Australian Government

International Air Services Commission

DECISION

Decision:	**[2012] IASC 201**
Variation of:	**[2006] IASC 130, [2008] IASC 105, [2008] IASC 109, [2009] IASC 126, and [2010] IASC 115**
The route:	**South Africa**
The applicant:	**Qantas Airways Limited (ACN 009 661 901) (Qantas)**
Public Register File:	**IASC/APP/201121**

1 The application and submissions

1.1 Qantas applied to the Commission on 15 August 2011 to vary Determinations [2006] IASC 130, [2008] IASC 105, [2008] IASC 109, [2009] IASC 126 and [2010] IASC 115 to enable South African Airways (SAA) to continue to code share on Qantas' services between Sydney and Johannesburg. Qantas has sought the variations to the determinations with effect from 1 January 2012 to 31 December 2017.

1.2 Qantas' application included a confidential attachment. On 18 August 2011 Qantas provided additional non-confidential material in support of its application.

1.3 Qantas argues that the code share has ensured efficient use of capacity and enhanced carrier viability and that its continuation will increase the prospects of maintaining sustainable competition. According to Qantas, third country carriers play an important role in offering highly competitive fares and in meeting peak seasonal demand. Qantas says that the block space nature of the code share means SAA is exposed to any losses if seats are unsold and this maintains a contested market and competitive pricing. Qantas has sought a five year approval because it says that rolling short term determinations do not give it the investment certainty it needs to develop the route over the long term. Qantas says that realistically the route can support only a small number of direct carriers and notes that it has failed to attract other long term investors. In Qantas' view, discontinuation of the code share would likely lessen competition benefits and it is highly probable that the route would eventually be served by a single direct carrier. Qantas says it spent some A$345,000 in the last financial year on marketing activity in South Africa, and suggests that without this activity associated with the code share visitor tourist numbers may well have fallen further than they did.

1.4 A detailed summary of the Qantas application is at **Attachment A**.

1.5 On 16 August 2011, the Commission published a notice inviting submissions from interested parties about the Qantas application. Submissions were received from Virgin Australia (Virgin), an interested member of the public, the Victorian Government and the Australian Competition and Consumer Commission (ACCC) and Qantas responded to the

62 Northbourne Avenue Canberra City ACT Australia • Postal: GPO Box 630 Canberra ACT 2601 Australia
Tel: (02) 6267 1100 • Fax: (02) 6267 1111 • Internet: www.iasc.gov.au • Email: IASC@infrastructure.gov.au • ABN 86 267 354 017

Virgin submission. A summary of the submissions is at **Attachment B**. The Commission has considered all of these submissions and will refer to them where relevant.

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

1.7 The Commission has analysed a considerable amount of data to assess changes to the public benefit situation on the route since its late-2010 review. The data includes information held by government agencies such as the Australian Bureau of Statistics and the Bureau of Infrastructure, Transport and Regional Economics; commercial-in-confidence material provided by Qantas; historical data on fares on the Australia-South Africa route provided by Qantas, Virgin Australia and an independent source; and fare information available on on-line web sites.

2 Requirements under the Act and the Minister's policy statement

2.1 Under section 15(2)(e) of the *International Air Services Commission Act 1992* (IASC Act), a carrier cannot use allocated capacity to provide joint services with another carrier without the prior approval of the Commission. Qantas, therefore, requires the Commission's authorisation to use its allocation of capacity through SAA code sharing on Qantas' services between Sydney and Johannesburg. The code share agreement also involves Qantas code sharing on SAA flights between Perth and Johannesburg. However, no approval for this is required from the Commission as under the Australia-South Africa air services arrangements Qantas as the marketing carrier is not using Australian capacity entitlements. Relevant provisions of the air services arrangements are outlined in **Attachment C.**

2.2 When considering applications to vary determinations, the Commission must decide whether the determinations, as varied, would be of benefit to the public. The Minister's policy statement makes it clear that where capacity can be used for code sharing under air services arrangements, the Commission would generally be expected to authorise applications for use of capacity to code share. The policy statement goes on to state that if the Commission has serious concerns that a code share application may not be of benefit to the public, it may subject the application to a more detailed assessment using the paragraph 5 criteria. Before doing so, the Commission must consult the ACCC and it has done so in this case.

2.3 The paragraph 5 criteria comprise competition, tourism, consumer, trade, and aviation industry benefits and any other criteria that the Commission may consider relevant. The Minister's policy statement states that the Commission is not obliged to apply all the paragraph 5 criteria, and that in applying the criteria it should take as the preeminent consideration the competition benefits of the application.

2.4 The Commission notes that Qantas has addressed all the paragraph 5 criteria and will therefore assess its application against all the criteria. In doing so, however, the Commission has taken as its preeminent consideration competition benefits, and notes that most of the other paragraph 5 public benefits identified in the Qantas application – tourism, consumer and trade – flow from increased competition. For these reasons, and in accordance with the Minister's policy statement, the Commission's main focus in assessing the Qantas application will be on competition issues.

3 The code share agreement

The nature of the code share agreement

3.1 Under the code share agreement, Qantas and SAA agree to provide specified services on the Sydney and Perth-Johannesburg routes respectively, and each operating airline agrees to supply the other with a specified percentage of the seats on their agreed flights. The code share is a hard block arrangement which means that SAA as a marketing carrier pre-purchases the fixed block (percentage) of seats on Qantas' Sydney services and cannot hand any back to Qantas. The fixed price paid for the seats is determined by the equivalent percentage of Qantas total costs of the flight, excluding costs relating to marketing and freight (which is not included in the code share). All seats are required to be priced and marketed independently and SAA carries the loss if it does not sell enough seats to cover the cost of the pre-purchased block. Reciprocal arrangements apply to Qantas' code share on SAA's Perth services. The code share can be terminated by either party with 12 months notice. The two airlines also have an interline special prorate agreement, covering domestic South Africa and Australia, other Africa and trans Tasman sectors, and a reciprocal frequent flyer agreement.

3.2 The code share enables the two airlines to offer combined double daily services on the Sydney and Perth-Johannesburg routes at a reduced overall operating cost and with the certainty of a pre-sold fixed block of seats at an agreed price on every flight they operate.

Previous decisions to approve the code share

3.3 The Commission has authorised code sharing between Qantas and SAA on a continuing basis since December 2000. However, the Commission has maintained short-term periods of approval, one or two years at a time, because of concerns that the code share may not be of benefit to the public over a longer period when circumstances may change. The Commission has also maintained various conditions of approval designed to encourage competition between the code share partners, such as minimum numbers of weekly frequencies which must be operated and independent pricing.

3.4 At each review, the Commission has assessed data and other information associated with the operation of the code share. This information provides the basis for the 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;
- trends in traffic numbers, including seasonal patterns and the composition of the market based on journey purpose of travellers;
- airline load factors and fares;
- confidential financial information including trends in Qantas' revenue yields, route costs, revenues and profits, as well as its forward bookings; and

- market shares, including the extent of third country carrier participation and its effect on competition in the market.

