absence of code sharing for the great majority of the two year time frame encompassed by the current application. October 2010 would appear to be the earliest commercially realistic opportunity for Qantas to do so. While there would be substantial extra public benefits if Qantas did so, these would only accrue in the final two to three months of the authorisation period sought. Qantas is likely to prefer to continue code sharing with SAA and, as noted above, can continue to do so without Commission approval, if the South African airline agrees.

7.33 In summary, the Commission sees little prospect of Perth receiving services from Qantas within the period of authorisation sought by the airline and, if it was to occur, would probably not happen until late October 2010. This means that SAA is likely to remain the only operator on the Perth–Johannesburg sector for nearly the next two years at least. If Qantas did not code share on that sector, SAA would hold a monopoly, which is likely to result in reduced public benefits compared with a continuation of code sharing. However, on a related point the Commission considers it now most unlikely that SAA would reduce services in the absence of code sharing with Qantas. At one time the Commission was concerned that this was a possible outcome. The Perth sector has exhibited strong growth and is very profitable for Qantas and, as noted above, is also likely to be for SAA. Indeed, there is probably a greater possibility that, in time, SAA would add frequencies to Perth as traffic continues to grow rather than reduced frequencies.

7.34 In the Commission's assessment, V Australia's entry also greatly reduces the likelihood of SAA serving Sydney in its own right if code share authority was withdrawn, either with direct flights or via Perth. The Commission considers it to be unlikely SAA would enter the Sydney market segment in competition with the two Australian operators. Qantas and V Australia will be flying a combined 12 flights per week, compared with the five that operated until December 2008, and pricing competitively. Entry by SAA would be likely to create a situation of excess capacity with strong price competition for market share. All airlines could also be operating in a weaker overall economic environment, if the effects of the global economic downturn affect this route as it has begun doing on many other international routes, evidenced by public statements from Qantas and other international airlines. This might dampen underlying demand on the route compared with the growth that has been underpinned by the sound economic circumstances of recent years.

7.35 SAA has been carrying out a major restructure over the past eighteen months or so. While this has reportedly been successful in restoring the airline to profitability, SAA has publicly announced plans to focus development primarily on African domestic routes for the time being. Entering a much more competitive Sydney sector in its own right in a weakening international economic environment may be inconsistent with the airline's financial recovery strategy. SAA therefore seems more likely to focus its efforts on the smaller but profitable Perth market where there appears to be little threat of entry by other carriers until at least October 2010.

7.36 If, as seems likely, SAA would not enter the Sydney sector in its own right if code share approval is withdrawn, this would leave Qantas and V Australia as the only competitors in that market segment. If, instead, code share authorisation was continued, this would mean that SAA could compete in the market through its hard block seat purchases from Qantas. In a situation of greatly increased capacity, there is likely to be genuine pressure on SAA to sell seats from its block, thus stimulating strong price competition between all three airlines. In this situation, there are likely to be greater public benefits than in the absence of code sharing.

7.37 In summary, the Commission recognises there is inevitably uncertainty about the likely responses of Qantas and SAA if code share authority was to be withdrawn. However, on the basis of its assessment of the most likely outcomes, the Commission considers that public benefits against the competition criteria are unlikely to be lessened while code sharing continues for the period of authorisation sought, compared with what the public benefits are likely to be if code share approval was withdrawn. The Commission has noted that a wider set of competitive options are likely to open up from October 2010 as a large tranche of capacity becomes available for operation. In particular, these possibilities include scope for more competitive outcomes for the Perth market and/or for other Australian cities which might be served. However, this is at the outer end of the period of authorisation for the code share sought by Qantas.

Other Benefits

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).

7.38 The size of the tourist market from South Africa to Australia has grown strongly over the past year in line with overall expansion of visitor arrivals to Australia. This contrasts with recent previous years when there was comparatively higher growth in the number of Australians travelling to South Africa. This is a slightly surprising development given a sharp strengthening of the Australian dollar from late 2007 which was sustained through to the middle of 2008. Although the dollar has weakened in recent months relative to the rand, it remains well above the levels seen over most of the past five years.

