DECISIONS

Decisions:	**[2016] IASC 220, [2016] IASC 221 and [2016] IASC 222**
Variation of:	**[2011] IASC 132 as varied, [2014] IASC 105 and [2016] IASC 110**
The route:	**Papua New Guinea (PNG)**
The applicant	**Qantas Airways Limited (ABN 19 009 661 901) (Qantas)**
Public Register File:	**IASC/APP/201633, 201634 and 201635**

The Commission varies determinations [2011] IASC 132, [2014] IASC 105 and [2016] IASC 110 to permit the capacity to be used for code share services by Qantas and Air Niugini on the Brisbane-Port Moresby and Sydney-Port Moresby sectors. The permission is valid until 30 June 2018.

1 The application and submissions

1.1 On 25 August 2016, Qantas applied for a variation of capacity allocations on the Papua New Guinea (PNG) route to enable reciprocal code sharing with Air Niugini, planned from 30 October 2016. Qantas states that under new free sale arrangements, it plans to code share on Air Niugini operated passenger services between Port Moresby and Brisbane, Port Moresby and Sydney and Port Moresby and Cairns, while Air Niugini plans to code share on Qantas operated passenger services between Port Moresby and Brisbane[1]. Qantas and Air Niugini also have an agreement in place in relation to belly-hold freight on the route.

1.2 The existing determinations issued by the International Air Services Commission (the Commission) allocate to Qantas 1888 seats per week in each direction on the PNG route. Of these 1888 seats:

- 1000 seats have been allocated until 30 June 2017 ([2011] IASC 132) and are currently used by Qantas to code share on Air Niugini ([2012] IASC 215) on services on the Brisbane and Sydney sectors under a hard block code share arrangement; and
- 888 seats have been allocated until 23 March 2020 ([2014] IASC 105) and cannot currently be used for code share purposes.

[1] For ease of reference, the PNG-Australia city pair sectors on which the airlines operate and market services will be referred to as the Brisbane, Sydney and Cairns sectors.

1.3 Earlier this year, the Commission renewed the allocation of 1000 seats to Qantas from 1 July 2017 to 30 June 2022 ([2016] IASC 110), but there is currently no approval for Qantas to use these 1000 seats to code share with Air Niugini.

1.4 Qantas has requested variations to Determinations [2011] IASC 132 as varied, [2014] IASC 105 and [2016] IASC 110, which allocate a total of 1,888 seats per week on the PNG route, to permit the capacity to be used under free sale code share arrangements with Air Niugini.

1.5 In its application, Qantas stated that the application should be considered against the general criteria for assessing the benefit to the public in paragraph 4 of the Minister's policy statement[2].

1.6 On 26 August 2016, the Commission published a notice, in accordance with section 22 of the *International Air Services Commission Act 1992* (the Act), inviting submissions about the application for a variation.

1.7 On 30 August 2016, the Commission advised Qantas by letter that Virgin Australia and the Australian Competition and Consumer Commission (ACCC) had indicated their intention to make submissions. The Commission advised Qantas that, in assessing Qantas' application, it would apply the criteria in paragraph 5 of the Minister's policy statement. The Commission stated that this would better enable it to assess the benefit to the public of the application and its impact on competition. It would also be consistent with the approach taken previously by the Commission in assessing code share applications by Qantas on the PNG route. The Commission invited Qantas to address the paragraph 5 criteria.

1.8 On 6 September 2016 Mr Michael Murphy of Morely, Western Australia, made a submission and on 8 September 2016 Air Niugini made a submission (with a confidential and a public version). On 9 September 2016 Virgin Australia wrote advising that it intended to lodge a submission in response to the supplementary application the Commission had invited Qantas to make.

1.9 On 14 September 2016 Qantas provided a supplementary application addressing the criteria in paragraph 5 of the Minister's policy statement. In response to this application, Virgin Australia and the ACCC made submissions on 30 September 2016 and 6 October 2016, respectively.

1.10 All public material supplied by the applicant and submitters is filed on the Register of Public Documents and available on the Commission's website. Confidential material supplied by Qantas, Virgin Australia and Air Niugini is filed on the Commission's confidential register.

1.11 The Commission has considered all submissions and will refer to them where relevant.

1.12 The Commission has analysed a considerable amount of data to assess any changes to the competitive environment and public benefit situation on the route since its 2012 review. The data includes information held by government agencies such as the

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[2] Minister's Policy Statement (No.5) of 19 May 2004

Australian Bureau of Statistics and the Bureau of Infrastructure, Transport and Regional Economics; commercial-in-confidence material provided by Qantas and Virgin Australia; and fare information available on web sites.

2 The Draft Decisions

2.1 The Commission issued Draft Decisions [2016] IASC 220d, [2016] IASC 221d and [2016] IASC 222d on 20 October 2016. In its Draft Decisions, the Commission proposed to approve the free sale code share arrangement for a trial period on the Brisbane and Sydney sectors. The Commission stated this would allow it to thoroughly assess the competitive impact of the code share on the city pair sectors that are of most concern to Virgin Australia, before deciding whether to approve the code share for a longer period and to broaden the approval to include the Port Moresby-Cairns sector.

2.2 The Commission proposed to approve the Qantas application for a variation to its Determinations until 30 June 2018. Prior to that, when 12 months of traffic and financial data up to 31 December 2017 was available, the Commission proposed to conduct a review to assess the impact of the code share arrangements on Virgin Australia's Brisbane services and on competition on the route in general. The outcome of the review would determine whether the approval would be extended beyond 30 June 2018. As part of this trial process the Commission proposed to limit the code share authorisation to the Brisbane and Sydney sectors.