3.5 In its reviews in 2007 and 2008, in particular, the Commission recorded its concerns about high air fares and rising load factors on the route. However, at its December 2008 review, the Commission welcomed major changes to the air services arrangements in mid-2008 which had resulted in a large increase in capacity available to Australian and South African carriers. Until that time, there was no capacity available for expansion by Qantas or SAA or for new entrants. The constrained capacity also meant that there was little incentive for the two code share partners to compete strongly through their code share blocks because aircraft were already very full.

3.6 In extending the code share approval for two years from the end of December 2008, the Commission took account of Qantas' plans to increase its services from five to seven per week by April 2009 and, more importantly, of V Australia's plans to enter the route and fully use its allocated capacity of five weekly frequencies by October 2009. The Commission was also aware that there was scope for SAA to increase frequencies to Perth above its then five weekly flights.

3.7 The Commission considered that these developments were likely to lead to substantially better public benefit outcomes, particularly once V Australia entered the route. The Commission indicated, however, that it would almost certainly have declined to approve continued code sharing if there had not been the prospect of a new entrant.

3.8 In September 2010, as a result of V Australia's decision to withdraw (announced on 26 August 2010, between the first draft and final decisions) the Commission strengthened the conditions requiring Qantas and SAA to operate a combined minimum number of services by increasing the minimum from 12 to 14 services per week. It also stated that "If, by the time of the next review in mid 2011, there is evidence that the public benefit indicators have turned down, the Commission is likely to be very inclined towards not granting a further extension ... beyond 2011." The decision made it clear that expansion plans and pricing behaviour by Qantas and SAA in the period following V Australia's departure would be an important consideration.

Competition Commission of South Africa

3.9 On 13 October 2010 SAA applied to the Competition Commission of South Africa for an exemption from Chapter 2 of South Africa's Competition Act to allow its code share agreement with Qantas to continue. On 26 July 2011 the Commission granted an exemption certificate until 31 December 2012. In advising SAA of the decision the Commission noted that the agreement had been exempted a number of times and for this reason, "the Commission would like to convey its apprehension regarding any further exemption." The exemption contains a number of conditions, several of which are similar to conditions contained in previous IASC decisions. These include a requirement for SAA and Qantas to price and sell their tickets independently of each other, a prohibition on sharing or pooling revenues and a stipulation that the exemption will only be applicable while SAA and Qantas together operate a minimum of 10 services per week. Prior notification and reasons are required if the airlines decide to either increase or decrease their frequencies.

4 The draft decision

4.1 The Commission issued Draft Decision ([2011] IASC d220) on 17 November 2011, proposing to authorise the code share arrangement for a further twelve months until 31 December 2012. The Commission indicated in the draft decision that it was not currently minded to extend approval of the code share beyond the end of 2012. The Commission also proposed to retain a condition included in the 2010 decision that would require Qantas and SAA together to operate at least 14 services per week for the approval to remain in effect.

4.2 In response to a request from SAA the Commission agreed to extend the previous approval until 31 March 2012 to allow more time for the parties to make submissions on the draft decision. Submissions were received from an interested member of the public, SAA and Qantas. SAA and Qantas each made public and confidential submissions, and the summaries below are of the public submissions.

4.3 The interested member of the public says that the code share has failed to deliver any benefits to the public; in fact the opposite has occurred and now fares on the route are the most expensive available in Australia. The submitter says that the primary reason is that there is effectively no competition on the route. The closest alternatives are indirect services via third countries and longer travel times mean that these are not an attractive alternative. He says that the next shortest duration is offered by Malaysia Airlines which will be terminating their South Africa service shortly, thus further restricting competition. In the submitter's view, extension of the code share will reduce choices and benefits to consumers.

4.4 SAA says that a one year approval makes it extremely difficult for SAA to plan its medium and long term strategies for the route. SAA has also expressed concern that requiring it to add a seventh frequency could cause the Perth route to go into loss, further exacerbating losses on the route overall. SAA says that it understands the Commission's position on providing only a 12 month extension, and while this creates planning and operational complications, it will work within this. Adding a seventh frequency, on the other hand, presents a much greater, rather prohibitive, obstacle and SAA requests an exemption from this requirement.

4.5 Qantas is concerned at the Commission's indication that approval of the code share will not extend beyond 2012 and believes that the Commission has not given appropriate weight to the role of third country carriers and to the strong competition between the direct carriers under the code share. Qantas argues that the arrangements are strongly competitive because there is a real incentive to sell pre-purchased seats as SAA cannot hand back seats and is exposed to losses if seats are not sold. Qantas says that the code share creates competition that would not otherwise exist and that withdrawal of approval would not only result in monopolies on both the Sydney and Perth routes, but more likely one or more of the incumbents would reduce services or withdraw entirely from the route. Qantas takes issue with the Commission's suggestion that disbanding its code share with SAA would "free up" SAA to enter into an arrangement with Virgin for domestic connections, saying it is not obvious why substituting one code share for another would promote competition. Qantas says that the Commission's proposal to maintain the minimum capacity requirement mandates inefficient excess capacity in a market where seasonal demand fluctuates significantly between the highest and lowest months. Qantas asks the Commission to remove this requirement and to authorise the code share for five years.

5 Traffic, capacity and services on the route

Traffic on the Route

5.1 It is almost four months since the Commission issued its draft decision. In that decision the Commission relied on traffic data for the year ended 30 June 2011. The Commission now has available to it data for the year ended 31 December 2011 and will use this data in this decision. Therefore, all annual statistics quoted below are for the years ended 31 December, unless otherwise stated.

5.2 In 2011 total passenger movements on the Australia-South Africa route numbered 372,264, an increase of 3.4% over the previous year. This number is made up of passengers originating in or destined for Australia or South Africa, as well as travellers on the route who have come from, or are destined for, countries beyond Australia or South Africa (eg. New Zealand, other African countries and the UK). This through traffic made up 21.5% of the passengers travelling on the route.

5.3 Australia-South Africa "origin-destination" traffic (Australians visiting South Africa as their main destination and South Africans visiting Australia) has slowed in recent years. After three years of strong growth between 2006 and 2008, over which period origin-destination traffic grew by 30%, traffic fell in 2009, coinciding with the global economic downturn. There was a spike in traffic in 2010 linked to the FIFA World Cup hosted by South Africa in June and July and in that year traffic grew by 13.8%. In 2011 traffic fell by 5.1%, with the biggest month on month falls in June and July, reflecting the impact of the World Cup the previous year. This compares with growth rates of more than 8% in each of 2006, 2007 and 2008 and an average annual growth rate of 4.2% over the last five years (2006-2011). Overall, the number of Australians and South Africans travelling between the two countries totalled 292,296 in 2011.

5.4 In terms of the services operated by the code share partners, Sydney-Johannesburg is the larger route with 194,102 passengers travelling on Qantas flights in 2011, an increase of 21,331 passengers over the previous year. 123,232 passengers flew on SAA's Perth-Johannesburg services in 2011, 347 fewer than the previous year.

5.5 In 2011 South Africans visiting Australia did so mainly to visit friends and relatives (40.2%) or to holiday (28.8%). 16.6% of South African visitors were in Australia for business reasons. 41.8% of Australians visiting South Africa recorded holiday as the main reason for travel, with 34.9% visiting friends and relatives and 13.5% travelling for business. Small proportions of travellers gave conventions, education and employment as their reason for travel. This journey purpose profile has not changed significantly over recent years.