7.39 Growth in overall travel via indirect ports slightly exceeded the growth rate for travel in direct services in the past year. This situation could be due at least in part to the lack of direct capacity on the route especially over peak months, resulting in travellers deciding to take flights via indirect points. Third-country carriers therefore continue to capture a significant share of the tourism market, especially in peak travel times and despite the longer travel times of their flights.

7.40 The introduction of additional capacity and a new airline as discussed in the competition criterion above, should stimulate increased fare competition and promotional activities from airlines, which is likely to contribute to supporting tourism from South Africa. An increasing proportion of the market is likely to travel on direct flights. However, withdrawal of code sharing approval would be unlikely to lead to a further incremental increase in tourism to Australia, for the reasons discussed above.

7.41 There are attractive options to travel to and from behind gateway points within Australia and South Africa, as well as to countries beyond. However, this would equally be the case in the absence of code sharing provided the same service frequencies were maintained.

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).

7.42 There has been little change to the situation for consumers since the previous Commission review when the introduction of business class sleeper seats by Qantas and SAA had improved consumer benefits, although these were offset by concurrent higher air fares.

7.43 There continued to be no choice of direct carrier for passengers to either Perth or Sydney. While code share arrangements generate cost savings for Qantas and SAA, these efficiencies appear not to have been passed on to consumers in the form of lower fares.

7.44 Consumer benefits should increase substantially with V Australia’s entry, both through the additional choice this brings, but also through the competitive responses of Qantas and SAA. The continuation of the code share is likely to add to price competition on the route relative to approval being withdrawn, as discussed under the competition criterion above.

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.

7.45 The code share arrangements exclude the carriage of freight. Qantas and SAA are each responsible for the sale of their own belly-hold capacity on the services they operate.

Industry Structure

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

7.46 The code share arrangements have had a positive impact on the Australian aviation industry by increasing Qantas' profits on the route, especially from 2004 onwards, and therefore adding to the viability of the airline as a whole. The expansion of services by Qantas, supported by the code share, should positively affect the industry through increased activity for related businesses.

8 Conclusion

8.1 The Commission concludes that the public benefits generated by the code share have continued to be poor, continuing in the same vein as the Commission found at its previous review a year ago. However, this was an unsurprising, if unsatisfactory, outcome and was anticipated by the Commission in its 2007 review. As expected, the inability of either Qantas or SAA to increase frequencies meant there was little or no incentive for them to compete with each other given already high load factors and strong underlying demand for travel. The result has been extremely high load factors in many months of the year, a continuation of high air fares and diversion of travellers to third-country airlines in those peak months of the year when obtaining a seat on the direct carriers would have been difficult.

8.2 The Commission was therefore pleased to see the major expansion of capacity entitlements in mid-2008 and the quick response by Qantas and V Australia in seeking and obtaining capacity from the Commission to take advantage of those new opportunities. This has signalled the imminent emergence of a new competitive dynamic on the route, with Qantas increasing frequencies and V Australia to enter the route in October 2009. There is likely to be an incremental improvement in public benefits with the addition of Qantas' sixth and seventh weekly services, with a major enhancement of benefits occurring with the entry of V Australia to the route in October 2009.

8.3 Had there been no sign of a new carrier entering the route as V Australia will do, the Commission would almost certainly have declined to continue to authorise the code share arrangement. This is because SAA would have been far more likely to have entered the Sydney market in its own right without V Australia's presence, and it is also more likely that Qantas would have entered the Perth market quickly with its own aircraft because there would have been additional capacity for it to do so and the Perth sector makes up a significant and profitable component of the total South African market.

