QANTAS

16 July 2009

Mr Michael Bird
Executive Director
International Air Services Commission
GPO Box 630
CANBERRA ACT 2601

Dear ~~Mr Bird~~ Mike

Re: Review of Code Share Arrangements between Qantas and Air Niugini

I refer to your letter of 23 June inviting Qantas to apply for an extension of the authorisations permitting it to code share with Air Niugini on the Papua New Guinea (PNG) route.

This letter seeks a variation to Determination [2006] IASC 129, which allocates capacity to Qantas on the PNG route, to enable it to use the capacity in code share services with Air Niugini from 1 January 2010 until 31 December 2012.

Qantas wishes to continue to place its code on Air Niugini services between Sydney and Port Moresby, Brisbane and Port Moresby and between Cairns and Port Moresby and vice versa.

Qantas believes that the continuation of the code share arrangements offers the best prospect of viable operations on the route by the two competing carriers and maximisation of the public benefit.

The code share arrangements have kept the Australia – PNG route on a profitable footing for Qantas. The lower operating costs of the arrangements have delivered substantial benefits to consumers. This has occurred against a background of increasing direct competition on the route, which has led to declining market shares for each of Qantas and Air Niugini.

The information sought by the IASC to assist in the review of these code share arrangements being conducted in conjunction with the PNG Independent Consumer and Competition Commission (ICCC) is set out in the attachments to this letter. As this information is commercial-in-confidence, Qantas asks that the attachments not be placed on the public register, nor disclosed to any third party other than the ICCC without Qantas' consent.

Australia – PNG Passenger Market

The Australia – PNG market exhibits a number of characteristics that make it unique amongst Qantas' routes.

<u>Traffic Flows</u>

Total origin-destination (O/D) passenger traffic between Australia and PNG for the year ending 31 December 2008 was 196,953 or 1,894 passengers each way each week. Passenger numbers grew by 33 percent between 2006 and 2008.

Australian origin travellers made up around 58 percent of the O/D market in 2008. The mix of travellers has remained reasonably steady over the past few years. The purpose for travel ex Australia is dominated by business travellers – 57 percent in 2008 – while passengers from PNG are mainly split between business and holiday traffic – 35 percent and 34 percent respectively.

The Australian – PNG route is largely a point-to-point market, with 87 percent of inbound visitors and outbound residents with an Uplift/Discharge (U/D) of PNG also having an O/D of PNG. As Attachment 2 shows, the volume of Australia – PNG traffic carried beyond Australia is limited, with the only third country traffic flows of any size being to/from the US and New Zealand.

<u>Route Characteristics</u>

As the distance between Port Moresby and the key Australian gateways of Cairns and Brisbane is commensurate with short haul domestic Australian sectors, competing in this market is a possibility for a wider range of operators than is the case on a number of Australia's other international routes.

It is therefore not surprising that Pacific Blue entered the market in November 2008. Pacific Blue is well placed to take advantage of its extensive Australian domestic network in competing with PNG based carriers and is an effective and vigorous competitor on the route.

There is no impediment to the designation of additional carriers to operate between Australia and PNG under the current air services arrangements. Any Australian airline may take up the unused capacity that exists, which currently stands at just over 1,000 seats per week.

Together, these considerations act as a further competitive constraint on each of Qantas and Air Niugini, in addition to those inherent in the structure of the code share arrangements.

Competitors

Airlines PNG

In November 2005, Airlines PNG introduced five weekly de Havilland Dash 8-100 services between Cairns and Port Moresby. This was soon increased to six services weekly and then to a daily operation in November 2006.

Airlines PNG also commenced twice-weekly Boeing B737-200 services between Brisbane and Port Moresby in August 2006 – operated by Ozjet – with frequencies varying between three and five per week up to and including Northern Summer 2008. This arrangement ceased in late 2008 when Pacific Blue entered the market through a code share arrangement with Airlines PNG (as authorised by the IASC and the ICCC in October 2008).