5.6 The table below gives the total number of passenger movements on services between Australia and South Africa on direct and indirect services and includes passengers travelling through Australia and/or South Africa to or from points beyond the other country.

5.7

Total Passenger Movements between South Africa and Australia and beyond Years Ended June 2006 –June 2011

AUSTRALIA - SOUTH AFRICA air passenger market	Years ended December					Share of Total Market	Compound annual growth rate 07-11
	2007	2008	2009	2010	2011		
Direct(origin/destination)	174,799	189,053	195,112	231,656	208,505	56.0%	4.5%
(Annual % change)		8.2%	3.2%	18.7%	-10.0%		
Indirect(origin/destination via third countries)	83,476	91,589	75,429	76,315	83,791	22.5%	0.1%
(Annual % change)		9.7%	-17.6%	1.2%	9.8%		
Through (starts/ends in a third country	67,228	66,241	67,057	74,891	79,968	21.5%	4.4%
(Annual % change)		-1.5%	1.2%	11.7%	6.8%		
Total Market	325,503	346,883	337,598	382,862	372,264	100.0%	3.4%
(Annual % change)		6.6%	-2.7%	13.4%	-2.8%		

Data in this table is derived from information supplied by the Australian Bureau of Statistics.

Capacity growth

5.8 Following the negotiation of a substantial increase in capacity between the Australian and South African Governments in 2008, services increased significantly. SAA began substituting larger A340-600 for A340-200 and 300 aircraft in mid 2008 and went to daily services in September 2009; Qantas added a sixth weekly B747 service in December 2008 and a seventh in September 2010; and in March 2010 V Australia commenced twice weekly B777-300ER services between Melbourne and Johannesburg, increasing to three weekly services in December 2010.

5.9 By March 2010 capacity had grown by over 50%, resulting in average load factors across the three direct carriers falling from 81.7% in 2008 to 73% in 2010. In its final decision in September 2010 approving the code share, the Commission noted that, even with the withdrawal by V Australia in February 2011, the code share partners alone would be operating 40% more capacity than they were two years previously.

5.10 In addition to the withdrawal of V Australia, in February 2011 SAA replaced its A340-600 aircraft with smaller A340-300 aircraft and in May 2011, with the consent of the Commission, reduced its services to six per week. The Commission agreed to this reduction of services in light of the exceptional circumstances that were affecting the commercial performance of SAA on the route.

5.11 Confidential information provided by Qantas indicates that its revenue passenger kilometre yields on both the Sydney and Perth-Johannesburg sectors were better in 2010 than in 2009, but below those in 2008. In 2011 yields were slightly down on yields in 2010 on both sectors.

6 Indirect competition and entry on the route

Indirect competition

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

6.2 In 2011 some 73% of origin-destination passengers travelled on Qantas, SAA, and up to February 2011, V Australia. The remaining 27% of passengers with a destination of Australia or South Africa travelled via third-countries on airlines such as Singapore Airlines, Malaysia Airlines and Emirates. In the four years before V Australia entered the route Qantas and SAA consistently had a combined share of around 70% of origin-destination passengers.

6.3 Unlike, for instance, on the Australia-UK/Europe routes, third country carriers competing in the Australia-South Africa market are a considerable distance from the route and are competing with non-stop services. Longer travel times on one stop services means they offer a poor substitute and limited competitive constraint for the direct services offered by the code share partners, Qantas and SAA, especially in the time-sensitive business market and on the Sydney and Perth routes. Of the main third country carriers, Singapore Airlines and Malaysia Airlines offer the shortest travelling times. However, flying on Singapore Airlines between Sydney and Johannesburg via Singapore still takes about 50% longer than on Qantas' direct service and between Perth and Johannesburg via Singapore is some seven hours, or 65%, longer than on SAA's non-stop service. When broken down into shares of route sectors with direct services and those without direct services, the third country airline share of the former (Sydney and Perth) is only 15%.

6.4 By contrast, for Brisbane and Melbourne inbound and outbound passengers, a one stop service via third countries provides a closer substitute to the alternative of flying on Qantas via Sydney or on SAA via Perth. For Brisbane and Melbourne passengers travel times on one stop routes via third countries are only 10-20% longer than flying via Sydney. With much lower fares being offered for flights which take only 10-20% longer, passengers travelling to and from Melbourne and Brisbane have shown a strong preference for third country carriers. Port of clearance data shows that in the case of Brisbane-Johannesburg, Qantas has only 10.9% of the market, compared with 44.3% for Singapore Airlines. The latest traffic statistics for Melbourne-Johannesburg include V Australia (which had a 33.5% share of traffic in 2011, having ceased services in February), but even allowing for this Singapore Airlines still carried 17.3% of traffic on the Melbourne-Johannesburg route, compared with 6.8% for Qantas. Prior to V Australia's entry, Singapore Airlines carried 38.6% of traffic on the Melbourne route and Qantas carried 9.4%.

V Australia's entry and subsequent exit from the Australia-South Africa route

6.5 As noted previously, in March 2010, V Australia commenced twice-weekly B777-300ER services between Melbourne and Johannesburg, increasing to three in December 2010. It withdrew from the route in February 2011. The Commission has examined fare and traffic data from a number of sources to analyse the impact of Virgin's entry on competition.

6.6 Historical fare data obtained by the Commission indicates a significant impact from V Australia's entry on the Melbourne-Johannesburg route, in particular on the leisure segment of the market. Throughout the period from November 2009 when V Australia started selling fares until it left the route in February 2011 its lowest economy class fares stayed fairly steady, with a slight downward trend from October 2010. Its fares were consistently lower than those of Qantas and SAA between March and December 2010, although by a relatively small margin. A large gap opened up between its economy fares and those of Qantas and SAA from December 2010.

6.7 Whereas Qantas normally common rates its Sydney and Melbourne fares, when V Australia introduced a Melbourne service Qantas priced economy class seats out of Melbourne lower than Sydney, in the order of between 6% and 18%. Once V Australia exited the route, Qantas' fares out of Melbourne reverted to being the same as for Sydney. On the Melbourne route the lowest economy class fares on sale by Qantas and SAA fell quite sharply in early 2010 and rose again in December 2010, although this also coincided with the start of the high season.

6.8 Data provided to the Commission indicates that Qantas' and SAA's business class fares on the Melbourne route did not fall and were consistently higher than V Australia's from late 2009 to February 2011. This would suggest that with only two and later three services a week, Qantas and SAA did not see V Australia as a serious competitive threat in the premium market, even for Melbourne-South Africa traffic.

6.9 As noted above, passengers flying between Melbourne and South Africa have shown a strong preference for flying on third country airlines, which offer cheaper fares for an alternative one stop service without substantially longer travel times. V Australia's entry with a direct service and competitive fares on the Melbourne-Johannesburg route had its most substantial impact on these carriers. In particular, Singapore Airlines saw its share of traffic between Australia and South Africa fall from 10.9% in 2009 to 8.7% in 2010.