2.3 The Commission stated that if, prior to 30 June 2018, a provision was included in the air services arrangements between Australia and PNG which allowed third country code sharing, this would be viewed as a positive development and would be taken into account in deciding whether to extend the duration and scope of the approvals.

2.4 Finally, as noted in paragraph 7.5 of the Draft Decisions, the Commission commented that Qantas would have unused capacity when the hard block code share arrangements ceased and it commenced services on the Brisbane sector on 30 October 2016. The Commission said it would ask Qantas to return its unused capacity by 30 November 2016.

2.5 Submissions on the Draft Decisions were received from Mr Brad Jackson in Cairns, the Australia-Papua New Guinea Business Council, Pacific Air Express and Qantas. The submissions are available on the Commission's website.

3 Relevant provisions in the bilateral air services arrangements

3.1 Under the Australia-PNG air services arrangements, any Australian designated airline is entitled to perform any of their agreed services through code sharing, blocked space and/or any other cooperative service arrangements with any designated airlines of either Australia or PNG, over the whole or any part of the specified routes in the Route Schedule.

3.2 In addition, Australian designated airline(s) may enter into code sharing, blocked space and/or any other cooperative marketing arrangements with an airline or airlines of Papua New Guinea or with a full member airline of the Association of South Pacific

Airlines over the whole or any part of the specified routes in Section 1(b) and Section 2(b) in the Route Schedule.

3.3 All code share arrangements must be operated in compliance with route, traffic rights and capacity entitlements applicable to each country.

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

4.1 Qantas' application seeks to vary Determinations to include a condition of a kind referred to in paragraph 15(2)(e) of the Act. In view of this, the application is a transfer application as so defined in subsection 4(1) of the Act and has been assessed in accordance with section 25.

4.2 Subsection 25(1) provides that the Commission must make a decision varying the determination in a way that gives effect to the variation requested, subject to subsection 25(2). Subsection 25(2) states that the Commission must not make a decision varying the determination in a way that varies, or has the effect of varying an allocation of capacity if the Commission is satisfied that the allocation, as so varied, would not be of benefit to the public.

4.3 Under section 26 of the Act, in assessing the benefit to the public of a variation of an allocation of capacity, the Commission is required to apply the criteria set out in any policy statement issued by the Minister under section 11.

4.4 Paragraph 6.3 of the Minister's policy statement provides that, subject to paragraph 6.4, where a carrier requests a variation of a determination to allow it flexibility in operating its capacity, including to use the Australian capacity in a code share arrangement with a foreign carrier, and no submission is received about the application, only the criteria in paragraph 4 of the policy statement are applicable.

4.5 Under paragraph 4 of the Minister's policy statement, the use of entitlements by Australian carriers under a bilateral arrangement is of benefit to the public unless such carriers are not reasonably capable of obtaining the necessary approvals to operate on the route and of implementing their proposals.

4.6 The Commission notes that Qantas is an established international carrier capable of obtaining the necessary approvals to operate on the route and of implementing its proposals.

4.7 Paragraph 6.4 provides, in part, that the Commission may apply the criteria in paragraph 5 in the circumstances set out in paragraph 3.6 of the policy statement.

4.8 Under paragraph 3.6, where capacity that can be used for code share operations is available under air services arrangements, including where foreign airlines have rights to code share on services operated by Australian carriers, the Commission would generally be expected to authorise applications for use of capacity to code share. However, if the Commission has serious concerns that a code share application (or other joint service proposal) may not be of benefit to the public, it may subject the application to more detailed assessment using the additional criteria set out in paragraph 5 (whether the application is contested or not). Before doing so, the Commission will consult with the Australian Competition and Consumer Commission (the ACCC).

4.9 As outlined below, on previous occasions when the Commission has considered applications for Qantas to code share on Air Niugini, it has had concerns about the impact of the code share on competition on the route. At the same time, it has considered the implications for competition if the code share were not approved. The Commission has again decided to assess the application against the paragraph 5 criteria.

4.10 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.

4.11 The Commission notes that Qantas, at the Commission's request, has addressed all the paragraph 5 criteria and the Commission will therefore assess its application against all the criteria.

5 Previous decisions by the IASC

5.1 On previous occasions when the Commission has considered applications for Qantas to code share on Air Niugini, it has had concerns about the impact of the code share on competition on the route. At the same time, the Commission has considered the implications for competition, and for Air Niugini, if the code share were not approved.

5.2 In its original decision in August 2002, the Commission commented that, at first glance, the code share would be of detriment to the public because it would mean a loss of Qantas' services, and with no third country carriers on the route, Qantas and Air Niugini would be under little pressure to price aggressively. More importantly, however, the Commission considered that the code share should ensure the continuation of Air Niugini's services, the loss of which would be likely to lead to a far greater loss of public benefit than under the code share arrangement.

5.3 In both the November 2007 and December 2009 decisions, the Commission commented that the code share favoured Qantas through its ability to match the supply of seats to daily demand variations, leaving Air Niugini to sell a higher number of seats on days of weak demand. This placed Air Niugini under more pressure to price competitively to sell its seats than Qantas. The decisions also criticised the soft block element of the arrangements that gave Qantas the option of buying or not buying extra seats, depending on whether the hard block was likely to be fully sold. The Commission considered that the ability to match supply to day to day demand enabled Qantas to generate strong returns without the need to discount significantly. The Commission said that the arrangements would be more competitive if the Qantas hard block seat numbers were larger and more uniform across flights, with smaller or no soft block components.