Pacific Blue Airlines

In November 2008, Pacific Blue entered the Australia – PNG market by introducing four times weekly Brisbane – Port Moresby services using B737-800 aircraft configured with 180 seats. As noted above, Airlines PNG also code shares on these services.

Pacific Blue and Airlines PNG provide considerable competition to both Air Niugini and Qantas. Since the Qantas/Air Niugini code share arrangements were reauthorised by the IASC in November 2007, capacity offered by these competitors has risen by approximately 38 percent.

Air Niugini

Air Niugini has expanded substantially on the Australian route since the IASC's last reauthorisation of the arrangements. It provides seven Fokker 100 services per week and a daily de Havilland Dash-8 service between Cairns and Port Moresby (a 17 percent increase in seats), six B767-300 weekly services plus a twice weekly Fokker 100 and once weekly B757 service between Brisbane and Port Moresby (a 12 percent rise in seats), and introduced twice weekly B757 services between Sydney and Port Moresby in Northern Summer 2008.

Market Shares

Despite overall growth in the O/D market, the entry of Airlines PNG and Pacific Blue has resulted in a decline in both Qantas and Air Niugini's market shares.

Attachment 3 shows that the carriers' combined share of passengers fell 10.4 percent between 2006 and 2008. This is well below the level of combined market share held by the carriers when the arrangements were initially authorised by the IASC in 2002.

Qantas' market share decreased almost eight percent between 2006 and 2008, reflecting aggressive price competition from Air Niugini and the expanding market share of Airlines PNG.

Pacific Blue achieved respectable market share figures in its first five months of operation, ranging between 10 and 16 percent. With Pacific Blue continuing to expand and consolidate its presence on the route, Qantas expects its market share on the Australia – PNG route to erode further.

Seat Factors

Bureau of Infrastructure, Transport and Regional Economics (BITRE) statistics show that total market seat factor (ie all carriers between all city pairs) between Australia and PNG was 55.7 in 2008.

The expansion of Air Niugini, the continued presence of Airlines PNG, and the introduction of Pacific Blue services in November 2008 have had an impact on Qantas' seat factors on the route, as indicated in Attachment 4. Between 2007 and 2008, Qantas' average seat factor on the Australia – PNG route fell four percentage points to 64 percent – the lowest seat factor recorded for at least the past six years, reflecting both the additional capacity and competition on the PNG route.

Qantas' forward bookings indicate substantial reductions in bookings held versus the previous year (see Attachment 5). Figures between July 2009 and June 2010 show a substantial fall compared with last year's forward bookings at the same point in time. It is difficult to separate the impact of the global financial crisis from those related to capacity and competition effects.

Traffic Mix

The high proportion of passengers travelling for business purposes on the Australia – PNG route is exceptional across Qantas' domestic and international networks. It is well above other markets with a high business component such as Canberra, Wellington and the mining centres in Western Australia, as the table in Attachment 6 shows.

The passenger mix within the business class cabin is also unique across the network, with the strong mix driven by the high proportion of passengers requiring flexible fare conditions. The mix in the economy class cabin, however, indicates a preference for low fares when compared to other similar routes.

The high proportion of business travellers, and the passenger mix within each cabin, drives the relatively strong yields on the route, shown in Attachment 7.

The comparative yields on PNG routes and other Qantas routes with substantial business travel components are shown in the graph in Attachment 8(A). Attachment 8(B) compares the Sydney – Port Moresby route with three of Qantas' other international routes. Although these other routes are all similar distances, it is difficult to find truly comparable routes given the PNG route's unique characteristics.

The volume of non-business travel to/from PNG is comparatively low and primarily consists of Visiting Friends and Relatives (VFR) traffic, expatriate leisure traffic, students returning home during vacation periods, and a small "soft adventure" market element participating in activities such as trekking, diving, fishing and surfing.

The expansion by Air Niugini, the continued competition from Airlines PNG, and to a lesser extent given the timeframe of the review, Pacific Blue's entry on the Australia – PNG route has resulted in a deterioration in Qantas' passenger yield mix (see Attachment 6), and we are now carrying proportionally fewer full/high fare passengers and a greater number of low fare passengers.

