QANTAS

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

Dear Mr Bird

Review of code share arrangements between Qantas and South African Airways

This letter is an application for an extension of the current authorisations that permit Qantas to code share with South African Airways (SAA) on Qantas services between Sydney and Johannesburg for a further two years.

Qantas believes that the continuation of the code share arrangements provides an efficient use of capacity that enhances the viability of the carriers in the face of increasing competition, and maximises the public benefit. Discontinuing the code share arrangements would result in significant increases in average costs for both airlines and erode these public benefits.

The arrangements will produce a superior outcome for the Australia-South Africa route than would be the case if they were not permitted to continue, and increase prospects for a sustainable level of competition in the long term.

Australia-South Africa Market

As the Commission will be aware, since the renewal of the Qantas-SAA code share arrangements in 2008, the operating environment for all carriers has been particularly unfavourable. The Global Financial Crisis (GFC) profoundly impacted traffic in the last quarter of 2008 and throughout 2009, and contributed to ongoing job losses in the industry. The industry lost US$9.4 billion in 2009, although the International Air Transport Association (IATA) predicts that it will make a combined profit of US$2.5 billion this year.

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Qantas responded to the downturn by reducing flying capacity by five percent, grounding the equivalent of 10 aircraft, deferring aircraft orders, reducing capital expenditure and removing a significant number of management positions.

Having begun the process of recovery in the first quarter of 2010, the industry is now facing rising fuel prices. IATA currently predicts the average oil price to be just under US$89 per barrel for 2010, which is an increase of US$27 per barrel on the average price of US$62 for 2009.

Not surprisingly, the downturn in global passenger numbers since late 2008 also affected the operating conditions on the Australia-South Africa route.

The weakness of South Africa's economy since 2008 has had a uniformly dampening effect on South African outbound tourism, with the unemployment rate now sitting at above 25 percent.

Although Australia originating traffic on the route increased by 9.4 percent in 2009, reflecting the relative health of the Australian economy, visitor arrivals from South Africa, which account for around 52 percent of the market, fell by 12.2 percent. Prior to this, arrivals from South Africa had been increasing substantially each year since 2004.

Today, there are 5,059 direct seats being offered by airlines on the South Africa route each week. At the time of authorisation in 2008, 3,340 seats were being operated each week.

The Soccer World Cup 2010 has had a weaker than expected impact on tourism to South Africa over the period of the event. Tourism South Africa initially expected 450,000 visitors. This forecast was then revised down to 375,000, and now sits at 250,000. Qantas had hoped the South Africa route would gain a one-off short term demand injection with the World Cup Soccer events in Cape Town during June to provide a boost in an otherwise flat period. However, the level of bookings received over this period has been disappointing.

There have been many developments on the Australia-South Africa route since 2008 which have resulted in a transformation of the competitive framework on the route, and generated a major increase in consumer and competition benefits. These developments are outlined below.

<u>Qantas-SAA Code Share Developments</u>

Since the code share arrangements were last re-authorised, Qantas and SAA's combined market share on the South Africa route increased from 69.0 percent in 2008 to 74.5 percent in 2009, primarily due to the increases in capacity the two carriers have injected into the market in the past two years. From the Northern Winter 2008 scheduling season, SAA began regularly deploying the larger A340-

600 aircraft on the Perth-Johannesburg route, which has over 25 percent more capacity than its A340-200 and A340-300 aircraft. In September 2009, SAA added two Perth-Johannesburg flights per week to take it from a five per week operation to a daily service offering. This followed Qantas' increase from five to six weekly services in late 2008. The combined market share of the two carriers has since fallen to levels below that experienced in 2008 due to changes in the competitive architecture of the route.

Although the market is still adjusting to the capacity changes that have taken place, the Qantas-SAA code share relationship is working to our satisfaction and is of considerable commercial importance to Qantas.

SAA has started to expand its market presence in Australia for passengers travelling beyond Perth and Sydney. It commenced an interline agreement with Virgin Blue in April 2009 for domestic Australian add-on sectors, and Qantas has since seen a decline in its share of the domestic Australia market from the South African point of sale.

SAA also commenced a code share agreement with Air New Zealand (NZ) in November 2009, enabling the two carriers to offer a one-stop service between Auckland and Johannesburg via Perth. SAA will also code share on connecting NZ domestic flights to Wellington and Christchurch, as well as NZ's trans-Tasman services between Sydney and Auckland, Wellington and Christchurch, and NZ will code share on connecting SAA services to Cape Town, Durban, Port Elizabeth and East London.