5.4 In its 2007 decision, the Commission said that if the approval were not continued, Qantas would almost certainly re-enter the Sydney and Brisbane sectors. It concluded that, in the short term, there could be higher public benefits as Qantas re-entered the market in its own right, with air fares falling as carriers fought for market share. However, within a relatively short time, there would probably be a rationalisation of services, with small carriers exiting and Air Niugini reducing its frequencies, leading to higher fares. The Commission noted that the code share had played an important role in maintaining wide bodied B767 services on the route, with the capacity to move large freight items in containers and on pallets.

5.5 In its 2009 decision, the Commission commented that the entry of Pacific Blue (Virgin Australia) in 2008 had provided an important competitive presence and that there was scope for it to establish itself more strongly in the market and to deliver a product that would better appeal to the key business market. The 2009 decision reiterated comments in the 2007 decision about the importance of maintaining B767 services for freight and the risks associated with Qantas re-entering the market in its own right if the code share were not approved. The Commission said that at the time of the next review it would expect to see a much better match between the volume of seat purchased by Qantas across the week and in both directions in order to improve the competitive situation. It said it would regard this as a significant factor in its decision making at the next review.

5.6 In its 2012 decision, the Commission noted that the competitive environment had improved with first Airlines of PNG and later Pacific Blue (Virgin Australia) entering the route, as well as Air Niugini nearly doubling its capacity since 2002. While it found little evidence that this increased competition had put downward pressure on fares, the potential was there, in particular if Virgin Australia continued to expand and began to make inroads into the business market. In any event, the Commission considered that price was perhaps less important for most passengers on this route than on other routes which did not have the same levels of business traffic.

5.7 Above all the Commission was concerned that rejection of the code share could result in less competition. In the short-term, there could be higher public benefits if, as likely, Qantas re-entered the market in its own right, increasing choice of carrier and frequency on the route and lowering fares. However, the Commission considered that within a relatively short time there would probably be a rationalisation of operations, with some of Qantas' competitors, including Air Niugini, reducing services and possibly leaving the route.

6 Proposed changes to services and the code share arrangements

6.1 Despite the scenario outlined in paragraph 5.7, Qantas has decided to re-enter the Brisbane market in its own right. The proposed changes involve Qantas withdrawing its services on the Cairns sector and instead code sharing with Air Niugini on this route; introducing services on the Brisbane sector; code sharing with Air Niugini on each other's flights on the Brisbane sector; and moving to a free sale structure on all sectors. On 27 July 2016, Qantas publicly announced the schedule change prior to its application to the Commission for authority to use its capacity allocation to undertake a free sale code share with Air Niugini.

Current services[3]

Cairns sector:

- Qantas: 12 DHC-8 services per week.
- Air Niugini: 11 F70/F100 services per week.
- No code sharing.

Brisbane sector:

- Air Niugini: eight B767 and six B737 services per week.
- Virgin Australia: six B737 services per week.
- Qantas hard block code share on Air Niugini's services.

Sydney sector:

- Air Niugini: two B737 services per week.
- Qantas hard block code share on Air Niugini's services.

Planned services after 30 October 2016 (by Qantas and Air Niugini)

Cairns sector:

- Air Niugini: at least 14 F70/F100 services per week.
- Qantas free sale code share on those services.

Brisbane sector:

- Air Niugini: seven B767 services per week.
- Qantas: seven B737 services per week.
- Air Niugini and Qantas reciprocal free sale code on each other's services.
- (Virgin Australia: six B737 services per week, assuming no change).

Sydney sector:

- Air Niugini: three B737 services per week.
- Qantas free sale code share on Air Niugini's services.

Decision by the PNG Independent Consumer and Competition Commission (ICCC)

6.2 On 22 April 2016, the ICCC authorised Air Niugini and Qantas to code share on the Brisbane and Sydney sectors for three years under a "hard block" arrangement. On 19 August 2016 the ICCC varied that authorisation to allow Air Niugini and Qantas to code share, on a free sale basis, on each other's aircraft on the Brisbane sector and Qantas to code share on Air Niugini services on the Sydney sector.

6.3 While the ICCC took the view that the free sale arrangement would produce a less competitive outcome than the hard block arrangement, it considered that Qantas' entry would have some balancing effect, especially on the Brisbane sector. It concluded that this would intensify competition and greatly benefit travellers as the three carriers competed to gain and retain customers.

6.4 The ICCC considered that a discontinuation of the code share would limit travellers' choice and time flexibility on both the Brisbane and Sydney sectors and create a monopoly on the Sydney sector. The ICCC also considered that the code share would

[3] Pacific Air Express has an allocation of 52.5 tonnes of freight capacity and currently operates 2 B737 freighter services per week, utilising 35 tonnes of capacity, between Brisbane and Port Moresby. Qantas holds an allocation of 17.5 tonnes of freight capacity which is not currently utilised.

enable the continuation of wide body freight services and, in turn, put competitive pressure on freight rates offered by dedicated freighters.

6.5 The ICCC also considered that Air Niugini's ability to code share on Qantas' domestic services would benefit its customers by giving them greater choice and convenient connections across Qantas' broader network.