Absent the Code Share Arrangements

Discontinuing the code share arrangements would result in significant increases in average costs for both airlines and erode the public benefits the code share has produced.

In reauthorising the code share arrangements in 2007, the IASC acknowledged that the removal of the code share approval could lead to less competition, noting that Qantas would potentially re-enter the market in its own right, resulting in the exit of small carriers and reduced frequencies by Air Niugini. Qantas has a range of suitable aircraft types and operating vehicles with which to offer an attractive high frequency service to meet the needs of the market.

While Qantas would expect services in our own right to be profitable, we believe that this would be to the significant detriment of Air Niugini's and Airlines PNG's viability.

Withdrawal of the Qantas brand from Air Niugini's services would result in the elimination of valuable marketing and promotional support to the carrier. As the carrier based where the largest proportion of the market is located, and with an integrated domestic and international network, Qantas would have a natural advantage in the market. In addition, Qantas believes that we would be better placed to weather the increased costs that would result for each airline under this scenario.

A reduction in Air Niugini's schedules would be an almost certain consequence of the code share arrangements ending. As Air Niugini operates only one wide-bodied B767-300 aircraft for the conduct of its entire network of international services (other than to Cairns), unless alternative flying was implemented this would reduce the weekly hours of B767 operations and undermine its economic viability.

In addition to the Brisbane schedule, Air Niugini operates weekly B767-300 services between Port Moresby and each of Singapore, Manila, and Tokyo, while it uses its one B757 to operate Hong Kong, Kuala Lumpur and Manila services. We assume that an expansion of any of these routes to fill any flying-hours gap would not be sustainable.

Qantas doubts that Air Niugini would be able to maintain a wide-bodied aircraft in its fleet absent the amount of flying and guaranteed revenue stream provided by the code share arrangements with Qantas.

A move to the use of narrow-bodied aircraft on the route has significant implications for the transport of cargo. The operation of a B737 or B757 in place of a B767 would reduce belly hold space available for the carriage of freight by up to 95 percent. It is unlikely that alternative freighter operators would step up to match the regular schedules that importers and exporters at both ends of the route have come to rely on from the Qantas/Air Niugini code share arrangements.

Paragraph 5 Criteria – Minister's Policy Statement

5.1(a) Competition Benefits

The code share between Qantas and Air Niugini is a block space arrangement, whereby Qantas as the marketing airline, pre-purchases a specified number of seats at a fixed agreed rate (a hard block) and cannot hand back those seats to Air Niugini. Qantas must therefore accept the full commercial risk of selling these seats and attempt to generate a satisfactory return, and is exposed to losses if seat block costs are not covered.

Additionally, since December 2005 Qantas has had the option to increase its seat commitment through the further purchase of a number of seats if warranted by market conditions (a soft block).

The following tables provide an overview of Qantas' weekly code share seat commitment by sector. A full listing by cabin class and day of week is at Attachment 1.

	Cairns - Port Moresby	Port Moresby - Cairns
Hard Block	154	193
Soft Block	57	35
Total	**211**	**228**

	Brisbane - Port Moresby	Port Moresby - Brisbane
Hard Block	408	421
Soft Block	216	235
Total	**624**	**656**

	Sydney - Port Moresby	Port Moresby - Sydney
Hard Block	79	79
Soft Block	46	20
Total	**125**	**99**

While we are not committed to pay for unsold seats beyond our hard block, it remains in Qantas' commercial interests to sell every seat that it can beyond its hard block.

The fact that the code share between Qantas and Air Niugini is a hard block arrangement means that competition between the carriers is retained, as well as their incentives for price discounting.

As the IASC is aware, under a hard block code share arrangement, the operating carrier sells a block of seats to the marketing carrier, which assumes sole financial responsibility for those seats. The marketing carrier manages that block of seats by putting them into its own reservations system, as if it operated a virtual aircraft on that route. As a result, the marketing and operating carriers each operate independent inventories for the same aircraft, as if two smaller aircraft were flying instead of one large aircraft.

