Virgin australia

Virgin Australia International Airlines Pty Ltd
Virgin Australia Airlines (SE Asia) Pty Ltd
PO Box 1034
Spring Hill QLD
Australia 4004
P +61 7 3295 3000

www.virginaustralia.com

30 September 2016

Ms Marlene Tucker
Executive Director
International Air Services Commission
PO Box 630
CANBERRA ACT 2601

Dear ~~Ms Tucker~~ Marlene

Submission in response to Qantas Airways' supplementary application on the Papua New Guinea route

Further to my letter of 9 September 2016, please find attached Virgin Australia's submission in response to Qantas Airways' supplementary application concerning its request for variation of determinations on the Papua New Guinea route.

Should you wish to discuss any aspect of our submission, please do not hesitate to contact me on (02) 8093 7001.

Yours sincerely

Jane McKeon

Jane McKeon
Group Executive
Government Relations

Virgin Australia Airlines Pty Ltd ABN 36 090 670 965 **Virgin Australia International Airlines Pty Ltd** ABN 63 125 580 823
Virgin Australia Regional Airlines Pty Ltd ABN 76 008 997 662 **Virgin Australia Airlines (SE Asia) Pty Ltd** ABN 79 097 892 389
Virgin Samoa Ltd ABN 90 116 233 517

NON-CONFIDENTIAL VERSION

VIRGIN AUSTRALIA

SUBMISSION IN RESPONSE TO QANTAS AIRWAYS' APPLICATIONS FOR VARIATION OF DETERMINATIONS ON THE PAPUA NEW GUINEA ROUTE

Qantas has applied to the International Air Services Commission (IASC) for variation of determinations ([2011] IASC 132, [2014] IASC 105 and [2016] IASC 110) on the Papua New Guinea (PNG) route, seeking approval to implement unrestricted code share services on flights operated by Qantas and Air Niugini. In Virgin Australia's view, these variation applications should be rejected on the basis that the proposed use of the relevant capacity will not be of benefit to the public. As outlined in this submission, we believe that the proposals in Qantas' applications have the potential to significantly erode competition on the PNG route, to the detriment of the travelling public and Australia's export sector.

Under the *International Air Services Commission Act* (the Act), the Commission must not make a decision varying a determination as requested under a transfer application if it is satisfied that the allocation as varied would not be of benefit to the public (section 25(2)). Section 26 of the Act requires that in assessing the benefit to the public of a variation of an allocation of capacity, the Commission must apply the criteria set out for that purpose in any policy statements made by the Minister under section 11.

In Virgin Australia's view, Qantas has failed to demonstrate that the proposals in its applications would be of benefit to the public when assessed against each of the additional criteria under paragraph 5 of the Minister's Policy Statement. Furthermore, Qantas' applications do not address, nor even acknowledge, the persistent strong concerns of the Commission over many years regarding the impact on competition on the PNG route of Qantas' code share arrangements with Air Niugini. It is these concerns that have led the Commission to assess each of Qantas' applications for a variation to permit continued code sharing on the PNG route with Air Niugini against the paragraph 5 criteria in 2007, 2009, 2012, and now again in the applications under consideration.

Recent trends on the PNG route

Although Virgin Australia is of the view that the entire history of code share cooperation between Qantas and Air Niugini is relevant to the Commission's assessment of this matter, we have provided some commentary regarding trends on the PNG route during the period in which Decision [2012] IASC 215 has been in effect (from 1 July 2012) to provide a backdrop for our submission.

Total passenger numbers on the PNG route have fallen in recent years, from around 315,000 in FY13 to under 300,000 in FY16. Aggregate industry load factors have also weakened during this period, although both Qantas and Air Niugini achieved higher loads than Virgin Australia in each of FY13, FY14 and FY16. In FY16, Qantas and Air Niugini together carried more than 80% of passengers on the route, with the remainder carried by Virgin Australia.

The route continues to be dominated by passengers travelling for business purposes, with the result that price discounting on PNG services has a limited effect in generating additional bookings and incremental revenue, given the relatively price inelastic nature of the business traveller and the lack of leisure traffic on the route. Such routes are generally characterised by a strong reliance by airlines on committed revenue earned under contracts with companies whose employees undertake a large amount of travel. Airline loyalty program affiliation also represents a key factor in competing for business travellers in the market.

Freight volumes on the route, in both directions, have trended downwards since FY13. In addition to belly space available on passenger aircraft, Pacific Air Express Australia operates two B737-300 dedicated freighter services each week, utilising 35 tonnes of capacity. Qantas holds an allocation of 17.5 tonnes of dedicated freighter capacity[1], which is not utilised at present according to the Department of Infrastructure and Regional Development's (the Department) Northern Summer 2016 Timetable Summary.