6.6 The ICCC noted from Air Niugini's confidential submission, that if approval was not granted, it would be detrimental to Air Niugini, to the competitive dynamics of the market and potentially to consumers. While the ICCC did not see the free sale arrangement as producing a strong competitive outcome, it concluded that it was equally important to ensure that Air Niugini was generating sufficient revenue to sustain its operations, which in turn gave choice to consumers and maintained some level of competition.

6.7 Since the Commission issued its Draft Decisions, the ICCC has made a Determination on 9 November 2016 authorising Air Niugini to code share with Qantas on the Cairns sector for five years. The ICCC considers that the free sale arrangement provides little incentive for the marketing carrier to compete on fares, but that it at least provides some element of competition until such time as there is independent entry onto the Port Moresby-Cairns route. The ICCC has imposed several reporting conditions on Air Niugini to assist it to monitor the competitiveness of the market, which if not fully complied with could result in the authorisation ceasing to have effect or being reviewed.

7 Traffic on the route

Characteristics of the route

7.1 PNG is Australia's 23rd largest international route. In the year ending June 2016 (2016) 281,861 origin/destination passengers (an average of 2,710 each way each week) travelled between the two countries.

7.2 After seven years of strong growth between 2006 and 2013, growth has slowed in recent years and traffic fell by 8.5% in 2016.

7.3 Brisbane, with 54.8%, and Cairns, with 33.7%, are by far the largest ports of clearance for origin/destination traffic, with 9% travelling to and from Sydney.

7.4 In 2016 Australian residents made up 57.8% of the two-way traffic. Most Australian residents visiting PNG gave 'business' (33%) and 'employment' (32.8%) as their reason for travel. As employment is linked to business activity, this means that business related travel accounted for some 66% of all travel undertaken by Australian residents. Holiday traffic accounted for 16.1% of Australians visiting PNG. 12.8% of PNG residents travelling to Australia did so for business, with 43.4% travelling for holiday and 21.1% to visit friends and relatives. Other reasons for travel included education and conventions.

7.5 In 2016 the airline share of Australia-PNG origin/destination traffic was Air Niugini 57.7% (which includes Qantas code share passengers), Qantas 16.5% and Virgin Australia 14.1%.

8 The Commission's assessment against the paragraph 5 criteria

Competition Benefits

8.1 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:
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> - 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."

8.2 In its 2012 Decision, the Commission noted that since the code share was first approved in 2002 the competitive environment had improved. While initially four Qantas B767 Port Moresby-Brisbane-Sydney services were discontinued, since 2002 Air Niugini had introduced direct Port Moresby-Sydney services for the first time and nearly doubled the number of seats and frequencies it operated on the Sydney and Brisbane sectors. Airlines of PNG (now PNG Air) entered the route in 2005 and Qantas began services between Cairns and Port Moresby in 2010. In 2008 Pacific Blue (now Virgin Australia) began services on the Brisbane sector. Moreover, Virgin Australia had increased its B737-800 services from four to five per week. This, in the Commission's view at the time, suggested that the code share was not acting as an impediment to new entry or expansion.

8.3 Since 2012, on the Brisbane sector, Virgin Australia has increased its services to six per week and Air Niugini has added six B737 services per week, bringing its services to 14 per week. Air Niugini has replaced its wide body B767 aircraft with smaller B737 aircraft on its twice weekly Sydney services. In December 2013 PNG Air withdrew its twice weekly Dash 8 services on the Cairns sector. PNG Air had been code sharing on Virgin Australia's Brisbane services and ceased doing so in October 2013.

8.4 There have never been any third country carriers operating on the route, and given the close geographic proximity of the two countries, indirect (sixth freedom) services by third country airlines seem unlikely. The Commission is not aware of what, if any, fifth freedom rights third countries may have with PNG which would enable their airlines to fly direct services between Australia and PNG. The Commission understands that the only international airline other than PNG and Australian carriers that flies to Port Moresby is Philippine Airlines. Overall, the Commission considers that prospects for third country airline entry, which would provide more competition on the route, are low.

8.5 In its application Qantas claims there is sufficient capacity for Australian or PNG airlines either to enter the market or expand existing services, a claim refuted by Virgin Australia which points out that there are only 400 seats per week available to Australian carriers. The Commission noted in its Draft Decisions that when Qantas commenced daily operations and ceased the hard block code share arrangements it would be using, according to the Commission's calculations, 1218 seats, leaving some 670 seats of its allocated capacity unused. The Commission stated that it would expect Qantas to return this unused capacity, which when added to the 400 seats already available, would amount to the equivalent of 6 B737-800 services per week.

8.6 In its response to the Draft Decisions, Qantas disputes the requirement to return capacity, stating that under the Australia-PNG air services arrangements, code share capacity is counted against the marketing carrier. Because of this, Qantas maintains that it requires an allocation of capacity to support free sale code sharing.

8.7 The Commission sought clarification from the Department on Qantas' claim. Advice from the Department suggests that some allocation of capacity is required to give effect to any free sale code sharing arrangement, given that the air services arrangements state that "All code share arrangements must be operated in compliance with the route, traffic rights and capacity entitlements applicable to each country...". There is, however, a question of how much capacity needs to be allocated. With the Commission requiring airlines to regularly report on their utilisation of allocated capacity, and in the absence of more specific guidance in the air services arrangements about the use of capacity by marketing airlines, the Department suggests allowing Qantas to retain its current allocation for a period to assess actual utilisation and to use this as the basis for determining the quantum of capacity required over the longer term to support the free sale code share.

