QANTAS

18 August 2011

Ms Sue McIntosh
Executive Director
International Air Services Commission
GPO Box 630
Canberra ACT 2601

Dear Ms ~~McIntosh~~ Sue

Review of code share arrangements between
Qantas and South African Airways

I refer to my letter of 15 August concerning the review of code share arrangements between Qantas and South African Airways. I have attached for your information additional material prepared in support of our application.

Yours sincerely

Tony Wheelens
General Manager Group
Government and Industry Affairs

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Background

The Minister's Policy Statement and the Government's Aviation White Paper both emphasise the importance of the role played by the Australian aviation industry in the broader economy. This application, we believe, should be considered against that background and the significant changes that have occurred in aviation policy and the operating environment in recent years.

The Commission will be aware that the aviation industry is exposed to a complex range of externalities beyond its control. In recent years these events have been sustained, deeply disruptive and are a material consideration in understanding the challenges and fragility of the sector. The aviation industry will continue to be exposed to such events. The industry is challenged also by the progressive marginalisation of benefits derived over the last two decades from micro-economic reform of the aviation sector.

We encourage the Commission to consider these issues broadly to ensure the inherent efficiencies, cost savings and consumer welfare benefits of the code share arrangements are maintained. The Australia - South Africa market continues to demonstrate characteristics which suggest there is little prospect of a different market structure emerging in the foreseeable future.

Both countries are at the end of long routes by global standards, distant from their principal markets, with demand between Australia and South Africa largely framed around point to point traffic. Traffic rights restrictions in the air services agreement ensure limited commercially viable hub opportunities for Qantas code share services, with the exception only of New Zealand.

Air services between Australia and South Africa can be conducted only with specialised, mission specific long haul aircraft. As a consequence it is not possible, as it is in many other markets, to introduce lower capacity aircraft to accommodate incremental growth or to easily adjust capacity, up or down, to efficiently accommodate seasonal demand. This lack of flexibility is compounded in a relatively small market where total all carrier demand can vary by as much as 15,000 passengers between the lowest and highest month.

Third country carriers play an important role in the Australia - South Africa market and their contribution should not be underestimated. Their market share is comparable to that obtained in other markets with similar characteristics. Third country carriers offer highly competitive fares and provide important capability to meet peak season demand.

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

Code share has become an essential component of the global aviation industry. It is used extensively by regulators to stimulate market growth and to break down impediments to open markets inherent in international air services agreements which regulate the global industry. Its importance is emphasised by guidance in the Minister's Policy Statement that where capacity that can be used for code share operations is available under air services arrangements, the Commission would generally be expected to authorise applications for use of capacity to code share.

The Qantas – SAA code share agreement, which was first approved in December 2000 is a block space arrangement. SAA as the marketing carrier pre-purchases a specified number of seats at a fixed rate and cannot hand these seats back to Qantas. In doing so it accepts full commercial responsibility for the sale of these seats. It is exposed to losses if the seats are not sold. This establishes and maintains a contested market and competitive pricing initiatives. Both carriers manage separate seat inventories within their own reservations systems. Public benefit is derived from these arrangements. In addition to the code share agreement between Qantas and SAA is important to take into consideration other significant and influential commercial agreement in place in this market.

The code share arrangements approved over the last decade do not, we believe, give rise to serious concerns about public benefit. With all circumstances taken into consideration, the market has performed beneficially under this framework which provides a strong guarantee of competition. Absent the code share arrangements it is unlikely a competitive presence in the market can be guaranteed.

The accumulated and detailed knowledge of this market should now suggest to the Commission its characteristics are unlikely to change in the foreseeable future. That being the case, we believe it is now appropriate to extend the current approval for a further five years. Rolling short term Determinations do not give us the investment certainty we need to develop the route over the long term and to effectively address the persistent challenges of the operating environment. This would ensure that we can invest with confidence to maintain legitimate profit; enhance consumer and welfare benefits, and continue to build the route over time. While V Australia has withdrawn from the route reduced competitive forces of themselves are not a basis for denying continued code share approval. The long term experience of this market suggests strongly there will be no lessening of public benefit.

Air fares, yields and load factors on the Australia - South Africa route are influenced by a range of complex factors. The fact they fluctuate on a route with these characteristics is not of itself remarkable. The involvement of third country carriers in this market, particularly in periods of high demand is predictable and fully consistent with the role they play more broadly in other Australian markets. It is likely in our view the market will maintain its long term growth pattern. Despite the opportunity for new carriers to enter this market, apart from Qantas and SAA it has failed to attract and retain other long term investors. The characteristics of the route are therefore a material consideration.

We are not aware of another mechanism or structure which would provide a superior public benefit to that already in place through the code share arrangements. Absent the code share approval it is highly probable the route would eventually be served by a single direct carrier. The code share agreement guarantees a competitive presence by the carriers in both the Perth and Sydney markets. Seats are pre-purchased and cannot be handed back. Carriers must manage the commercial risk of inventory not being sold. The carriers operate independently and in direct competition with each other.