Virgin Australia's presence on the PNG route

Virgin Australia holds allocations of 1,232 seats in total on the PNG route, to support the operation of six return services each week between Brisbane and Port Moresby with B737-800 aircraft, with a seventh weekly service during periods of peak demand. Our services on this route commenced in November 2008 under the Pacific Blue brand with the operation of four weekly frequencies (page 6 of Qantas' supplementary application incorrectly states that we entered the market in 2005). Although passenger numbers on the Brisbane-Port Moresby route have increased by more than 25% between FY10 and FY16, it has only been commercially viable for us to expand our operations by two return services per week since our entry to the market.

Before ceasing operations to Australia in 2013, Airlines PNG (herein after referred to by its new name of PNG Air) offered code share services on Virgin Australia's flights (page 2 of Qantas' supplementary application incorrectly states that PNG Air exited the Australian market in July 2014).

Australia-PNG air services arrangements

The provisions of the Australia-PNG air services arrangements and their current operation are relevant to this matter. These arrangements provide that airlines of both countries are entitled to operate a total of 3,520 seats per week for passenger services and a total of 130 tonnes per week for dedicated freighter services. Only code share arrangements with airlines of each country are permitted and capacity offered by marketing carriers must comply with the capacity entitlements applicable to each country.

According to the Department's Northern Summer 2016 Timetable Summary, Air Niugini is operating a total of 3,464 seats per week with its own aircraft. In previous seasons, Air Niugini's operations have exceeded PNG's capacity entitlement, on the basis that the calculation of its capacity utilisation includes the subtraction of the number of code share seats offered for sale by Qantas on its flights. For example, Air Niugini exceeded the capacity entitlement in the Northern Summer 2015 scheduling period when it operated a total of 3,855 seats each week on the route. The corresponding Timetable Summary

[1] [2013] IASC 123.

indicates that this utilisation was reduced by up to 868 seats for code share services offered by Qantas. The arrangements do not specify that an operating carrier's capacity utilisation will be reduced by the amount of capacity offered on its flights as code share services by a marketing carrier.

This practice has allowed Air Niugini, through its partnership with Qantas, to exceed the capacity entitlement for PNG carriers. It has also removed any incentive for the PNG Government to negotiate with the Australian Government to secure a larger capacity entitlement for PNG carriers under the air services arrangements, as additional capacity can be created by simply increasing the quantum of nominated seats on which the Qantas code is placed. We have seen this manifest itself in the PNG delegation's failure to attend scheduled air services negotiations in Canberra in March 2016, following on from two previous rounds in August 2011 and September 2012 at which no outcome was agreed. This is particularly problematic for Virgin Australia, as we wish to secure a third country code share provision under the arrangements to enable our alliance partners to code share on our Brisbane-Port Moresby services. This would assist in supporting the sustainability of these flights, particularly when we become the smallest operator in the market in terms of capacity once Qantas commences a daily service between Brisbane and Port Moresby with B737-800 aircraft on 30 October 2016. In these ways, the mechanism applied to the counting of capacity entitlements under the air services arrangements has the potential to distort outcomes on the PNG route and limit effective competition.

The Australia-PNG air services arrangements allow airlines of both countries to market code share services on domestic flights operated within the territory of the other country, provided such services form part of a through international journey.

Previous decisions of the Commission

Elements of the Commission's previous decisions on the PNG route which remain germane to the current case have been highlighted below.

<u>Decision [2002] IASC 219</u>

Qantas and Air Niugini's code share cooperation was significantly expanded in 2002, as authorised by Decision [2002] IASC 219. This occurred at a time when Air Niugini was at risk of imminent collapse due to its critical financial situation. A core element of the revised code share arrangements was the inclusion of a requirement for Qantas to purchase a hard block of code share seats on Air Niugini's services. Qantas also had the option to purchase additional code share capacity under a soft block. The Commission noted that, "The hard block code share arrangement does provide at least some incentive for competitive pricing by the two partners, but the absence of any third country competition places them under little pressure".[2] While the Commission was concerned about the potential detriment of the proposed code share arrangements from a competition perspective, it considered that such risk was outweighed by the loss of public benefits that would have occurred if Air Niugini had exited the route.

[2] [2002] IASC 219, paragraph 4.3.

Decision [2007] IASC 213

In Decision [2007] IASC 213, the Commission was only prepared to approve the continuation of the code share arrangements on a short-term basis until 31 December 2009, citing strong concerns regarding the potential impact of such arrangements on competition on the PNG route over time. In its application, Qantas argued that the hard block component of the code share arrangements provided a financial incentive for it to offer its code share seats at competitive prices, as it would be exposed to losses if it could not recover the fixed hard block costs that it was liable to pay Air Niugini. The Commission did not accept that the hard block element of the arrangements was, of itself, sufficient to ensure a competitive outcome on the route. It took the view that, "the arrangements would be more competitive if the Qantas hard block seat numbers were larger and more uniform across flights on different days, with smaller or no soft block components".[3] In approving Qantas' application, the Commission took the view that the removal of the code share arrangements would likely see Qantas re-deploy its own aircraft on the route and over time, this would see the rationalisation of operations by Air Niugini and other smaller carriers, leading to higher airfares and fewer public benefits.