8.8 Confidential data provided by Qantas in 2012 showed that it obtains high passenger revenue yields on the Brisbane and Sydney sectors of the PNG route. The Commission concluded that this likely reflected the unusually high proportion of business and employment-related traffic on the route, upwards of 70% of all Australian origin traffic. This pattern has not changed significantly since 2012. In 2016 some 66% of Australian origin passengers travelled for business and employment reasons. While most of these passengers would not travel business class, given the time sensitive nature of their travel needs, and the fact that companies and not individuals are paying, it seems likely that fares paid for non-business class passengers would generally be at the higher end of the economy class range.

8.9 The Commission has undertaken a brief study of pricing from Australia to PNG. From fare information available on on-line web sites, it appears that on the Brisbane sector there are only small differences between the lowest economy fares offered by Qantas, Air Niugini and Virgin Australia. Qantas' and Virgin Australia's business class fares are almost identical, while Air Niugini's business class fares are some 15% lower than the other two airlines, even though it offers flat beds on the B767-300 aircraft.

8.10 Higher fares do not seem to have been an impediment to Qantas capturing a substantial portion of the business market, as evidenced by its high yields and its profits on the route. This could be due to several factors, including, under the current hard block arrangement, Qantas' ability to match supply to forecast demand, corporate travel contracts and connectivity to its large domestic and international networks, which underpin this result. Whatever the reason, while business passengers generally are not as price sensitive as leisure passengers and frequency and convenience of schedule are more important, they currently at least have the choice of somewhat cheaper fares on Air Niugini for what is effectively the same product.

8.11 With the predominance of business related traffic on the route, high fares do not appear to have been an impediment to growth – growth is very much linked to the strength of the PNG economy and lower fares are unlikely to generate more traffic. Having said that, high fares do add to business costs and it is in the interests of those Australian companies doing business in PNG that fares do not rise as a result of a lessening of competition on the route. The Commission notes that more convenient schedules that reduce time can also reduce business costs.

8.12 Historically, load factor and yield information indicates that this has been a consistently profitable route for Qantas and from confidential data provided by Qantas on this occasion, this appears to continue to be the case. In its 2012 decision, the Commission stated that were the code share application to be rejected, it had no reason to doubt that Qantas would re-enter the route, in direct competition with Air Niugini and Virgin Australia, a view shared at the time by Air Niugini. While in the short term this would be likely to result in lower fares as airlines competed for market share, the Commission considered that Qantas would be likely to emerge as the strongest competitor. It concluded that in such a situation Air Niugini would be forced to reduce services and possibly leave the route, resulting in a reduction in competition.

8.13 As Virgin Australia points out in its submission, it now seems that this counterfactual scenario is set to emerge, even with the code share, with Qantas announcing its return to the Brisbane sector.

8.14 Of itself, the Commission views the return of Qantas to the Brisbane sector as a positive development as it will mean that there are now three carriers operating on the sector and competing for traffic. In the Commission's view, Qantas is likely to be the strongest of the three carriers on the sector, with its extensive domestic and international network, the largest loyalty program of the three airlines and contracts with companies whose employees undertake large amounts of travel to PNG throughout the year.

8.15 In relation to the other two carriers on the Brisbane sector, the question for the Commission is whether code sharing on parallel services by Qantas and Air Niugini will swing the balance in favour of Air Niugini at the expense of Virgin Australia. Were Air Niugini to be forced to reduce its services (beyond what it is proposing in place of the services being introduced by Qantas) or to leave the sector, this would be a concern for the Commission because it would mean a substantial lessening of competition. From an industry perspective, however, the Commission's responsibility under the Act and the Minister's policy statement is towards Australian carriers and their ability to compete in international markets, and it is required to assess the impact of applications on the Australian aviation industry.

8.16 The Commission acknowledges the point made by Qantas in its submission on the Draft Decisions that Virgin Australia has the same opportunities for code sharing as Qantas under the bilateral arrangements, which means that both airlines can code share with an airline of the other country and that neither can code share with a third country airline. That said, the commercial reality is that Qantas and Air Niugini have been code share partners since well before Pacific Blue (Virgin Australia) began services, and that unless another PNG airline enters the route and in the absence of provisions in relevant air services arrangements that would allow for third country code sharing, there seems little real prospect of Virgin Australia entering into a code share arrangement with another airline.

8.17 Qantas' decision to leave the Cairns sector, with or without code sharing on Air Niugini, will, in the Commission's view, result in a lessening of competition. The Commission shares Virgin Australia's doubts about a new entrant replacing Qantas on the sector, at least in the near term. In the Commission's view, approving the code share on the Cairns sector would make this even less likely. With regard to the Sydney sector, Air Niugini has indicated its intention to introduce a third weekly service. The Commission sees this as a positive development and does not see the switch from a hard block to a free sale code share making a material difference, given the size of the sector compared to the other city pairs, and connecting opportunities via Brisbane.

Other Benefits

8.18 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:
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> - 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)."

8.19 PNG's small population and low average incomes mean that PNG's potential as a tourism market for Australia is limited and is unlikely to grow significantly in the foreseeable future. However, to the extent that the code share keeps Air Niugini in the market and provides some price competition, it is likely to be a positive factor in the development of the small market that does exist. This benefit would be negated if as a result of the Qantas-Air Niugini partnership, Virgin Australia were to reduce its services or vacate the route. Overall, the Commission considers that in the case of PNG the tourism criterion is not a significant factor in assessing the application.