This establishes a contested market; guarantees competitive pricing initiatives, and ensures that monopoly rent is not being generated on the route. The public benefits of these arrangements have been demonstrated to the Commission on many occasions as has the counter-factual of the likely circumstances absent the code share agreement.

Paragraph 5 Criteria

In view of the circumstances discussed above we believe the application meets fully the Paragraph 5 criteria contained in the Minister's Policy Statement.

The Minister's Policy Statement provides that in assessing the extent to which applications will contribute to the development of a competitive environment for the provision of international air services, the Commission should have regard to:

- *the need for Australian carriers to be able to compete effectively with one another and the carriers of foreign countries*
  - The code share arrangements, by ensuring that Qantas and SAA compete against each other, do not create market circumstances detrimental to the interests of other Australian carriers. V Australia did participate for a short period as a direct air carrier in this market before withdrawing. The Virgin Group has an interline agreement with SAA covering domestic on-carriage within the Australian market.
- *the number of carriers on a particular route and the existing distribution of capacity between Australian carriers*
  - Qantas and SAA operate on the route in a wholly competitive relationship. The air services agreement provides for the designation of multiple carriers and there is sufficient negotiated capacity to ensure a commercially viable level of start-up capacity. Since the entry and subsequent withdrawal of V Australia from the market no Australian carriers other than Qantas operate direct services on the route.
- *prospects for lower tariffs, increased choice and frequency of service and innovative product differentiation*
  - Lower tariffs, increased choice and frequency of service and innovative product differentiation are ensured by the code share arrangements. The arrangements maintain dedicated non-stop capacity from Johannesburg to both Sydney and Perth and enhanced frequency and schedule choice between South Africa and Australia, bringing benefits for business travelers and Australian exporters. Absent the code share arrangements

with the carriers almost certainly not competing in the Sydney and possibly the Perth markets this criterion could not be assured.

- *the extent to which applicants are proposing to provide capacity on aircraft they will operate themselves*
  - Qantas operates the code share services on aircraft it operates.
- *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*
  - not applicable
- *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*
  - not applicable
- *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*
  - not applicable

Tourism Benefits

- *the level of promotion, market development and investment proposed by each of the applicants*
  - The underlying weakness of the South African economy will continue to be a major constraint on the development of inbound tourism to Australia. Nevertheless, Qantas in the last financial year spent approximately AUD 345,000 on marketing activity in South Africa. By comparison, promotional expenditure by Tourism Australia in South Africa during the same period was, we believe, significantly under AUD 100,000
  - Withdrawal of code share approval is highly unlikely to lead to an increase in inbound tourism from South Africa. The weak economic situation in South Africa is an important consideration as is Qantas' ability through the code share arrangements to promote Australia on SAA services to Perth. Without Qantas's marketing activities associated with the code share services tourist visitor numbers may well have fallen further.
- *route service possibilities to and from points beyond the Australian gateway(s) or beyond the foreign gateway(s)*
  - Qantas provides strong links beyond Australia to New Zealand. SAA operates code share services with Air New Zealand on services beyond Perth. Qantas passengers link directly with the Qantas Group domestic and international services. SAA passengers also link to the Virgin Group's domestic and international networks. Constraints in the air services agreement limit Qantas' ability to effectively compete in markets beyond South Africa

Consumer Benefits

- the degree of choice (including, for example, choice of airport(s), seat availability, range of product)

- The code share arrangements mean that both Qantas and SAA maintain a competitive presence in both the Perth and Sydney direct markets. This maximises the degree of choice in the market. Absent the code share agreement, it is highly likely that Qantas would be the only carrier operating direct services from Sydney. Behind the gateway points Qantas and Virgin compete for SAA beyond traffic within the Australian, South African and New Zealand markets.

- *efficiencies achieved as reflected in lower tariffs and improved standards of service*
  - The efficiencies gained from code share are demonstrated amply in the counter-factual. Simply, absent the code share arrangements competition would be reduced for the reasons outlined elsewhere in this submission. However, it would not be entirely be eliminated by virtue of SAA's interline arrangements with the Virgin Group and the presence of third country carriers in the market.
- *the stimulation of innovation on the part of incumbent carriers*
  - Qantas and SAA compete for market share under the terms of the code share agreement. Because the code share arrangements ensure that SAA remains an active competitor in the market consumer benefits are derived.
- *route service possibilities to and from points beyond the Australian gateway(s) or beyond the foreign gateway(s)*
  - See above – Tourism Benefits

<u>Trade Benefits</u>

- *the availability of frequent, low cost, reliable freight movement for Australian exporters and importers*
  - The code share arrangements exclude the carriage of freight. Qantas and SAA are each responsible for the sale of belly-hold capacity on the services they operate.

<u>Industry Structure</u>

- The Commission should assess the extent to which applications will impact positively on the Australian aviation industry.
  - The code share arrangements have had a positive effect on the Australian aviation industry by increasing Qantas' profits on the route, especially in relation to Perth, and over time have enabled Qantas to add extra capacity. The expansion of services, supported by the code share, positively benefits Qantas itself, as well as benefitting ancillary aviation businesses which are integrated with Qantas' operations.