Continued price competition therefore exists between Qantas and Air Niugini as each competes with the other in selling their blocks of capacity on the Brisbane – Port Moresby vv, Cairns – Port Moresby vv and Sydney – Port Moresby vv city pairs.

Each airline independently sets its prices, determines its fares and rules attached to each fare, operates its own yield management systems, and sells its products through its respective sales networks.

This leads to highly competitive pricing between the two carriers to the extent that from time to time Air Niugini's fare levels are below the hard block seat price that Qantas pays for the purchase of code share seats from Air Niugini.

Sometimes Qantas accepts the competitive disadvantage this creates, but at other times, in order to remain competitive in the market, Qantas' response is to price to clear its inventory and receive some contribution towards seat costs.

5.1(b) Tourism Benefits

Given the characteristics of the PNG economy and this relatively small population, the promotion of inbound tourism to and within Australia is currently limited.

Although the Australian Bureau of Statistics figures in Attachment 2 show that holidaymakers presently comprise around one third of the inbound visitor market, this figure needs to be treated with some caution, due to specific characteristics of the market.

There remains a reasonably large number of expatriate Australian residents in PNG, many of whom make multiple trips to Australia each year. For instance, it is not uncommon for groups of expatriate spouses to take short duration shopping trips to Cairns and Brisbane, and it is very likely they would show their purpose of travel as "holiday". Many families send their children to boarding school in Australia, and holiday visits in both directions by students and parents are standard practice.

The number of services now available on the route, including competitive fares has enabled more PNG nationals to travel to Australia, with total visitor arrivals growing by 28 percent between 2006 and 2008. Since 2006, Qantas has mounted approximately eight special fare initiatives ex PNG.

5.1(c) Consumer Benefits

The efficiencies derived from the Qantas/Air Niugini code share arrangements have delivered considerable benefits for travellers on the PNG route.

The code share arrangements have supported enhanced frequency and capacity.

The number of weekly services Air Niugini operates has increased substantially since the arrangements were last reauthorised, from 16 services in Northern Winter 2007 compared with 25 services during the current season, with the number of operated seats increasing from 2,084 to 3,046 per week, a 46 percent increase.

In that time, the number of services between Cairns and Port Moresby has increased from nine to double daily, with the number of seats operated rising from 855 to 1,001 (a 17 percent increase). The frequency between Brisbane and Port Moresby has increased from seven to nine, with seat capacity increasing from 1,494 to 1,667 seats weekly (a 12 percent increase).

In Northern Summer 2008, Air Niugini introduced a direct Sydney – Port Moresby service providing those consumers who were required to make a stop at Brisbane, with a direct link between the two cities. This is particularly beneficial for business travellers who dominate the traffic mix on the Sydney – Port Moresby route. Capacity has increased through the use of larger B757 aircraft, with seats increasing from 188 to 378 over this period, representing a doubling of available seats.

Convenient timings and connections are offered for domestic transfer passengers, and some of Qantas' flights to/from New Zealand and the US also offer good connections for passengers travelling behind and beyond Australia.

The efficiencies that the code share has produced have resulted in the development of more competitive fares over the course of the agreement.

Qantas regularly offers attractive special fares to boost sales and/or match competitive offerings. Between 2006 and 2008, Qantas mounted approximately 10 special fare initiatives ex Australia. Sale periods of these initiatives vary, but often overlap, and in some cases have been extended to further stimulate demand.

Holiday traffic ex Australia to PNG has increased substantially over the past few years, rising by 50 percent between 2006 and 2008.

A listing of all fares offered on the PNG route by Qantas between 2002 and 2008 appears in Attachment 9(A).

A comparative listing of all the fares currently on offer on the PNG route by Qantas, Air Niugini, Airlines PNG and Pacific Blue appears at Attachment 9(B).

5.1(d) Trade Benefits

The Qantas/Air Niugini code share arrangements have delivered competition in the freight market on six B767 services per week between Brisbane and Port Moresby. Qantas purchases approximately half the belly hold cargo space on these services on a hard block basis, with the option of taking additional space on a soft block basis should it be required.