Decision [2009] IASC 216

In Decision [2009] IASC 216, the Commission continued to articulate its concerns about the competitive impacts of the code share arrangements in granting a further short-term authorisation of three years until 30 June 2012. In its application, Qantas once again placed strong emphasis on the fact that the hard block element of the arrangements would ensure competition between the carriers was retained, together with incentives for price discounting. The Commission noted its disappointment that Qantas had not taken steps to address concerns outlined in Decision [2007] IASC 213 regarding the imbalances in the seat hard block sizes and the flexibility afforded to Qantas by the soft block option, stating that, "At the time of the next review, the Commission expects to see a better match between the volume of seat purchases by Qantas across the week and in both directions in order to improve the competitive situation".[4]

In reference to Pacific Blue's entry to the market, the Commission noted that it would, "need to see ongoing evidence of improved fare levels on the dominant Qantas/Air Niugini alliance before it is satisfied that there are no longer significant competition concerns associated with the code share arrangements. The confidential data provided in relation to the most recent 12 months indicates that Qantas has significant pricing power".[5]

Decision [2012] IASC 215

In Decision [2012] IASC 215, the Commission authorised the arrangements for five years until 30 June 2017. Key factors in this decision included the removal of the soft block component of the arrangements and the continued existence of both PNG Air and Virgin Australia as competitors on the route. Once again, Qantas' application emphasised that the hard block promotes highly competitive pricing between the two carriers. In its supporting submission, Air Niugini stated in reference to removal of the soft block component of the

[3] [2007] IASC 213, paragraph 7.23.
[4] [2009] IASC 216, paragraph 8.8.
[5] Ibid, paragraph 7.26.

arrangements that, “Since early December 2011, the code share agreement only provides for purchasing of hard block seats…We are of the view that this form of code share arrangement is recognized by competition regulators around the world as the most competitive form of code sharing arrangement”.[6]

In its submission, the Australian Competition and Consumer Commission (ACCC) outlined a number of matters for the IASC to take into consideration in its assessment of Qantas' application. In particular, the ACCC noted that:

> “if both airlines could be expected to operate competing services on these routes in the absence of the code share arrangements, then the continuation of the code share may not result in a net public benefit compared to the situation without the code share arrangements, particularly if the code share arrangements were to continue to contain the elements that caused concern for the IASC in its 2009 determination…If the counterfactual involves both airlines operating services on the routes, then depending on the likely frequency and capacity of these operations, the continuation of the code share arrangements may be expected to lessen competition benefits by preventing direct competition between the airlines”.[7]

In making its decision, the overriding consideration for the Commission was its concern that rejection of the code share could result in less competition than currently existed, as Qantas' re-entry to the market in its own right would likely see a rationalisation of operations over time, with competitors either reducing services and possibly leaving the route. It would seem that precisely this counterfactual scenario is set to emerge, even with the code share arrangements still in effect, with Qantas announcing its intention to re-enter the Brisbane-Port Moresby route and Air Niugini announcing an identical reduction in capacity on the same route, with both announcements made on the same day. The code share arrangements proposed in Qantas' applications would undoubtedly diminish the benefits of the counterfactual that has eventuated.

Response to Qantas' supplementary application addressing the paragraph 5 criteria

Virgin Australia notes that many of the claims within Qantas' supplementary application have not been substantiated and rely on general or nebulous commentary. It is vital that the Commission tests the veracity of each of Qantas' assertions in conducting its assessment of the application, given the potential public detriment that we believe will arise if it is approved. This is consistent with the Commission's role in ensuring that the public benefits derived from the utilisation of capacity are not neutralised by inappropriate commercial agreements.

Virgin Australia notes that Qantas has not referenced the competition concerns held by the Commission in relation to the code share arrangements, as outlined in detail in each of its decisions since 2002 (and as canvassed briefly above). Qantas has neglected to note that the hard block component of the code share arrangements has played a critical and decisive role in it successfully securing authorisation from the Commission to permit ongoing cooperation with Air Niugini. In its previous applications and submissions, Qantas has emphasised that a hard block incentivises it to compete strongly with Air Niugini, and as

[6] Letter from Air Niugini to the IASC, dated 10 April 2012.
[7] ACCC letter to the IASC, dated 16 March 2012.

recently as June 2015, Qantas confirmed its support for the continuation of the hard block element of the arrangements.[8]

It should be noted, however, that repeated market interaction between Qantas and Air Niugini is likely to diminish the competitive benefits of hard block arrangements. Decisions on the South Africa route in relation to previous code share arrangements between Qantas and South African Airways are relevant in this regard, including Decision [2012] IASC 106 where the Commission stated:

> "While the hard block code share arrangement can, in theory, promote competition between Qantas and SAA in the marketing and sale of direct services, in practice the intensity of the competition created in this duopoly environment, characterised by repeated market interaction and little threat of competition from indirect competition or new entrants, is likely to be very limited".[9]

Virgin Australia disputes Qantas' characterisation of the PNG route as a "historically challenging market". In previous decisions, the IASC has noted that Qantas has achieved high yields on the route, which suggests that the market has in fact performed strongly for Qantas. Qantas has also failed to provide any evidence to support its statement that, "the code share arrangements have delivered significant public benefits in the form of increased competition, efficiencies and lower operating costs". While both free sale and hard block code share arrangements are capable of delivering public benefits, free sale code share arrangements are undoubtedly more efficient for an airline to manage. Such arrangements may therefore be appropriate if the carriers concerned are not the two dominant operators on the route in question. That is not the case with the code share cooperation between Qantas and Air Niugini.

Qantas has stated that it "is only in a position to code share on the Papua New Guinea route with Air Niugini on a freesale basis and the current code share arrangements will not apply from 30 October 2016". We note that the reasoning for Qantas' position has not been provided in its supplementary application. Given the clear and consistent views held by the Commission on this matter since 2002, it is difficult to understand why Qantas would seek to structure its commercial cooperative arrangements with Air Niugini in a manner which is unlikely to enable it to satisfy the criteria under paragraph 5 of the Minister's Policy Statement.

<u>Competition Benefits</u>

Paragraph 5.1 (a) provides that 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 a number of considerations, including:

– the need for Australian carriers to be able to compete effectively with one another and the carriers of foreign countries;

[8] Qantas Airways letter to Independent Consumer and Competition Commission of Papua New Guinea regarding the Authorisation Application for the Code Share Agreement between Qantas Airways Limited and Air Niugini Limited for flights between Port Moresby and Brisbane/Sydney, dated 17 June 2015.
[9] [2012] IASC 106, paragraph 8.23.

- the number of carriers on a particular route and the existing distribution of capacity between Australian carriers; and

- prospects for lower tariffs, increased choice and frequency of service and innovative product differentiation.

Qantas and Air Niugini's code share arrangements are, of themselves, the single most significant characteristic of the PNG route, representing a material influence on its competitiveness and the public benefits that the use of capacity allocations held by Australian carriers should deliver. The code share arrangements also represent a substantial barrier to entry as they consolidate and entrench the combined market power of the strongest carriers on the route. The dominance of the Qantas and Air Niugini partnership creates a significant deterrent for any competitor to enter or expand their operations on the route, given the challenges it presents for the sustainability of such services. Such a powerful presence limits Virgin Australia's ability to compete effectively on the route, and increased cooperation would represent an even greater threat.

There is no presence by third country carriers – either fifth freedom or sixth freedom operators – on the PNG route. It is unlikely that services operated via a third country would be an attractive proposition due to the additional travel time involved with an indirect routing, particularly for business travellers. The potential for such services to provide an effective competitive constraint on the code share cooperation is therefore extremely limited.

In its supplementary application, Qantas states that the proposed free sale code share arrangements, "are consistent with and provided for under the air services arrangements between Australia and Papua New Guinea" and that such "commercial entitlements should be readily accessible by carriers to compete with existing carriers in the market or potential carriers to whom equivalent rights may be available". That the proposed code share arrangements may be consistent with the air services arrangements does not obviate the need for the Commission to assess its potential competitive implications and benefit to the public in accordance with the Act and the Minister's Policy Statement.

Qantas also asserts that, "Under the freesale code share arrangements, the marketing carrier is incentivised to price competitively with the operating carrier and vice versa". This statement has not been substantiated and stands in direct conflict with Qantas' previous assertions regarding the price competition that is driven by a hard block arrangement. While both free sale and hard block arrangements have the potential to lead to lower tariffs, increased choice and frequency of service and innovative product differentiation, the scope for such outcomes to be realised will depend on the combined market power of the airlines between whom the code share is proposed.

With its heavy dependence on activity in the mining and resources sector, the PNG economy has been significantly impacted by the fall in global commodity prices in recent years. Passenger loads on Australia-PNG routes have come under downward pressure since FY13, consistent with the weaker economy in PNG during this period. The PNG economy is expected to strengthen in the coming years, as a number of major oil, gas and mining projects in the country progress towards final approval and construction stages. Such a recovery could increase the scope for the code share partners to take advantage of the limited competition on the route, further diminishing the public benefits that would be generated in the absence of code share arrangements.