6.10 V Australia's entry seems to have had little competitive impact on prices charged for direct services between Sydney and Johannesburg. Data provided by Qantas indicates that there was a moderate upward trend in its Sydney-Johannesburg discount economy fares between June 2010 and August 2011, with little discernible change when V Australia entered and left the market. This suggests that Qantas did not see V Australia as a competitive threat in the Sydney market, with its two to three weekly services via Melbourne.

6.11 The apparent lack of competitive threat posed by V Australia's entry for the code share partners' direct services is reflected in their share of traffic. SAA's share fell from 30.2% in 2009 to 27.8% in 2011, but its market share has been on a downward trend since 2004 when it peaked at 35.9%. Qantas' market share has remained fairly steady over the same period, ranging from a high of 44.4% in 2003 to a low of 37.5% in 2005 and is currently just over 42%.

<u>Implications for future competition on the route</u>

6.12 In the Commission's view, the preceding analysis strongly suggests that competition from indirect carriers only provides a serious competitive constraint on the code share airlines in relation to passengers who need to fly indirectly in any case, principally those flying to and from Melbourne and Brisbane. When V Australia offered passengers from Melbourne a direct service, this proved very attractive in fare classes other than business.

6.13 With the withdrawal of V Australia it is reasonable to expect that the combined market share of third country airlines will return to around 30%, assuming no change in the number of services operated by the direct carriers.

6.14 In the Commission's view, the third country airline share of passengers on the route as a whole is unlikely to grow significantly and any real competitive pressure, in particular in the premium market, must come from airlines operating direct services. The impact of V Australia's entry on fares and traffic share confirms this view. Whereas V Australia had a significant impact on fares and traffic share on the Melbourne route, there was little discernible impact on the Sydney route.

6.15 The Commission believes that the impact of V Australia's entry on Qantas' pricing behaviour and the shares of indirect carriers confirms that indirect routes are not attractive to passengers on this route when direct services are available. Qantas was forced to respond competitively to V Australia's entry with lower fares on the Melbourne route, but not on the Sydney route. Indirect third country carriers lost significant numbers of passengers once V Australia offered a direct service on the Melbourne route, but there was little discernible impact on the passenger fares of direct services from Sydney.

7 The Commission's assessment against the paragraph 5 criteria

Competition benefits

7.1 In terms of competition benefits, paragraph 5 of the Minister's policy statement provides:

> "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."

7.2 In order to assess the likely competition benefits from renewing the code share agreement, the Commission must assess and compare the likely state of competition on the route with and without the code share in place. This is sometimes referred to as a comparison of the likely factual and counterfactual situation. Submissions have canvassed a range of possibilities. The general consensus is that the likely future state of competition with the code share in place will be a continuation of the status quo, however that is assessed. The future without the code share canvasses a broader range of possibilities, from each code share airline continuing to operate their respective routes as monopolists, to the possibility of one or other airline exiting the route and/or the possibility of new entry.

7.3 Two factors are critical to the Commission's assessment of the likely state of competition in the future with and without the code share agreement in place:

- The likely extent and nature of competition from other carriers; and
- The likely extent and nature of competition between the code share partners.

Competition from other carriers

7.4 In the future with and without the code share agreement in place, third country carriers will likely continue to provide, as they have in the past, very limited competition from the code share gateway cities of Sydney and Perth. The time penalty in terms of total travel times for trips between Australia and South Africa is too great for third country carriers to compete against the direct services, except for passengers who either need to make stops in those third countries or the least time sensitive passengers (who are likely to be relatively limited in numbers).

7.5 By contrast, third country carriers have and likely will continue to provide significant competition to the code share carriers from major Australian cities which do not have direct services. As described in the previous section, these third country carriers provide an alternative one-stop service between cities such as Brisbane and Melbourne at attractive prices and with travel itineraries that impose only a relatively minor time penalty compared with the code share carriers' indirect services; and they have captured a large share of traffic to and from these cities. However, the total number of passengers that travel between these cities and South Africa is relatively small compared with passengers travelling to and from Perth and Sydney.

7.6 In the Commission's view significant competitive pressure on the code share parties, especially in relation to flights to and from Sydney and Perth, can only come from the entry of a new carrier operating direct services. It is clear from the experience with V Australia's entry on the Melbourne-Johannesburg route that entry with a direct service has a significant and much more profound impact on competition than third country carriers. Accordingly, if entry is more likely in the counterfactual, this will be significant for the assessment of the likely competition benefits arising from a renewal of code share approval.

7.7 However, it is also clear from V Australia's experience, that entry at a low frequency will have limited impact on the business market and is not likely to be profitable for the entrant. The Commission recognises that more substantial entry involves significant challenges. The need to offer a sufficient level of services to attract high yielding business traffic means making a substantial investment in a route which is relatively low in volume, highly seasonal and already served by two well established airlines operating under a code share partnership. Entry is also not likely to have a beneficial effect on airfares from cities beyond the entrant's gateway.

7.8 The likelihood of significant entry (defined as daily or near daily service frequency) by another carrier providing a non-stop service between Australia and South Africa in the short term appears to be low. While the existence of the code share agreement may make it somewhat less likely for such entry to occur, regulatory hurdles, the length of the route, the current level of passenger traffic and limited potential for significant increases in that traffic, make it unlikely that such non-stop entry would be attractive to any carrier, even without the code share in place.

7.9 In the longer term, in a growing market new entry may be more likely without the code share, to the extent that a new entrant would not be competing against the combined market position of the incumbent carriers. Alternatively, one of the incumbents may exit and another competitor enter. Any new entrant is most likely to be an Australian or a South African airline, although the possibility of a third country airline entering the route cannot be ruled out. For example, the Commission understands that Air New Zealand has the necessary rights under New Zealand's air services agreements with both Australia and South Africa to operate direct services between Australia and South Africa. However, such entry is by no means certain.

7.10 In assessing the possible impact of the code share on a potential new entrant, the Commission thought it useful to seek to understand the reasons for V Australia's early departure. Start up losses are to be expected on a new route, but in announcing V Australia's withdrawal after only six months, Virgin's CEO said that, as a minor player, the prospects of achieving a return were not good. Clearly, in the Commission's view, not being able to match the daily flights offered by both Qantas and SAA in the east coast market was a major problem for V Australia and choosing Melbourne rather than Sydney, given the much larger South African born population in Sydney, may not have helped. Also, the Commission understands that operational restrictions on flight paths which could be flown by V Australia's twin engine B777 meant longer flying times and higher costs than for Qantas.

7.11 It is difficult to untangle the multiple reasons for V Australia exiting the route, but in the view of the Commission, the existence of the code share arrangement between Qantas and SAA was likely, even if only to a small extent, to have been a contributory factor. The Commission notes that entry to a new route requires any airline to make a considerable investment in areas such as promotion, marketing, systems and timetable changes, and realignment of operations to service the new route. The experience in Australia and internationally is that it is difficult for a new entrant with a limited schedule to compete with an existing carrier operating a daily or close to daily schedule. This exacerbates the difficulties that will be faced by any airline seeking to compete on the Sydney-Johannesburg or Perth-Johannesburg routes.

7.12 The code share is unlikely to be the sole determinant of whether or not a new entrant will seek to compete on this route. However, in a case where the decision to enter or not was finely balanced, the existence of the code share would be an additional factor that would disincline a prospective entrant from competing on the route.