8.4 However, V Australia's entry has altered the likely responses of Qantas and SAA to the increased available capacity entitlements if code sharing was to be disallowed. For reasons discussed above, neither Qantas nor SAA would be likely to seek to operate new services to Perth and Sydney respectively within the two-year period of approval sought, except possibly in Qantas' case when the earliest it might consider operating to Perth would be from October 2010 when more capacity is potentially available to the airline. The Commission considers that there is likely to be no lessening of public benefits from continuing the code share for the two year period sought by Qantas. This is principally because approval will enable the continued participation of SAA in the Sydney market through the code share, whereas, as noted, it is unlikely to enter the Sydney market in its own right if code sharing is no longer authorised. SAA is likely to compete vigorously to sell its seat blocks, given the competition from V Australia and also Qantas. Qantas would also continue to have a presence in the Perth market through its hard block seat purchases under the code share.

8.5 The Commission records as a matter of interest that it does not consider services to Perth would now be in any way threatened by the withdrawal of code share approval per se. In the early years of the code share approval this seemed some possibility and the cost efficiencies gained through the code share may have assisted the maintenance of those services. However, strong growth on the route combined with the operation of efficient A340 aircraft and high fares has seen rising profitability. It therefore seems very unlikely that SAA would withdraw or reduce frequencies in the absence of code share approval, even allowing for a possible softening of demand due to the global economic slowdown. However, continuation of code sharing might be more likely to encourage SAA to add frequencies over time given the marketing support of Qantas in selling these services, if demand on the route continues to rise.

8.6 The Commission will vary the relevant determinations as requested by Qantas, thereby extending the period of authorisation to 31 December 2010. The Commission records that it may well not have granted continued authorisation had Qantas sought a three year extension. This is because the extra capacity available for operation from October 2010 opens up scope for improved competitive outcomes, particularly in relation to services to Perth. These possibilities may have tipped the balance of benefits away from a continuation of authorisation.

8.7 The Commission will maintain the existing conditions of approval of the code share as well as formalising a requirement for Qantas to report its passenger revenue yields quarterly, bringing it into line with conditions on other routes where the Commission closely monitors the effect of code share arrangements. This data is already reported to the Commission as part of Qantas' application process so effectively adds no new requirement on the airline.

8.8 At the next review during 2010, assuming Qantas seeks authorisation beyond the end of 2010, there should be sufficient market and financial data available to the Commission to clearly assess the public benefit impacts of the pro-competitive market changes that will occur through 2009 and into 2010, including the effects of the code share in that new environment. Further, by the time of that review, it is possible that Qantas and/or V Australia will have sought additional capacity from the two services currently available for operation from October 2009 and the seven weekly services that can be used from October 2010. Whether or not they have done so, the presence of that extra capacity creates scope for an expansion of services including to Perth and other Australian points, which is likely to be important in the Commission's public benefit assessment of the code share beyond the end of 2010.

8.9 The Commission expects Qantas to apply by 30 June 2010 should it wish to seek continued authorisation beyond 31 December 2010. If the Commission decides at that review not to authorise the code share for a further period, this lead time will allow the airlines sufficient time to make alternative arrangements. The Commission would not be of a mind to grant a short term extension beyond 31 December 2010 simply because Qantas had not applied early enough.

9 Role of the ACCC

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

10 Decision ([2008] IASC 225)

10.1 In accordance with section 24(1) of the Act, the Commission varies Determinations [2004] IASC 119, [2005] IASC 125, [2006] IASC 130, [2008] IASC 105 and [2008] IASC 109 to permit SAA to code share on Qantas' flights operated to and from South Africa until 31 December 2010, consistent with the Qantas/SAA code share and commercial agreements provided to the Commission, subject to the following conditions:

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

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

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

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

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

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

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

- Qantas must submit to the Commission reports each quarter on the number of code share seats available for sale and sold by it on each of SAA's operated services and by SAA on each of Qantas' operated services; and its quarterly yields per revenue passenger kilometre for all passenger classes on these services.

Dated: 4 December 2008

John Martin	Philippa Stone	Ian Smith
Chairman	Member	Member