8.20 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:
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> - 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)."

8.21 The ACCC has suggested that the Commission investigate whether consumers are likely to benefit from lower fares or greater frequencies and choice of service as a result of the code share, adding that it will also be relevant to consider potential consumer benefits from better online connections for passengers travelling behind and beyond Brisbane and Port Moresby.

8.22 There is little evidence that consumers have benefited from lower fares as a result of the code share between Qantas and Air Niugini over the years. Qantas' yields on both the Brisbane and Sydney sectors have been consistently high. On a route with such a high proportion of business related traffic, however, frequency and convenience of schedule are arguably more important for most passengers, and although high fares do add to the cost of doing business, better connectivity can reduce overall travel cost and travel time.

8.23 The Commission notes that Brisbane-Port Moresby flights are clustered into a narrow time band. The proposed code share, however, does extend the possibility of a more seamless journey, both to and from southern cities through Brisbane.

8.24 Travellers, and business travellers in particular, are likely to welcome the increased competition and choice of service that the return of Qantas to the Brisbane sector will bring. They will now have the choice of three differing on-board products, and as price is less important on this sector than most, quality of service will be an important factor in determining which carriers are the most successful.

8.25 The consumer benefits on the Brisbane sector will be partially offset by Qantas' decision to withdraw from the Cairns sector.

8.26 In his submission on the Draft Decision, Mr Brad Jackson from Cairns has expressed concern that if code sharing on the Cairns sector is not approved passengers will be denied frequent flyer benefits. From information available to the public on the Qantas website, even without the code share, passengers who are members of the Qantas frequent flyer program will still be able to collect and use frequent flyer points on Air Niugini's Cairns-Port Moresby flights,

8.27 In terms of trade benefits, 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."

8.28 Qantas says that regular B767 services on the Brisbane sector are vital to the carriage of commercial volumes of palletised and containerised freight, not available on narrow body services, and that the frequency of Air Niugini's services are vital for the regular export of fresh produce, express products, pharmaceuticals, mining equipment and aviation parts and machinery from Australia.

8.29 Air Niugini says that as cargo is carried as supplementary revenue, passenger carriers can offer lower freight rates than dedicated freight providers. According to Air Niugini, wide body services will promote trade between Australia and PNG through increased availability of lower cost, high frequency and reliable freight movement for Australian exporters and importers. Air Niugini states that "...it would need to substantially withdraw these wide body services if the Proposed Code Sharing is not implemented," which would mean PNG losing a substantial proportion of freight services and higher prices for air freight. The Commission notes that the B767-300 aircraft has significantly higher block hour costs than the B737-800 used on the sector by Qantas and Virgin Australia. As configured by Air Niugini, this aircraft has a relatively low seat count, and requires a substantial freight load to meet the additional operating cost.

8.30 Virgin Australia questions the importance of wide bodied aircraft on the Brisbane sector, pointing out that there are other operators providing dedicated freighter capacity that could satisfy demand and suggesting that a substantial fall in freight volumes may indicate that a wide bodied capability is no longer required. A similar view has been expressed by Pacific Air Express (PAE), which has been operating scheduled freighter services to PNG since 2009. As PAE states, there is sufficient allocated and available freight capacity for it to operate four B737F services per week. This would offset a reduction of some, although not all, of Air Niugini's wide body B767 services were they to be withdrawn. On the other hand, it would leave PAE effectively as a monopoly freight provider on the route, given the unsuitability of B737 passenger aircraft for the carriage of bulk cargo. This, combined with its sole reliance on freight for revenue, would, in the Commission's view, potentially result in higher freight rates.

8.31 The Commission considers that the loss of the B767 aircraft as a result of the code share being rejected would be significant, both for Australian exporters and for trade between the two countries generally. While there is some dedicated freight capacity on the route, passenger carriers have the ability to offer freight services at a lower cost and at a higher frequency. Because of its ability to carry containerised and palletised cargo, the B767 is much more competitive with dedicated freight aircraft than the B737 and is therefore more likely to place downward pressure on freight rates, as well as provide substantial additional freight capacity. The Commission notes from BITRE data that Air Niugini carried some 3200 tonnes of freight in FY 2016. This equates to 61 tonnes per week, which is well beyond the small bulk loaded capability of daily narrow body services.

8.32 The Commission agrees, as Virgin Australia and PAE suggest, that were the wide body services to cease other carriers might fill the void, but whether this would be with comparable aircraft capacity, frequency and price is unclear.

8.33 Overall, the Commission concludes that the continuation of wide body B767 services is important to maintaining frequent, low cost and substantial freight capacity between the two countries.

8.34 In terms of industry structure, the Minister's policy statement provides:

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

8.35 Qantas has taken a commercial decision to withdraw from the Cairns sector, re-enter the Brisbane sector and enter into a free sale code share arrangement with Air Niugini across the whole PNG route. Presumably Qantas believes that these changes to its route structure and code share arrangements will increase the profitability of the route, and to the extent that they do this will have a positive impact on the Australian aviation industry. This benefit, however, needs to be weighed against the impact on Virgin Australia, of having to compete with a new airline coming onto the Brisbane sector in partnership with Air Niugini.

8.36 The Commission cannot forecast the likely net impact on Australian airline profitability in advance of the proposed new arrangements coming into effect, but notes the planned reduction of Air Niugini capacity on the Brisbane sector as Qantas mounts services.