Competition between the code share partners

7.13 Absent entry or an effective competitive constraint from third country airlines, competition between Qantas and SAA in the future with the code share in place depends critically on the incentives created by the code share agreement itself.

7.14 Hard block code share arrangements are generally considered to be more competitive than free-sale type arrangements, because they create an incentive for the code share partners to sell as many seats as they can to cover the fixed price of the blocks they have purchased from each other. However, while a code share in the form of a block sale arrangement could, in theory, promote competition between Qantas and SAA on the two direct routes they serve, the context and details of this block sale arrangement appear substantially to limit the intensity of competition between the two airlines.

7.15 The code share operates in the context of a duopoly for direct services between Australia and South Africa, with little constraint from third country airlines and little prospect of entry, at least in the short run. Each airline is clearly each other's closest rival, being the only alternative for direct services (via the code share) on each of the two routes, with repeated market interaction between the parties on a daily basis, such that each learns and anticipates the likely reaction of the other party to any competitive moves they may consider making.

7.16 Each airline determines the other's cost base on the route it operates as a pro rata share of total costs for the flight. The price at which the blocks are sold to each airline appears to be relatively high, putting an effective floor under the price at which each airline can sell tickets and expect to make a profit. The high price reflects the fact that the code share airline pays a pro rata share of the operating airline's total costs. Given expected load factors, this makes it relatively difficult for the purchasing airline to earn a profit on the seats it purchases.

7.17 Except in the very short run (and even these incentives would be attenuated by the nature of the interactions between the airlines) the code share airline has little incentive to price fares below the price it pays to the carrier airline. If deep price cuts became persistent, the airlines would be better off exiting the code share (since deep price cuts would likely be unprofitable except at unrealistically high load factors) and retreating to a monopoly position on their respective routes.

7.18 Both code share airlines know that any price reduction by one will be quickly matched by the other, implying that deep price cuts would be self-defeating as each airline simply cannibalised its own revenues. Cognisant of these incentives and knowing the cost it is charging the code share airline, the carrier airline also has no incentive to price seats below the cost it charges to the code share partner.

7.19 Therefore, by setting the price that each pays to the other, the code share airlines set a floor price for the route (with other more flexible and business/first class fares priced above the floor). Furthermore, in the absence of an effective competitive constraint from third country carriers or new entry, there is also limited competitive pressure to improve cost or dynamic efficiency.

7.20 The price at which the code share airlines sell connecting flights (and in particular, the price at which Qantas sells connecting flights to SAA from Sydney) may discourage competition for connecting traffic. Given that fares to/from several East Coast Australian cities to/from South Africa are common rated with Sydney fares, an additional price charged by Qantas to SAA for connecting flights would discourage competition between the code share carriers for this traffic.

Conclusion on competition benefits

7.21 The state of competition in the future with the code share seems likely to be a continuation of the present state of competition. The code share agreement appears to provide only limited incentives for competition between Qantas and SAA, there is limited competition from third country airlines on the direct routes and there is little prospect of new entry, at least in the short term and possibly much longer. For traffic between other Australian cities and South Africa, third country carriers will likely continue to provide an effective competitive alternative. However, since most of the traffic between South Africa and Australia originates or terminates in Sydney and Perth, the lack of competitive threat from indirect carriers and the unlikelihood of non-stop entry in the short run, means that the code share airlines face and will likely face little competitive pressure from other airlines for services to and from these major gateway cities.

7.22 The state of competition absent the code share depends to a great extent on entry and exit. In the short term, the Commission considers that the most likely counterfactual situation in relation to the code share partners is a continuation of the current pattern of operations – that is, Qantas and SAA each operating on its existing route with the same or similar levels of capacity. It is unlikely that either airline under the counterfactual would offer additional services to any other gateway in Australia or South Africa.

7.23 Given the constraints on competition under the code share arrangements, prices may not rise significantly under this scenario, but to the extent that there is some limited scope for price and non-price competition on each other's route under the code share, then that competition would be lost. There might be some incentive for the airlines to compete more for each other's traffic, but the data and history suggests that indirect services are not attractive to passengers when direct services are available.

7.24 Any increase in competition in the counterfactual in the short term is likely to be on indirect routes (Melbourne and Brisbane in particular). This could involve, for instance, SAA reinstituting its code share with Virgin to provide improved one-stop service via Perth to and from other Australian cities, particularly Adelaide, Melbourne and Brisbane. Given its relatively modest load factors between Perth and Johannesburg, SAA would have the incentive to revive this agreement, as long as the price charged by Virgin for passenger interconnects, plus its own incremental costs of flying those additional passengers between Perth and South Africa, were less than the total fares it could charge to such passengers. Both Virgin and SAA would have incentives to enter into such an arrangement if it would lead to an increase in high-yield business class traffic – SAA because its business class traffic between Perth and Johannesburg has always been relatively light (compared with business class traffic between Sydney and South Africa), and Virgin because its publicly announced corporate strategy is to make a more concerted effort to attract such traffic – in which case interline long-haul business class traffic to and from Perth may be of benefit to it.

7.25 In its response to the draft decision Qantas queried why substituting one code share arrangement for another in this way would materially promote competition. In the Commission's view, an incumbent airline code sharing with a new airline on complementary routes in direct competition with the other incumbent is quite different from the incumbents code sharing with each other. A code share arrangement between SAA and another airline could also provide an opportunity for that airline to enter the route as a marketing airline.

7.26 In the longer term, as discussed earlier, entry may be more likely in a growing market without the code share, to the extent that a new entrant would not be competing against the combined market position of the incumbent carriers.

7.27 In the short term, therefore, there are likely, on balance, to be marginal competitive benefits gained from approving the code share. However, the long term competitive benefits from the agreement are uncertain and possibly negative to the extent that the continued existence of the code share agreement discourages entry and discourages competition between the partner airlines from gateway cities other than Sydney and Perth.

Other benefits

7.28 In terms of tourism benefits, paragraph 5 of the Minister's policy statement provides:

> "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)."

7.29 V Australia's presence on the route added more capacity, a new airline and Melbourne as a destination for South African tourists, as well as putting some downward pressure on fares (as discussed earlier). This benefit has now been lost.

7.30 Assuming current patterns of operation continued, withdrawal of the code share approval would remove the incentive for Qantas to promote Perth as a destination and for SAA to promote Sydney. Qantas says that in the last financial year it spent approximately A$345,000 on marketing activity in South Africa. It is not known how much of this was spent on marketing Perth, but some reduction of Qantas' promotional activity might occur. The Commission does not have information on how much SAA spends on marketing Australia in South Africa.

7.31 On the other hand, each carrier may simply shift their promotional activity to focus on the gateway city which they serve.

7.32 South Africa is not a major or growing tourism market for Australia. Most short term visitor arrivals from South Africa are visiting friends and relatives, with holiday traffic comprising 27% of total traffic. In 2011 16,666 South Africans travelled to Australia on holiday, compared with 17,910 the previous year.

7.33 The Commission concludes that the code share may provide some marginal incentive for the code share carriers to market and promote their services to the non-operating destination and to behind gateway destinations. Withdrawal of the code share approval could result in some lessening of tourism benefits if the current pattern of operations continued, but there could be an increase in tourism benefits if this encouraged a new airline to enter the route.