<u>V Australia</u>

Another significant competitive development since the Commission last approved the Qantas-SAA arrangements is V Australia's (VA) entry to the South Africa route, which has increased competition considerably through its direct services with a differentiated product and routing.

In March 2010, VA introduced two weekly B777 Melbourne-Johannesburg services. VA has announced plans to introduce a third weekly service in December 2010, and has a capacity allocation which will enable it to add a further two weekly services on the South Africa route.

VA achieved a respectable market share of 14.8 percent in its first full month of operations in April 2010. In the same month, Qantas' market share fell to 39.1 percent, while SAA's market share was 27.5 percent, giving a combined total of 66.6 percent. In the first four months of this calendar year the combined Qantas-SAA market share on the South Africa route fell to 68.5 percent. As VA continues to expand and consolidate its presence on the route, Qantas expects its own market share on the Australia-South Africa route to fall further.

VA will undoubtedly establish itself more strongly in the market over the next two years as it builds frequency to an even more competitive level, particularly with the business market which prefers a greater choice in days of travel. Qantas anticipates VA gaining a growing share of South Africa business traffic as it adds capacity to the market.

There is scope for VA to move beyond five weekly flights, as from October 2010 there will be nine weekly frequencies available for Australian carriers to utilise under the air services arrangements with South Africa.

VA is well placed to take advantage of its extensive Australian domestic network in competing with Qantas, and has already proved to be an effective and vigorous competitor on the South Africa route.

VA has been promoting its services as having faster and more convenient connections from South Africa to Auckland via Melbourne, and we understand is also planning to negotiate interline agreements with other carriers, such as SAA and Comair, for domestic add-ons.

VA's entry to the South Africa market has given consumers a higher frequency of services to choose from, and an increased choice of carrier, in-flight experience, aircraft type and time of travel. There is also now a wider range of fare types and levels available in the market than previously.

Third Country Carrier Competition

Competition from third country carriers on the Australia-South Africa route continues to have an impact on Qantas, accounting for approximately 25.5 percent of the market in 2009. Although this is lower than their corresponding market share from the previous two years, this is attributable to the increases in capacity by Qantas and SAA over the period, and does not reflect any less aggressive pricing measures of sixth freedom carriers.

The growing number of services from third country carriers means that they can use their geographical positions to operate one-stop services to several different points on the African continent by connecting two separate services through their home base. As such, many passengers travel to other parts of Africa using the services of third country carriers rather than travelling on Qantas or SAA via South Africa. From a geographical perspective, South Africa is not a particularly effective means of serving north or central Africa. Many of these third country carriers operate to multiple points in Australia with high frequency.

Qantas' Growth Plans

Qantas will introduce a seventh weekly service between Sydney and Johannesburg in September 2010. This service will introduce an additional 353 weekly seats to the market, which is an increase in capacity of 17 percent on the Sydney-Johannesburg route. It will offer a four class service, including Premium Economy Class.

Although Qantas had originally planned to introduce this new service in April 2009, in light of the substantial deterioration in global economic conditions which led to decreasing traffic flows despite lower fares to stimulate demand, this was deferred. In July 2009, the Commission granted an extension to Qantas of the full use of capacity on the South Africa route to 31 December 2010.

Qantas is now in a position to implement its expansion plans, despite the fact that yields are still lower than 2007 and 2008 levels, fuel prices are rising, forward bookings are down, and there is growing competition on the route. We expect the additional frequency will result in a yield decline and a seat factor reduction for Qantas, even when calculated with a generous amount of market growth built in. Despite these matters, Qantas proposes to introduce the additional service because a daily service offering will give passengers more flexibility in their travel plans and increase the marketability of our product offering.

A daily frequency will provide greater convenience and choice for our passengers, especially those travelling for business, and for passengers connecting to/from other ports who may not be able to make same-day connections in the absence of daily flights.

A daily frequency will also be important in Qantas' ability to compete effectively with third country carriers, in particular those who offer a relatively high frequency of service in the South African market.

Taking into account the capacity injected into the South Africa market by VA, direct capacity between Australia and South Africa will have risen by 70 percent between December 2008 and December 2010. This is well in excess of recent and forecast growth for the Australia-South Africa market.

From late-2011, Qantas anticipates removing the First Class cabin on the B747 aircraft that serve this market due to low demand. In its place, we will offer a three-class service on its South Africa flights, which will have more seats on each flight than the four class services.