Commentary on the competition benefits of the proposal for each of the Brisbane-Port Moresby, Cairns-Port Moresby and Sydney-Port Moresby city pairs has been provided separately below, given the differing nature of operations on these individual routes. For each of these routes, Virgin Australia is of the view that the proposed code share services do not deliver competition benefits sufficient to justify approval by the Commission.

Brisbane-Port Moresby

Qantas is proposing to implement parallel code share arrangements on the Brisbane-Port Moresby route, whereby Qantas and Air Niugini will each offer code share services on the other's flights. Virgin Australia's services on this route would not necessarily reduce the power of the combined presence of Qantas and Air Niugini under parallel code share arrangements – even if the carriers formally compete with each other – given that they will collectively provide more than 80% of the seat capacity on the route. As a market dominated by business traffic, the loyalty program element of the code share arrangements can also be expected to significantly restrict Virgin Australia's ability to attract more passengers, given the size of the membership base of the Qantas Frequent Flyer program relative to our Velocity Frequent Flyer Program.

With three carriers operating their own services on the route, it is difficult to understand how code share arrangements between the two strongest operators would enhance competition. In fact, the opposite is likely to occur, as approval of the code share arrangements would give Qantas and Air Niugini the ability to offer a double-daily service, compared with the six weekly services operated by Virgin Australia. Over time, this could be expected to erode commercial performance and threaten the viability of our flights. Should Virgin Australia be forced to withdraw, this would leave Qantas and Air Niugini as the only passenger service operators on routes between Australia and PNG, and free from any competitive constraint, it is likely that airfares would rise and service options would be reduced. Accordingly, public benefits would be significantly diminished.

Virgin Australia refutes the assertion in Air Niugini's submission in support of Qantas' supplementary application that the proposed free sale arrangements would enable it to continue to operate wide-bodied services on the Brisbane-Port Moresby route. Air Niugini suggests that, "Qantas' support…is critical to Air Niugini's ability to achieve sufficient passenger loads and frequency of services on its Australian routes to make wide body aircraft operations viable".[10] Under free sale arrangements, Qantas is free to sell as few seats on Air Niugini's services as it wishes, in contrast to the current hard block arrangements which ensure Air Niugini receives a guaranteed amount of revenue from Qantas for each of its flights, regardless of the number of code share seats Qantas actually sells.

[10] Submission on public benefit by Air Niugini in support of application for variation of capacity allocations to enable reciprocal air passenger code sharing between Air Niugini and Qantas on the Port Moresby and Cairns/Brisbane/Sydney routes, page 5.

We also reject Air Niugini's claim that it and Qantas will continue to be competitively constrained by Virgin Australia on the Brisbane-Port Moresby route. [CONFIDENTIAL MATERIAL REDACTED]

As noted above, the Australia-PNG air services arrangements do not permit third country code share arrangements. This prevents our preferred partners from offering code share services on our flights, to support their sustainability.

The Commission has consistently expressed concerns regarding code share arrangements in markets dominated by two carriers and has never approved any proposal which would allow such carriers to code share on routes they operate in parallel (except for such arrangements encompassed under integrated alliances which have been granted authorisation by the ACCC).

Decision [2002] IASC 218 on the Japan route was issued in response to an application by Qantas to vary decisions to enable Japan Airlines to code share on its new services between Melbourne and Tokyo. Japan Airlines did not operate on this route. While the Commission approved Qantas' application in that case, it noted that:

> "the code share arrangement is not proposed to apply to the Sydney-Tokyo leg of the three weekly northbound services. Sydney-Tokyo is a major route on which Qantas and Japan Airlines are established direct competitors and it is difficult for the Commission to foresee circumstances where code sharing on this route would be anything but anti-competitive with little public benefit".[11]

In its submission concerning that case, the ACCC noted that it was unlikely that Japan Airlines would commence its own flights on the Melbourne-Tokyo route if the code share arrangements were approved. The ACCC did not accept Japan Airlines' desire to expand its route network to include Melbourne was sufficient justification for the code share, on the basis that, "accepting such an argument would provide a precedent for similar arrangements on other or similar routes, such as between Qantas and Cathay Pacific on the Hong Kong route."[12]

It remains the case today that Qantas and Japan Airlines do not code share on each other's parallel services between Sydney and Tokyo.[13]

On the South Africa route, it is also notable that the code share arrangements previously in place between Qantas and South African Airways did not apply when both carriers operated on the Sydney/Perth-Johannesburg route in parallel.

Cairns-Port Moresby

Qantas has applied to the Commission for the ability to place its code on Air Niugini's flights on the Cairns-Port Moresby route, in light of its announcement that it will cease its own operations on this route on 30 October 2016. Compared with the current scenario on the route where both carriers independently operate their own flights, the proposed code share services are unlikely to deliver enhanced benefits for passengers. It would also be more

[11] [2002] IASC 218, paragraph 4.5.
[12] Ibid, paragraph 3.9.
[13] Northern Summer 2016 Timetable Summary, Department of Infrastructure and Regional Development.

difficult for a new entrant to commence services on the route if code share arrangements were in place between the two strongest operators, given the prospect of competing with Air Niugini and Qantas in combination, each with a dominant position at one end of the route. If the arrangements include frequent flyer program cooperation, the challenge for a new entrant would be even greater, particularly on a route dominated by business traffic.