7.34 In terms of consumer benefits, paragraph 5 of the Minister's policy statement provides:

> "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)."

7.35 Consumers generally benefit from competition between airlines. Hence the Commission's analysis of consumer benefits flows directly from its analysis of competition benefits.

7.36 The continuation of the code share may provide some consumer benefits relative to removing approval if the status quo is maintained in terms of current operations. However, were withdrawal of the approval to encourage a new airline to enter the route with direct services, it is likely that there would be an increase in consumer benefits.

7.37 In terms of trade benefits, paragraph 5 of the Minister's policy statement provides:

> "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."

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

7.39 If a decision not to approve the code share resulted in a reduction in services by the incumbent carriers there would be less belly-hold capacity available and trade benefits would be reduced. On the other hand, if the incumbents maintained their current level of operations and a new airline was encouraged to enter the route, a decision to discontinue the code share approval would mean increased belly-hold capacity and therefore enhanced trade benefits.

7.40 In terms of industry structure, paragraph 5 of the Minister's policy statement provides:

> "The Commission should assess the extent to which applications will impact positively on the Australian aviation industry."

7.41 From Qantas' perspective the code share arrangements have had a positive effect on the Australian aviation industry by increasing its profits on the route.

7.42 On the other hand, the code share may have contributed to V Australia's losses on the route and to its eventual withdrawal. To the extent that continuation of the code share could act as a deterrent to it or another Australian airline entering the route, approval of the code share would not have a positive impact on the Australian aviation industry overall.

8 Conclusion

8.1 When the Commission released its previous decision on this matter in September 2010, it concluded that the public benefits associated with the code share had improved dramatically since the previous review in 2008. The Commission noted that there was a new carrier on the route (albeit temporarily as V Australia's withdrawal had just been announced), the incumbent carriers had increased capacity substantially, air fares had declined sharply and load factors had eased.

8.2 Since then there has been a deterioration in the competitive environment. V Australia has now withdrawn from the route and one of the incumbent carriers has reduced its capacity. Having said that, the situation today still remains better than in 2008, when capacity was severely constrained and load factors were substantially higher.

8.3 In determining whether to renew approval for the code share, however, the Commission must consider whether that is likely to give rise to public benefits, and in particular competition benefits, going forward as compared to a future without the code share.

8.4 On the basis of the public and confidential information available to it, the Commission considers that the current state of competition for passengers travelling between Australia and South Africa is limited and that the code share provides a poor substitute for direct competition. The two airlines have an effective duopoly on the main routes (Sydney and Perth), subject to very little competitive constraint from third country airlines or threat of entry. In the Commission's view, the nature of the code share under that market scenario does not provide strong incentives to compete.

8.5 In the Commission's view, significant competitive discipline will only be imposed by the entry of a new carrier on the code share routes. The Commission also considers that code sharing arrangements between incumbent and non-incumbent airlines could contribute to competition, although not to the same degree as own aircraft operations by a new entrant.

8.6 A particular concern of the Commission, prompted by the failure of V Australia to sustain services on the route, is the impact that the code share may be having on contestability. Barriers to entry are relatively high in the aviation sector due to high investment costs and government regulation. Qantas itself has pointed out that V Australia faced significant challenges in trying to compete with incumbent carriers that were supported by significant investments and extensive product development and the reality that the business segment of the market requires the flexibility of daily services. The Commission is concerned that the difficulties for any new entrant in attempting to compete with the combined market position of the incumbent carriers may be made worse by the code share.

8.7 Having considered the possibility of not approving an extension of the code share, the Commission concluded that this would not be of benefit to the public. Coming at short notice, it would cause considerable disruption to the airlines and their planning and also to the travelling public. It would, in the short term at least, result in monopolies for direct services on both the Sydney and Perth routes and the possibility of one or other of the incumbent carriers reducing services or withdrawing from the route could not be ruled out.

8.8 Qantas has sought an extension of the code share approval for five years, arguing that rolling short term determinations do not give it the investment certainty it needs to develop the route over the long term. Qantas says that it has already made significant investments in the route and it is not clear to the Commission what further investments might be required over the next five years for it to improve its services. Competition on the route has deteriorated since September 2010 when the Commission, as on all previous occasions, approved an extension for a short period only.

8.9 In the short term, the Commission is concerned that under the block seat arrangement purchasing costs may be set at a level that provides little scope for meaningful competition between the respective marketing and operating carriers. Over the longer term, the Commission is also concerned that the existence of the code share may be an impediment to a new airline entering the market.

8.10 The Commission concludes that there are competition benefits from approving the code share in the short term. Over the longer term there is a greater prospect of either entry and/or more competition between the incumbent airlines for traffic which currently travels via third countries in the absence of the code share.

8.11 The Commission is keen to encourage more competition on the route, either through new entry or code sharing arrangements between incumbents and other airlines, and considers this is more likely to occur in an environment in which there is no code sharing between the incumbent airlines. Hence the Commission remains of the view that, as matters currently stand, the approval of the code share should not be extended beyond the end of 2012.

8.12 Accordingly, the Commission will not approve the code share for five years. Instead it will extend approval of the arrangement to 31 December 2012 only.

8.13 The Commission notes that the Competition Commission of South Africa also has concerns about the code share and it too has expressed doubt about granting a further exemption beyond 2012. The Commission plans to consult the Competition Commission on the possibility of harmonising our approaches to future applications for extensions of the code share.

8.14 SAA and Qantas both argue that the requirement in the draft decision for a combined minimum of 14 services per week could pose difficulties on a route such as this with fluctuating demand. The Commission notes that in its decision last July the South African Competition Commission included a condition that SAA and Qantas together must operate a minimum of 10 services per week for the code share approval to remain in effect. The Commission also notes that since its draft decision the data suggests that there has been some softening of demand on the route, although much of this can be attributed to traffic returning to normal levels in the year after the World Cup. The Commission will therefore include the same condition as the South African Competition Commission in its decision.

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 [2012] IASC 201

10.1 In accordance with section 24(1) of the Act, the Commission varies Determinations [2006] IASC 130, [2008] IASC 105, [2008] IASC 109 and [2009] IASC 126 and [2010] IASC 115 to permit SAA to code share on Qantas' flights operated to and from South Africa until 31 December 2012, consistent with the Qantas/SAA code share and commercial agreement provided to the Commission, subject to the following conditions:

- any amendments to the code share agreement (including to Annex 1), or to the commercial agreement 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 must not share or pool revenues under any such agreement;
- 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;
- nothing in this decision exempts Qantas from complying with the Australian Consumer Law and Qantas is required to take all reasonable steps to ensure that passengers are informed, at the time of booking, 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; and
- 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: 29 February 2012

Jill Walker	Stephen Bartos
Chairwoman	Member

Attachment A

Detailed summary of the application

Qantas has made the following claims in support of its application:

- Continuation of the arrangements will maximise choices and benefits for consumers, optimise growth in Australian tourism and trade and assist Qantas in competing with foreign airlines, including third country airlines, in the market.