Against this background, the code share arrangements with SAA will be instrumental in our ability to sell these additional seats and an important factor in sustaining 14 direct services operated by Qantas and SAA in combination from September 2010 through to the medium term.

Qantas – SAA Code Share Arrangements

As the Commission is aware, the code share with SAA is a block space arrangement, whereby SAA, as a marketing airline, pre-purchases a specific number of seats at a fixed agreed rate (a hard block), and cannot hand back these seats to Qantas. SAA 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.

Qantas and SAA operate independently of each other. All seats are priced and sold independently by the two carriers, as well as with other competitors such as VA.

Both carriers manage their blocks of seats by including them in their reservations systems as if they are operating virtual aircraft on the Australia-South Africa route. The maintenance of separate seat inventories by Qantas and SAA produces the effect of two smaller aircraft operating instead of one separate larger aircraft.

The fact that the code share between Qantas and SAA is a hard block arrangement means that competition between the carriers is retained, as well as their incentives for price discounting. Price competition exists as each competes with the other in selling their blocks of capacity, leading to highly competitive pricing between the two carriers.

Each competitor has the objective of winning market share and Qantas regularly offers special fares to boost sales. Between 1 July 2008 and 31 May 2010, Qantas mounted approximately 50 special fare initiatives ex Australia. Sale periods of these initiatives varied, but often overlapped, and in some cases were extended to further stimulate demand. From time to time Qantas' fare levels are below the hard block seat price that it pays for the purchase of code share seats from SAA in order to remain competitive in the market, to clear its inventory and to receive some contribution towards seat costs.

Prior to the commencement of the code share agreement between the two carriers in 2000, the Africa route was not a profitable one for Qantas, with significant losses being incurred each year. The restructuring of operations made possible under the code share arrangements with SAA has transformed a former heavy loss making route into a profitable one for Qantas.

The code share arrangements enabled the commencement of non-stop Sydney-Johannesburg services by Qantas, and the termination of SAA's services in Perth, allowing SAA to eliminate the uneconomic loads on the Perth-Sydney leg, on which it is restricted to the carriage of own-stopover traffic.

The lower operating costs of these arrangements have kept the route on a firm financial footing for Qantas, while delivering substantial benefits to consumers. This has occurred at the same time as additional competition was introduced by new and existing carriers.

The efficiencies obtained from the code share arrangements have produced considerable consumer benefits. There is now a greater frequency of services and more capacity and, from September 2010, Qantas and SAA's combined number of seats operated each week on the route will have increased by over 40 percent since the code share arrangements were last authorised in 2008.

The code share arrangements offer the best prospects for maintaining the presence of three direct competitors across three different non-stop routes between Australia and South Africa. Following the large increase in direct capacity since 2008, the South Africa route is now in a position where the substantial benefits of the code share far outweigh any anti-competitive detriments that may have been perceived prior to the entry of VA on the route.

The competitive tension between the two airlines is evident in the attempt by SAA to reduce its reliance on Sydney-South Africa and Perth-South Africa point to point traffic by commencing code share agreements with NZ, enabling it to carry passengers on its code all the way through to Auckland, Wellington and Christchurch from both Sydney and Perth, and with Virgin Blue, enabling it to carry passengers on domestic Australian add-on sectors.

Qantas has demonstrated that it has used the authorisation to act in a manner that is advantageous to the public benefit with the introduction of its sixth weekly service in December 2008, and with its planned seventh weekly service in September 2010. These services have been added to the detriment of our short to medium term profitability on the route, at a time when the operations of every route on Qantas' network are being scrutinised in a bid to maximise profitability.

Route Performance

Regrettably, since the Commission last re-authorised the code share arrangements, many of the international routes that Qantas operates have struggled to achieve profitability, and even fewer have managed to earn an acceptable return on capital employed.

Although the South Africa services have been relatively less affected and are performing better than many of Qantas' other international routes, conditions on the route have deteriorated, and while it has been a traditionally strong performing route for Qantas, it has experienced a significant reduction in profitability since 2008. Given the increases in capacity that will be introduced to the market this year, it is likely to be some time before the commercial performance of the route improves.

While it is difficult to separate the impacts of the GFC from those related to capacity and competition effects, we are certain that the reduction in profitability is attributable to both the significant capacity growth from direct and indirect competitors, as well as the dampening effect of the GFC on demand.

Naturally, yields have suffered during this period, as the Commission is aware from the quarterly reports submitted by Qantas, as required by the conditions of the code share authorisations. The cutbacks on corporate travel by as much as 50 percent during the GFC in 2009 were a major reason for the decline in yield and premium class travel.