It is notable that when Qantas commenced its own operations between Cairns and Port Moresby in 2010, it ceased code sharing on Air Niugini's flights on the route and did not apply to the Commission for a variation to allow Air Niugini to code share on its new services. Seat capacity fell by 2% on this route between FY13 and FY16, despite both carriers maintaining independent operations. We would question why Qantas did not seek to implement parallel code share services with Air Niugini on this route at any point during the past six years, yet it is now seeking such approval on the Brisbane-Port Moresby route (on which capacity has grown by 14% between FY13 and FY16).

When the Commission issued Decision [2012] IASC 215 in June 2012, the Cairns-Port Moresby route was also served by PNG Air. In its application to the Commission in 2007, Qantas referenced a decision of the Australian Competition Tribunal in order to support its claim that PNG Air, although holding a small market share on the route, would continue to provide a competitive constraint in the market. The opposite occurred, with PNG Air exiting the route in December 2013. Even without code share arrangements in effect on the Cairns-Port Moresby route, PNG Air was not able to compete effectively against Air Niugini and Qantas.

In its supplementary application, Qantas refers to a report on PNG Air published by the CAPA Centre for Aviation to support its claims that the prospect of new entrants "continues to act as a real competitive constraint on both Qantas and Air Niugini". While the report claims that PNG Air would reconsider the Port Moresby-Cairns route in the future, it should be noted that the airline selected Jayapura as the first destination for the resumption of its international services on the basis that the route was not served by a competitor. The report also states that the "airline is focussed on domestic opportunities and continuing to improve its product in the local market".[14]

There is also the possibility that PNG Air may not be able to secure the bilateral capacity required to recommence services to Australia. As Air Niugini has exceeded the PNG entitlement as recently as the Northern Summer 2015 scheduling period, it would seem that Air Niugini holds all of the capacity under PNG's entitlement.

On page 3 of its supplementary application, Qantas claims that, "In FY18, capacity on the Cairns route will increase 16 per cent" as a result of the capacity changes made by Qantas and Air Niugini. Based on our own analysis of published schedules[15], capacity on the route will decrease by 17% in FY17 and 10% in FY18.

In its submission in support of Qantas' supplementary application, Air Niugini states that it would need to review the ongoing sustainability of its services on the Cairns-Port Moresby route "in the absence of ongoing contributions toward operating costs of those services,

[14] Papua New Guinea's PNG Air: fleet renewal to drive domestic growth and international resumption, *CAPA Centre for Aviation*, 24 August 2016.
[15] Virgin Australia analysis based on Diio Mi as at 28 September 2016.

which would otherwise be earned from Qantas as marketing carrier on this route if the Proposed Code Sharing occurs".[16] Under a free sale code share agreement, Air Niugini cannot expect to receive a guaranteed revenue stream from Qantas. It is highly unlikely that the sustainability of Air Niugini's services on the Cairns-Port Moresby route would depend on code share seats sold by Qantas, particularly given that Qantas has not code shared on its flights on this route in the past.

Furthermore, Qantas' supplementary application states that the commencement of additional services by Air Niugini on the Cairns and Sydney routes has been "made possible only through the proposed freesale codeshare partnership with Qantas". No evidence in support of this claim has been provided by Qantas and it is more likely that any decision by Air Niugini to increase its frequencies has occurred as a result of Qantas not operating its own aircraft in these markets.

Sydney-Port Moresby

As with Cairns-Port Moresby, Qantas has applied for permission to implement free sale code share arrangements on the Sydney-Port Moresby route. Accordingly, our comments above regarding the effect of such arrangements on competition also apply to the Sydney-Port Moresby route, with Air Niugini as the sole operator in both markets. In contrast to Cairns-Port Moresby, Qantas currently code shares on Air Niugini's flights from Sydney. The proposed code share arrangements will allow Air Niugini to continue to leverage Qantas' capabilities in distribution, marketing and customer loyalty. If the proposed cooperation between the two strongest operators on the PNG route is approved, it will become even more difficult than it is under the current code share arrangements for another airline to mount a competitive and sustainable operation between Sydney and Port Moresby. Accordingly, termination of code sharing between Qantas and Air Niugini could facilitate competition in the provision of direct services on the route that would not otherwise have occurred or have been delayed. Certainly, greater public benefits would be delivered through the entry of a new operator on the route, compared with a code share on existing services, as recognised in paragraph 3.3 of the Minister's Policy Statement.