- Arrangements approved by the Commission since 2000 have ensured efficient use of capacity, enhanced the viability of carriers in the face of increasing competition and maximised public benefit.

- The circumstances of this market and the public benefit derived from these arrangements are consistent with the policy statement guidance that where code share capacity is allowed under air services arrangements, the Commission would generally be expected to authorise applications for its use.

- Discontinuing the arrangements would likely lessen the competition benefits achieved by the code share. Continuation of the arrangements will produce a superior outcome than if they were not permitted to continue and will increase the prospects of maintaining a sustainable level of competition in the long term.

- In recent years, events beyond the control of the aviation industry have been sustained and deeply disruptive and are a material consideration in understanding the challenges and fragility of the sector. The Commission is encouraged to consider these issues broadly to ensure the inherent efficiencies, cost savings and consumer benefits of the arrangements are maintained.

- Both countries are at the end of long routes with demand largely framed around point to point traffic. Traffic rights restrictions in the air services agreement ensure limited commercially viable hub opportunities for Qantas code share services, with the exception of New Zealand.

- The route requires the use of specialised, long haul aircraft which means it is not possible to introduce lower capacity aircraft to accommodate incremental growth or to easily adjust capacity up or down to accommodate seasonal demand. This lack of flexibility is compounded by a relatively small market where demand can vary by as much as 15,000 passengers between the highest and lowest month.

- Third country carriers play an important role in the market. They offer highly competitive fares and provide important capability to meet peak seasonal demand.

- The air services agreement permits the entry of multiple Australian and South African carriers and there is sufficient capacity available to accommodate their entry. Realistically this route can support only a small number of direct carriers.

- The code share agreement is a block space arrangement. SAA as the marketing carrier pre purchases a specific number of seats at a fixed rate and cannot hand back those seats to Qantas. It is exposed to losses if the seats are not sold. This establishes and maintains a contested market and competitive pricing initiatives.

- Absent the code share agreement it is unlikely a competitive presence in the market can be guaranteed.

- As the accumulated and detailed knowledge of this market should now suggest to the Commission that its characteristics are unlikely to change in the foreseeable future, Qantas argues that it is now appropriate to extend the current approval for five years. Rolling short term determinations do not give Qantas the investment certainty it needs to develop the route over the long term. This would ensure that Qantas can invest with confidence to maintain legitimate profit, enhance consumer benefits and continue to build the route over time.

- While V Australia has withdrawn from the route reduced competitive forces of themselves are not a basis for denying continued code share approval.

- Despite the opportunity for new carriers to enter the market, it has failed to attract and retain long term investors apart from Qantas and SAA. The characteristics of the route are therefore a material consideration.

- Absent the code share approval it is highly probable the route would eventually be served by a single direct carrier. The code share agreement guarantees a competitive presence by the carriers in both the Perth and Sydney markets. Seats are purchased and cannot be handed back. The carriers operate independently and in direct competition with each other. This establishes a contested market, guarantees competitive pricing initiatives and ensures that monopoly rent is not being generated on the route.

- Qantas believes the application fully meets the paragraph 5 criteria in the Minister's policy statement. Specifically:

    - By ensuring that Qantas and SAA compete, the arrangements are not detrimental to other Australian carriers. V Australia operated for a short time before withdrawing and has an interline agreement with SAA covering domestic carriage in the Australian market.

    - The air services agreement allows for multiple carriers and there is a commercially viable level of start up capacity available.

    - Lower tariffs, increased choice and frequency and innovative product differentiation are ensured by the arrangements. Absent the code share, with the carriers almost certainly not competing in the Sydney and possibly the Perth markets, these benefits could not be assured.

    - In the last financial year Qantas spent approximately A$345,000 on marketing activity in South Africa, compared with, Qantas believes, significantly less than $100,000 by Tourism Australia.

    - Considering the weak economic situation in South Africa, without Qantas' marketing activities associated with the code share services, tourist visitor numbers may have fallen even further.

- Qantas provides links beyond Australia to New Zealand and Qantas passengers link with Qantas Group domestic and international services. SAA code shares with Air New Zealand beyond Perth and SAA passengers also link to the Virgin Group domestic and international networks. Constraints in the air services agreement limit Qantas' ability to compete in markets beyond South Africa.

- The code share means that both Qantas and SAA maintain a competitive presence in both the Sydney and Perth direct markets and absent the code share it is highly likely that Qantas would be the only carrier operating direct services from Sydney.

- Absent the code share, competition would be reduced, but not entirely eliminated by virtue of SAA's interline arrangements with the Virgin Group and the presence of third country carriers in the market.

- The arrangements have had a positive effect on the Australian aviation industry by increasing Qantas' profits on the route, especially in relation to Perth, and have over time enabled Qantas to add extra capacity.

In the confidential attachment to its application, Qantas provided detailed supporting information on load factors, market shares, third country passenger carriage, forward bookings, passenger per kilometre revenue yields, total revenues, costs and profits on the route.

Summary of submissions

Virgin Australia (Virgin)

Virgin's submission does not constitute an objection, but it makes a number of observations. When V Australia entered the route in March 2010 direct carrier fares fell markedly across all classes. It became apparent, however, that the competitive imbalances created by the Qantas-SAA arrangements would not support the profitable operations by V Australia on the route. The combined double daily frequencies and associated cooperative marketing activities of Qantas and SAA would have required a substantial presence by V Australia for the route to be viable.

Comparative journey times means that third country carriers are only a genuine competitive influence in the leisure market. Flying via Singapore with Singapore Airlines, the most significant third country competitor, increases travel time between Sydney and Johannesburg by seven hours or 50% and adds 10 hours or 100% to a Perth-Johannesburg journey, relative to the non-stop flights.

Virgin disputes claims by Qantas that the air services agreement limits hub opportunities for code sharing over Johannesburg and Sydney, saying that this does not occur because of a commercial decision by the carriers (Qantas and SAA), as opposed to a regulatory barrier. Traffic rights restrictions do represent impediments to Virgin's ability to code share with third country carriers over intermediate points. Contrary to claims by Qantas, V Australia's interline arrangement with SAA behind Australian gateway points has been inactive since V Australia's withdrawal in February 2011 and that it does not sell any SAA traffic beyond Perth.

The Qantas suggestion that the counterfactual (the likely situation that would prevail if the code share were not approved) would see the route served by a single direct carrier is highly improbable, and Virgin would expect the withdrawal of either Qantas or SAA to attract a new Australian or South African carrier. The route offers a relatively balanced mix of inbound and outbound travellers and a solid business component that assists in offsetting the seasonal nature of the leisure segment. Over time the Qantas-SAA arrangements will act as a competitive deterrent to aspiring new entrants.

Should the Commission extend the authorisation, Virgin cautions against five years and suggests that the Commission might consider options for injecting greater competition into the arrangements, such as conditions tied to the size of the hard blocks purchased by the carriers on each other's flights.