The yield decline is a reflection of how the airlines in the market have maintained elevated levels of capacity in the face of falling underlying demand, which has been to the benefit of Australian and South African residents.

The difficult operating environment on the route has also affected SAA, and it has elected to cancel 18 services over the non-peak period on the route between March and September 2010, which indicates that the market is now suffering from over-capacity, at least during certain periods. Qantas has only cancelled one service this year, which was replaced by a supplementary service to South Africa as part of our sponsorship of the Qantas Socceroos for the Soccer World Cup. We have one more cancellation planned for 31 December, due to lack of demand.

The substantial deterioration in global economic activity, the expansion of capacity by both SAA and Qantas, the competitiveness of third country carriers on the route, and the introduction of VA services has had an effect on Qantas' seat factors on the route over the past two years. In the three month period ending February 2010, Qantas' average seat factor on the Australia-South Africa route fell 4.1 percentage points compared to the equivalent period last year, to 79.5 percent, reflecting both the additional capacity and competition on the route.

This is expected to continue as Qantas' forward bookings indicate substantial reductions in bookings held versus the previous year. Figures for June to November 2010 show an 7.8 percent fall compared with last year's forward bookings at the same point in time. The introduction of our seventh weekly service, together with VA's planned increase in capacity in December 2010, and likely increases beyond this, may serve to drive Qantas' seat factor and market shares down further in the future.

Average Qantas airfares to South Africa fell between 2008 and 2010, while costs have increased. The forecast significant increase in the fuel price will adversely affect route performance.

According to IATA, the price of fuel is now just under $US86 per barrel, and the most recent West Texas Intermediate Forward Curve estimates that the crude oil price will increase from $US79 per barrel for the 2011 financial year to $US83 the following year and to $US85 for the 2013 financial year. While Qantas may have the option to increase the fuel surcharge if prices do escalate significantly, this would only partially offset the impact on Qantas' increased fuel bill on the route.

As projected passenger growth in the market will fail to keep pace with the increases in capacity the market is currently experiencing, it is likely to be some time before the route improves its profitability.

Benefits of the Code Share Services

The code share arrangements between Qantas and SAA have enabled the two carriers to improve the level of capacity and product on the route over the past two years in very difficult circumstances. They have delivered a range of benefits including:

- The continuation of dedicated non-stop capacity from Johannesburg to both Sydney and Perth, delivering significant tourism benefits for New South Wales and Western Australia;
- Enhanced frequency and schedule choice between South Africa and Australia; bringing benefits for business travellers and Australian exporters;
- By September 2010, the operation of a daily service into both Perth and Sydney;
- Capacity expansion of 41.2 percent in total by Qantas and SAA on the Australia-South Africa route since the Northern Summer 2008 scheduling season (from 3,072 to 4,337 combined seats);
- The promotion of both Sydney and Perth by SAA, using its well developed distribution networks in the South African market;
- A twofold promotional effort in marketing Sydney and Perth in South Africa by Qantas and SAA;
- Continuing competition between Qantas and SAA due to the nature of the code share (block space arrangement).

Reauthorisation of the code share arrangements will facilitate continuation of these benefits, plus the implementation of an additional Qantas service between Sydney and Johannesburg in September 2010.

Variations Sought

Qantas seeks an extension of the IASC approval to permit SAA to code share on Qantas operated flights on the South Africa route for a further two years.

The code share arrangements will continue to be limited to the carriage of passengers. Qantas and SAA will each control and market all cargo capacity on their own flights.

Accordingly, Qantas seeks to vary Determinations 125/2005, 130/2006, 109/2008, 105/2008 and 126/2009 on the South Africa route to enable SAA to code share on Qantas services operated pursuant to these determinations and in accordance with the Qantas-SAA Commercial Agreement and Code Share Agreement of December 2000, as amended.

The variations are sought with effect from 1 January 2011 to 31 December 2012.

Qantas believes that a two-year authorisation would be an appropriate timeframe in light of Qantas and VA's expansion plans on the route, and the challenging operating environment.

Qantas considers that the variations requested meet the requirements of the IASC Act and the terms of the Minister's Policy Statement for favourable action by the Commission.

As with previous applications, information sought by the Commission for the review of these code share arrangements is set out in the Attachment to this letter. As the majority of this material is commercially sensitive, we would ask the Commission to withhold it from the public register and not disclose it to any third party without Qantas' consent.

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

Yours sincerely

David Epstein
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