9 Conclusion

9.1 The Act requires the Commission not to make a decision varying a determination (in a way that varies, or has the effect of varying, an allocation of capacity) if the Commission is satisfied that the allocation, as so varied, would not be of benefit to the public.

9.2 Code sharing on the PNG route has been the subject of concern over a series of Commission decisions on the PNG route since 2002. Code shares have previously been approved on the basis that the block space mode of code share moved an element of commercial risk and pricing flexibility from Air Niugini to Qantas.

9.3 A block space code share moves some risk of the flight to the marketing carrier as the seat block must be paid for regardless of its utilisation. Block space agreements generally have a price point for the seat purchase that reflects the commercial risk assumed, considering forecast seat factors and yields for the flight. If the marketing carrier can improve the proportion of seats it sells or the average fare it achieves, then the code share is more profitable. If the market softens, the marketing carrier has an incentive to discount some of its fares (even below the average seat cost) to stimulate the market and to generate traffic that makes some contribution towards the sunk cost of the seat purchase. This risk assumed by the marketing carrier provides a degree of public benefit from the code share.

9.4 The shift in the Qantas application from block space to free sale code share moves the commercial risk on the flights from Qantas to Air Niugini. On the Sydney and Brisbane sectors, the Commission believes that the reduced commercial risk for Qantas is offset by the introduction by Qantas of a daily service operated in its own right from Brisbane to Port Moresby. These flights not only serve the Brisbane market, but can consolidate connecting traffic from other Australian cities. Also, the introduction of a third Air Niugini B737 service on the Sydney sector adds frequency and capacity for travellers.

The Cairns sector

9.5 The Cairns to Port Moresby sector is a thin market with no viable indirect routing option. Until the recent schedule change with effect from 30 October 2016, both Qantas and Air Niugini operated services on this sector, providing opportunities for price and service competition. The Commission viewed the withdrawal of Qantas services as such a lessening of competition that the approval of a free sale code share was not in the public interest.

9.6 In a free sale code share, the commercial risk stays with the operating carrier. The Commission recognises that a seat purchase can be priced in a number of ways, but notes that the seat purchase price is invariably higher than a block space would be, to reflect the risk remaining with the operating carrier. The common pricing options for a free sale are either a fixed purchase price per seat (which may vary by booking class) or a prorate of the fare. Fixed prices are generally set to leave the marketing carrier with an adequate margin for the marketing effort required to generate the passenger. Fare prorates have several options:

(1) Special Prorate Agreement (SPA): the airlines agree a fixed fare value for a sector in a booking class, regardless of the face value of the ticket or the amount collected by the marketing carrier.
(2) Multilateral Prorate Agreement (MPA): the airlines agree to share the fare on the ticket where two or more airlines are involved in the journey - in accordance with the International Air Transport Association (IATA) multilateral prorate agreement - essentially based on the distance share of the journey.
(3) Agreement to prorate the fare between airlines on the basis of a discounted fare paid, that may include incentives or commissions.

9.7 Prorate agreements that split the fare between carriers depending on the share of the journey or fixed seat prices allow competition where the passenger is exchanged partway on a long trip. A passenger who transfers between two airlines in Asia on a journey between Australia and Europe is a good example. In this case, one marketing carrier has some latitude to price differently from the code share partner by sacrificing a little of the revenue from its leg of the journey to make the overall fare more competitive.

9.8 In a single sector market like Cairns-Port Moresby, the marketing carrier has no operated sectors in the journey from which to fund a discount. The code share simply adds the marketing carrier's brand presence to increase the market strength of the two airlines against competitors.

9.9 In a market where there is a single operating carrier, the operating carrier has no incentive to give a deeply discounted price to the marketing carrier as they simply reduce their profit on a seat that would be sold on the aircraft in any case. Further, the partnership of two airlines in a thin market reduces the options for new carrier entry and reduces the prospect of future competition.

9.10 In its submission, the Australia-Papua New Guinea Business Council says that should the Commission confirm its decision to disallow code sharing on the Cairns-Port Moresby city pair, this decision will leave Air Niugini as the monopoly carrier on the route. In the Commission's view, with or without the code share, Air Niugini will effectively be a monopoly carrier on the route for the reasons outlined above.

9.11 The Commission considers that code sharing by Qantas on Air Niugini on the Cairns sector is a poor substitute for competition between two operating carriers as had previously been the case. PNG Air withdrew from the sector in 2013 when it was competing with both airlines. Now that Qantas has withdrawn, the Commission considers that this at least opens up the opportunity for other carriers to enter or return to the route. In the Commission's view, this would be less likely if Qantas and Air Niugini were permitted to code share on the sector.

9.12 In light of the above, the Commission is of the view that the proposed free-sale code share between Qantas and Air Niugini on the Cairns-Port Moresby sector would not be of benefit to the public.

The Brisbane sector

9.13 In all previous decisions the Commission has approved the code share on the basis that it was a block space arrangement and thereby placed some pressure on the marketing carrier to sell seats for which it had already paid. Also, in previous cases the two carriers were not operating parallel services on the same sector.

9.14 Generally, the Commission has taken the view that block space as opposed to free sale arrangements provide a greater incentive for the marketing carrier to compete on price. In the case of PNG, however, the Commission has long had concerns that the block space arrangement was weighted in Qantas' favour, involving a relatively small number of seats overall, designed to enable it to match the supply to daily demand variations, leaving Air Niugini with a high number of seats to sell on days of weak demand. This effectively meant that Qantas could charge higher prices for the same product and achieve a better seat factor than Air Niugini at times of peak demand.