Qantas response to the Virgin submission

In responding to the Virgin submission, Qantas reiterated its reasons for wanting the determination to be granted for five years, in particular the need for investment certainty to develop the route over the long term. Qantas also objects to Virgin's suggestion that conditions be attached to the size of the hard blocks purchased by the carriers. By making this suggestion Virgin apparently does not contest that public benefit and competition are already present in the arrangements and Qantas says that imposing another layer of conditions would not improve these benefits. Qantas also disputes Virgin's suggestion that the code share arrangements may have contributed to the challenges faced by V Australia, arguing rather that the challenges were due to V Australia entering a market with two services a week (later three) which contained two incumbent carriers competing with each other, each operating daily services. The challenge no doubt was compounded by the fact that the incumbent carriers were well established on the route and that an important part of the market was made up of business traffic requiring the flexibility of daily services.

The air services arrangements are deficient in a number of areas, particularly in respect of access to beyond rights and third country code share arrangements. That Virgin may also find itself constrained in code sharing on third country carriers is not the defining issue. Qantas, a carrier actually operating on the route, is constrained by the arrangements from accessing certain market segments in a manner its competitors, SAA and third country carriers are not.

Code sharing is practised globally by Qantas, Virgin and most of the world's airlines and an overwhelming majority of governments actively support and encourage code sharing for sound public policy reasons. Code sharing provisions were included in the air services agreement by the Australian and South African governments in the full knowledge of the underlying characteristics of the market. In this context there is little that is remarkable about the code share arrangements on the South Africa route.

It remains the Qantas view that absent the code share arrangements it is possible the route ultimately could be served by a single carrier. Virgin's suggestion that the code share is a deterrent to new entrants ignores two salient points – it did not deter V Australia and the capital cost and operational constraints of establishing and maintaining a competitive presence are far more likely to be relevant considerations.

An interested member of the public

An interested member of the public says that Qantas and SAA are raising their fares by over 50% between August and December 2011 and that fares on Singapore Airlines are substantially lower despite the much longer flying time. He attributes the high fares on the direct route to lack of competition, comparing them with lower fares on the London route on which there is more competition. He suggests that the Commission seriously consider these fare comparisons when deciding whether to extend the code share arrangement which, in many ways, appears to have developed into a cosy monopoly.

The Victorian Government

The Victorian Government would like Qantas and SAA to consider the opportunity of commencing direct services between Melbourne and South Africa before extending their current code share agreement. Victoria and South Africa have strong historical links dating back to the 1800's and these links continue today with BHP Billiton having two of its four head offices in Melbourne and Johannesburg. In the year ending June 2011 traffic between Melbourne and South Africa increased by 49% and immigration passenger card data suggests that this would have been considerably higher but for leakage of passengers through Sydney and Perth. This market also has the potential to grow with continuing immigration, with a significant and growing number of South African-born people living in Victoria. There are also strong trade and educational links, with Monash University establishing one of its two international campuses in Johannesburg. Considering that Melbourne is Australia's second largest city and growing faster than Sydney, it is important that Qantas and SAA's focus be on establishing direct Melbourne flights before attempting to extend any code share agreements on the Sydney-Johannesburg via Perth route.

The ACCC

The ACCC has distinguished between more price sensitive (leisure) passengers and more time sensitive (business) passengers and suggests that, given the long haul nature of the route, it may be relevant for the IASC to consider the public benefits and/or effects on competition of the code share arrangements for these separate customer segments. It is important to consider the extent to which passengers are likely to consider different destinations as close substitutes, which is unlikely for a business traveller.

The ACCC applies a "future with-and-without test" (the counterfactual) to compare the public benefit and anti-competitive detriment generated by an arrangement if authorisation is granted, with those generated if authorisation is not granted. The counterfactual in this case may involve one of several different scenarios, including:

- Neither Qantas nor SAA significantly change their operating patterns
- SAA commences new Sydney services
- Qantas commences new Perth services
- Either Qantas or SAA withdraw, leaving one direct operator
- Either Qantas or SAA withdraw, attracting a new Australian or South African entrant.

Aspects of the route remain similar to the time of the last approval, but that there have been some developments, including the withdrawal of V Australia and, as a consequence, Virgin's interline arrangement with SAA is inactive. The ACCC has not reached a concluded view on the most likely counterfactual and says it will be for the IASC to determine whether the current market dynamics are sufficiently different from those in September 2010 to warrant departing from the view that neither Qantas nor SAA would significantly change their operating patterns.

In assessing applications for authorisation of arrangements between competing airlines, the ACCC has identified a number of likely public benefits, including new services, reduced travel times, cost efficiencies, lower fares on domestic sectors, increased tourism and increased airline competitiveness. The assessment of competition benefits, which the IASC is required to consider, will depend on the likely counterfactual.

If the counterfactual involves no changes to the airlines' existing services, or the withdrawal of one so that there is a single operator, then continuation of the code share is unlikely to lessen competition benefits since the hard block nature of the code share will at least maintain a degree of rivalry between the airlines. If the counterfactual involves one or more of the airlines commencing new services on the city pair it currently does not serve, then the continuation of the code share is likely to lessen competition benefits by preventing direct competition between the airlines.

Third country carriers provide only a limited competitive constraint on Qantas and SAA because the longer travelling times involved place them at a competitive disadvantage, especially for time sensitive passengers. The ACCC has previously found that barriers to entry are relatively high in the aviation sector due to investment costs and government regulation. It is arguable that new entrants seeking to provide direct services between Australia and South Africa face barriers from the regulatory environment and the need for specialised, long haul aircraft. The IASC would need to be satisfied that the code share will continue to result in strong public benefits before allowing them to continue.

In relation to Qantas' argument that rolling short term determinations do not give it the investment certainty it needs to develop the route, it is not clear what types of investment are likely to be made by Qantas if the code share is approved for five years and how these would contribute to the public benefit or improve performance on the route.

The South African Competition Commission has granted an exemption under its Act for the code share until 31 December 2012 and, given the uncertainty around the likely counterfactual and the potential competition issues, it may be appropriate for the IASC to consider a further short term period for any approval. The issues which led the IASC to imposing conditions on past approvals appear to persist. In the absence of information that these have been ineffective or created an unreasonable burden on the airlines, it may be prudent to maintain similar conditions on any approval to maximise competition between the partners.

Relevant provisions in the bilateral air services arrangements

The air services arrangements between Australia and South Africa provide for the multiple designation of carriers. In relation to capacity, the number of services that the airlines of each country can operate between Australia and South Africa is 21 per week. With the return of V Australia's capacity and seven services per week allocated to Qantas, there are 14 services per week remaining available for allocation to Australian carriers.

The air services arrangements permit the designated airlines of each country to enter into code share, block space or other cooperative marketing arrangements with any other airline, including airlines of third countries. When the airlines of each country code share on the services of the other, seats purchased by the 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, capacity allocated by the Commission and used by Qantas as the operating carrier is counted as a use of bilateral capacity. Under the *International Air Services Commission Act (1992)*, an Australian carrier may only use its allocated capacity in joint services with the approval of the Commission. Qantas therefore requires Commission authorisation for SAA to code share on Qantas' services.

The air services arrangements grant unrestricted intermediate and beyond fifth freedom rights (traffic rights between the other country and a third country) to the airlines of both countries, provided a commercial agreement has been concluded between the Australian and South African airlines and the services are operated jointly pursuant to that agreement. This means that an airline cannot exercise fifth freedom traffic rights independently, or through code sharing on the services of an airline of a third country.