In its submission in support of Qantas' supplementary application, Air Niugini asserts that, "There is also a material risk that, without the contribution of revenue from Qantas seat sales towards operating costs of Air Niugini's services, Air Niugini will need to withdraw from the route as there is insufficient demand on the Sydney route to maintain an independent operation".[17] This claim would seem to be overstated as there would be no guarantee of particular levels of revenue from Qantas under free sale code share arrangements and current levels of demand for travel on the route would continue to exist. It is reasonable to expect that one or more other operators would introduce services between Sydney and Port Moresby if Air Niugini were to withdraw.

[16] Submission on public benefit by Air Niugini in support of application for variation of capacity allocations to enable reciprocal air passenger code sharing between Air Niugini and Qantas on the Port Moresby and Cairns/Brisbane/Sydney route, page 5.
[17] Ibid.

Other Benefits

Other benefits to be assessed by the Commission under paragraph 5 of the Minister's Policy Statement comprise those related to tourism, consumers, trade and industry structure.

Tourism Benefits

For tourism benefits under paragraph 5(1)(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).

In its supplementary application, Qantas states that, "Under the proposed code share arrangements, for the first time Air Niugini will code share on domestic services within Australia operated by Qantas between Brisbane and Melbourne / Perth, and Sydney and Melbourne / Perth". As noted above, the Australia-PNG air services arrangements allow airlines of both countries to market code share services on domestic flights operated within the territory of the other country. Air Niugini's ability to code share on Qantas' domestic services does not require approval by the Commission and is not dependent on the outcome of Qantas' current application. That such code share services have not been implemented to date is a commercial matter between the parties. In Virgin Australia's view, this aspect of the proposed code share arrangements should be afforded little, if any, weight by the Commission.

Based on the material in Qantas' supplementary application, it does not appear that the proposed code share arrangements will involve any promotional, market development or investment activities designed to stimulate tourism. It is important to note, however, that as a proportion of short-term arrivals into Australia, visitors from PNG represented only 0.65% in FY16, falling from 0.93% in FY13.[18] Accordingly, even if Qantas were to undertake significant promotional activities, it is unlikely that such initiatives would be capable of delivering any material public benefits in relation to tourism.

Consumer Benefits

For consumer benefits under paragraph 5(1)(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);

[18] 3401.0 – Overseas Arrivals and Departures Australia, Australian Bureau of Statistics.

- 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).

Virgin Australia refutes the claim by Qantas in its supplementary application that, “The proposed code share arrangements maximise the degree of choice in the market as this outcome would unlikely be matched if the code share was not in effect, potentially leading to fewer competitors, fewer frequencies or smaller aircraft operating, or less [sic] destinations being served and/or less choice of fares”. Qantas has provided no evidence to support this assertion. In fact, the absence of the proposed code share services would reduce the combined market power of Qantas and Air Niugini, creating the conditions to support the introduction of services by new entrants or potential expansion of services by Virgin Australia as the only other competitor on the route at present. Furthermore, the proposed code share services do not entail additional destinations being served. We are also not aware of any evidence to support Qantas’ claim that the proposed code share arrangements will support “innovative product differentiation”.

We are aware that members of the business community have expressed concern about Qantas’ withdrawal from the Cairns-Port Moresby route (please refer to the attached confidential document). This suggests that the code share proposal may not provide the choice required by business travellers on that route.

It is important to note that the overarching rationale for the Commission’s initial approval of the expanded code share cooperation between Qantas and Air Niugini in 2002 was its concern to ensure that Air Niugini, which was in a precarious financial situation at the time, continued to serve the Australia-PNG route. In 2015, Air Niugini presented a PGK20m (approximately AUD8m) dividend to the PNG Government. In an address in December 2015, Chairman of the Air Niugini Board Sir Frederick Reiher remarked that:

> “The renegotiation of the employee contracts of the airline’s pilots, and others to follow, had helped ensure the airline will remain financially sound in a challenging airline industry and general national economic environment. Wider cost cutting and restructuring measures now under way will help ensure the airline remains not just viable, but is also able to improve its fleet and expand services to meet passenger demands”.[19]

Given that Air Niugini now appears to be in a sustainable financial position, arguments that suggest the proposed code sharing is necessary to ensure the ongoing viability of Air Niugini are tenuous.

[19] Air Niugini presents K20 million dividend to Government, *ONE Papua New Guinea*, 27 December 2015 < http://www.onepng.com/2015/12/air-niugini-presents-k20-million.html>.

Qantas' supplementary application also refers to comments made by Air Niugini in a submission to PNG's Independent Consumer and Competition Commission that its wide-bodied services to Australia represent a significant proportion of its overall wide-bodied operations and that the viability of such operations therefore depends on achieving sufficient passenger loads on its Australian flights. This claim is inconsistent with the fact that Air Niugini's wide-bodied services to Australia account for approximately one third of the block hours and available seat kilometres of its wide-bodied operations.