This arrangement does not operate in exactly the same fashion as the passenger code share arrangement, as space is not sold under the Qantas flight designator (QF), however, Qantas actively sells cargo space on its own air waybills under the Air Niugini (PX) code.

There is no purchase of cargo space on Cairns – Port Moresby and Sydney – Port Moresby services, as the narrow-bodied aircraft used on this route have negligible space for freight.

Attachment 10 sets out the value and weight of the freight carried by Qantas under the arrangements with Air Niugini for 2007 and 2008. It is clear that revenues and freight carried have fallen between these two years.

Even though all space is sold under an Air Niugini flight designator, Qantas representatives actively sell freight space on the wide-bodied services on its own waybills. As highlighted in Attachment 11, base rates charged by Qantas have risen only slightly since the arrangements were last reauthorised. This was initiated by Qantas to simplify rates by adjusting them to more manageable whole numbers, while the unit load device rate's flat charge has remained relatively stable.

The contribution towards operating costs provided by the code share (for both passenger and cargo traffic) reduces the overall risk and cost to the airlines, providing a greater opportunity to maintain stable cargo rates.

The use of the B767 aircraft on the Australia – PNG route is particularly important for certainty of carriage of palletised and containerised freight. A B767-300 aircraft can carry up to seven tonnes of freight on services between Brisbane and Port Moresby.

The narrow – bodied B737 and B757 carry only "loose" cargo, in that there is no container or pallet facility available on this aircraft type, and the amount of space for loose freight is generally very low after passenger baggage has been loaded. Typically, freight would be limited to approximately 1.5 tonnes depending on the aircraft configuration. Particular specialised and higher value categories, such as fresh seafood, would be precluded completely from carriage on the B737.

Freight forwarders, especially tuna exporters, prefer the consistency of wide – bodied aircraft space provided by the stable and regular Qantas/Air Niugini schedule, and the knowledge that efficient Qantas transhipment to wider markets in Asia, most commonly Japan, will result from dealing with the code share partners.

The frequency of services between Brisbane and Port Moresby means that exporters in each of these cities have a choice of days on which to transport items and have the ability to transport items more regularly than through an all – cargo carrier. The code share arrangements have established the schedules on which exporters are able to largely depend to provide certainty of regular operations.

No other carrier currently provides this level of reliability in the Australia – PNG scheduled cargo market. Under the Australia – PNG air services arrangements, a separate capacity entitlement is available for the operation of all-cargo services. A number of carriers – with the exception of HeavyLift – including Transair and Pacific Air Express, have received capacity allocations to operate on the route, but have not been able to effectively sustain regular services.

Qantas offers its freight customers access to a global route network of 135 countries and territories covered by the **one**world alliance. Domestically, Qantas Freight has partnered with Australia Post to provide freight and mail services, and seamless transfer between international and domestic networks, through Australian Air Express.

5.1(e) Industry Structure

The code share arrangements have seen Qantas continue to participate profitably in the market at the same time as supporting the ongoing viability of Air Niugini's Australian operations in an increasingly competitive market.

The continued presence of Qantas and Air Niugini in the Australia – PNG market has encouraged the entry of another Australian carrier in Pacific Blue, which has judged that there are returns to be made on the route – in addition to Airlines PNG, which has now had a presence on the route for a number of years.

Variation Sought

Qantas seeks an extension of the IASC approval to permit Qantas to code share on Air Niugini operated flights on the PNG route for a further three years.

Accordingly, Qantas seeks to vary Determination [2006] IASC 129 on the PNG route to enable Qantas to code share on Air Niugini services operated pursuant to this Determination and in accordance with the Qantas – Air Niugini Commercial and Code Share Agreements of 11 November 2001 (Cairns – Port Moresby route), and 30 August 2002 (Sydney and Brisbane – Port Moresby routes) – as amended.

The variation is sought with effect from 1 January 2010 to 31 December 2012.

We would be pleased to provide further assistance to the IASC in relation to the attached material should it be required.

Yours sincerely

Jane McKeon

Jane McKeon
Head of Government and International Relations