9.15 While the Commission does not consider that a free sale arrangement will put significant pressure on the airlines to sell more seats, the decision by Qantas to return to the Brisbane sector will increase competition as there will now be three carriers operating in their own right and competing for passengers on the sector. The question is, however, whether there is sufficient traffic to sustain three operating carriers over the longer term. In its 2012 decision the Commission expressed concern that if the code share were not approved Qantas would re-enter the sector and that this would compel Air Niugini to reduce its services, and over the longer term, possibly withdraw altogether. Air Niugini has stated that it will reduce its services as a result of Qantas re-entering the sector, but this adjustment simply reflects the increase in capacity on the sector as a result of the introduction of daily services by Qantas. There will be little change in the total amount of capacity operated.

The approval

9.16 In 2007 and 2009, the code share arrangements were approved for shorter periods than those requested by Qantas. In 2012, with the code share having been in place for ten years with no apparent lessening of competition and the removal of the soft block component, the Commission approved the variation for the full period requested by Qantas.

9.17 The Commission would normally consider the counterfactual: that is comparing the likely future with and without the code share. In this instance, however, the new arrangements (with Qantas returning to the Brisbane sector, abandoning the hard block code share and proposing to enter into a reciprocal free sale code share with Air Niugini on parallel operated services) represent a significant departure from those in place prior to 30 October 2016. It is unclear how much revenue will flow to Air Niugini from a free sale code share, as opposed to the hard block, and what impact this may have on the competitive dynamics of the route.

9.18 Another concern the Commission has is that currently the code share is only marketed on the Sydney and Brisbane sectors. The Commission is now being asked to expand the approval to include services between Port Moresby and Cairns, in the process of the airlines shifting from a block space to a free sale arrangement and Qantas ceasing services, leaving Air Niugini as the sole operator.

9.19 Against the background of this uncertainty, the Commission has found it difficult to forecast likely outcomes with and without the code share. The Commission, therefore, would like to have the opportunity to see how the new arrangements work in practice on those city pairs on which the airlines are currently code sharing. In particular, the Commission is concerned that Virgin Australia, without the ability for its alliance partners to code share on its Brisbane services, will be competing with the combined marketing power of Qantas and Air Niugini code sharing on each other's flights.

9.20 Accordingly, the Commission has decided to approve the free sale code share arrangement for a shorter period than that requested on the Brisbane and Sydney sectors. During the period of approval, the Commission will monitor the competitive impact of the code share on the route.

9.21 The Act allows the Commission to include such terms and conditions as it thinks fit, including stating the extent of time for which any carrier may use the capacity under joint (or code share) services with another carrier. In this case, the Commission has decided to include a condition permitting the capacity to be used by Qantas to provide code share services with Air Niugini between Port Moresby and Brisbane and between Port Moresby and Sydney until 30 June 2018. Six months prior to 30 June 2018, the Commission will ask Qantas if it intends to seek an extension. If Qantas does apply for an extension, the Commission will conduct a review, based on 12 months of traffic and financial data up to 31 December 2017, to assess the impact of the code share arrangements on competition on the route. The outcome of the review will determine whether the approval is extended beyond 30 June 2018.

9.22 The Commission recognises that for code sharing with third country carriers to be possible, there need to be rights under PNG's air services arrangements with relevant third countries, as well as in the Australia-PNG air services arrangements. Nonetheless, if prior to 30 June 2018, a provision is included in the air services arrangements between Australia and PNG which allows third country code sharing, this would be viewed by the Commission as a positive development and would be taken into account in deciding whether to extend the duration of the approvals.

9.23 Finally, the Commission agrees to Qantas retaining its current allocation of capacity of 1888 seats per week and will ask the airline to report the average weekly number of code share seats sold on Air Niugini services, as well as Air Niugini code share seats sold on Qantas services, in its six monthly capacity utilisation reports. The Commission anticipates that when it has a full 12 months of reporting it should be possible to determine how many seats Qantas needs to support the free sale code share.

10 Role of the ACCC

10.1 The Commission invited and received a submission from the ACCC and its submission was fully considered in the Commission's deliberations.

10.2 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.

11 Decisions ([2016] IASC 220, [2016] IASC 221 and [2016] IASC 222)

11.1 In accordance with section 25 of the Act, the Commission varies Determinations [2011] IASC 132, [2014] IASC 105 and [2016] IASC 110 by adding the following conditions:

- the capacity may be used by Qantas to provide code share services with Air Niugini, between Port Moresby and Brisbane and between Port Moresby and Sydney until 30 June 2018 in accordance with:
  - the code share agreement dated 30 August 2002, as amended;
  - or any subsequent code share agreement between Qantas and Air Niugini for operations on the Australia – PNG route with the prior approval of the Commission;
- under any code share agreement with Air Niugini, unless authorised under the *Competition and Consumer Act 2010* or otherwise authorised by the Australian Competition Tribunal, in the event of a review by that tribunal:
  - Qantas must price and sell its services on the sector independently of Air Niugini; and

- Qantas must not share or pool revenues on the sector with Air Niugini; and

- nothing in this decision exempts Qantas from complying with the Australian Consumer Law. The airlines are required to take all reasonable steps to ensure that passengers are informed, at the time of booking, of the carrier actually operating the flight.

11.2 This decision comes into effect from the date this instrument is issued.

Dated: 16 November 2016

IAN DOUGLAS
Chairperson

JOHN KING
Commissioner