Virgin Australia is also of the view that impacts on PNG's economy and the overall performance of Air Niugini's wide-bodied network are not relevant considerations for the Commission in this matter, noting that the object of the Act is to enhance the welfare of Australians by promoting economic efficiency through competition in the provision of international air services, resulting in:

(a) increased responsiveness by airlines to the needs of consumers, including an increased range of choices and benefits;

(b) growth in Australian tourism and trade; and

(c) the maintenance of Australian carriers capable of competing effectively with airlines of foreign countries.

Qantas has not provided any material to demonstrate that the proposed code share services would result in increased choice, efficiencies in the form of lower tariffs and improved standards of service, stimulation of innovation or new route service possibilities. It would therefore appear that the proposed code share arrangements deliver little consumer benefit.

Trade Benefits

For trade benefits under paragraph 5(1)(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.

While Virgin Australia acknowledges that Air Niugini is the only carrier operating wide-bodied aircraft on the PNG route, there are other operators providing dedicated freighter capacity between the two countries. These dedicated freighter aircraft have the capability to carry containerised and palletised cargo. If Air Niugini were to withdraw its wide-bodied aircraft from the Brisbane-Port Moresby route, other operators would look to satisfy any unmet demand. This would provide an opportunity for other Australian and/or PNG-based carriers to commence dedicated freighter services in this market. In this regard, we note Qantas currently holds an allocation of 17.5 tonnes of cargo capacity on the route.

It is also worth noting that freight volumes on the route have fallen by 30% between FY13 and FY16, which may indicate that a wide-bodied freighter capability is no longer required on the route. Subsidising the continued operation of an aircraft type that may be too large for both the passenger and freight markets cannot be a justification for permitting Qantas and Air Niugini to code share on each other's services on the Brisbane-Port Moresby route, to the detriment of Virgin Australia and the travelling public. Furthermore, in contrast to the current hard block arrangements, Air Niugini will not receive a guaranteed revenue stream from Qantas to support its wide-bodied operations under the proposed free sale arrangements. This weakens any argument that the sustainability of flights will depend on financial contributions from Qantas.

We also note that the Commission attached little weight to this criterion in Decision [2009] IASC 216. In our view, Qantas has not provided sufficient evidence to demonstrate that the proposed code share arrangements will deliver meaningful trade benefits.

Industry Structure

For industry structure under paragraph 5(1)(e), the Commission should assess the extent to which applications will impact positively on the Australian aviation industry.

Qantas' broad claims in its supplementary application that the proposed code share arrangements will positively impact the Australian aviation industry are unsubstantiated.

Virgin Australia does not agree with Qantas' suggestion that sufficient capacity remains available for allocation on the route to accommodate the commencement of services by a new entrant. The 400 seats per week available to Australian carriers would only support a twice-weekly service with a B737-800 aircraft, which is unlikely to be a competitive offering against the frequencies offered on the route by Qantas, Air Niugini and Virgin Australia. Certainly, this quantum of available capacity is inadequate to allow Australian carriers, either current operators or prospective new entrants, to develop plans for expansion on the route beyond the short term.

Rather than having a positive impact, it is much more likely that the proposed code share services will have a negative effect on the Australian aviation industry, particularly in relation to the Brisbane-Port Moresby route. With over 60% of traffic on the Australia-PNG route travelling between Brisbane and Port Moresby, it is critical that competition is maintained. Virgin Australia expects that it will be extremely challenging to compete against the own aircraft operations of both Qantas and Air Niugini on this route, even in the absence of code share arrangements between the two carriers. Allowing Qantas and Air Niugini to increase their market power on the route through expanded code sharing will make it very difficult for Virgin Australia to win, or even retain, corporate business on the route. On a route dominated by business traffic, this is critical. Such an impact could be expected to threaten the viability of our continued operations on the PNG route.

Conclusion

Qantas' supplementary application provides insufficient evidence to support its assertions that its code share arrangements with Air Niugini have delivered significant public benefits, or will deliver public benefits in the future under the proposed free sale arrangements. It also fails to recognise that previous approvals granted by the Commission were entirely dependent on the existence of the hard block component of its code share arrangements with Air Niugini, as forcefully argued in its own submissions in previous cases.

The Qantas and Air Niugini code share arrangements, both current and proposed, are the single most significant barrier to entry on the PNG route. Accordingly, the code share arrangements are themselves acting to restrict competition in air services between Australia and PNG. This has negative implications for consumers and businesses, as well as tourism and trade.

Approval of the proposed code share services would directly and detrimentally impact Virgin Australia's presence on the route, which has provided a much needed source of competition since our entry to the market in 2008.

Based on all the material presented above, and consistent with the object of the Act, Virgin Australia believes that the Commission should reject Qantas' applications for variations to its determinations on the PNG route.