10 February 2012

Ms Sue McIntosh
Executive Director
International Air Services Commission
GPO Box 630
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Dear Ms McIntosh Sue

Review of Code Share Arrangements between Qantas and South African Airways: Draft Decision [2011] IASC d220.

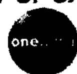
Thank you for the opportunity to comment on the draft Decision [2011] IASC d220 issued on 17 November 2011, in which the Commission indicated its intention to permit South African Airways (SAA) to code share on Qantas' flights operated to and from South Africa until 31 December 2012.

While Qantas welcomes the intention to extend the approval of the code share arrangements with SAA, we are concerned with the Commission's indication that approval of the code share will not extend beyond the end of 2012.

The code share arrangements remain, in our view, consistent with established policy and the treaty arrangements between Australia and South Africa; continue to be of benefit to the public, and meet the requirements of the Minister's Policy Statement.

For this reason, the draft Decision raises important questions about the future direction of Government policy and criteria used by the Commission to assess public benefit. In assessing public benefit the Commission has not in our view given appropriate weight to the important characteristics of the Australia – South Africa market and the role of third country carriers; the strong competition between the direct carriers created by the code share arrangements and the clear benefits that continue to accrue from approving the code share (the factual) compared to a world in which the code share does not continue (the counterfactual).

The features of the Australia-South Africa market are important. Direct operators (those that offer non-stop services between Australia and South Africa) compete with third country carriers such as Singapore Airlines; Emirates; Etihad; Thai Airways; Malaysia Airlines, and Cathay Pacific which operate one stop services. These third country carriers are broadly free to enter or exit without constraint.



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Third country carriers have geographic and cost advantages that allow them to offer Australian consumers premium one stop services through their hub. They are not short of capacity to participate in fifth and sixth freedom markets. Australian Government policy is specifically framed to ensure fifth and sixth freedom carriers create a competitive presence within markets. In this market Qantas competes for all traffic often against carriers using code share in far more open arrangements than ours. Based on the Commission's own expectation that 30 per cent of the market will be carried by foreign carriers there will be a high degree of competitive market tension.

The Commission's assertion that competition from indirect carriers provides only a serious competitive constraint on the code share services operated from indirect points ignores the genuine threat of entry created by the presence of third country carriers and legitimate commercial decisions unrelated to the code share arrangements.

Direct services are more convenient and attractive for some time sensitive consumers. However, competition for the marginal passenger is the important dynamic here and in this regard there are no impediments to third country carriers competing against the direct services from Sydney and Perth. The code share arrangements do not amount to foreclosure or create a barrier to entry or further expansion. Instead the challenging dynamics of the Australia-South Africa market dictate whether entry or expansion by direct or indirect carriers is likely in the future.

The Commission has not placed sufficient weight on the level of competition that already exists between the code share partners. The code share arrangements themselves are pro-competitive as they create real financial incentives for the direct carriers to price their respective blocks of seats at a competitive level.

For example, SAA as the marketing carrier pre-purchases a specified number of seats at a fixed rate. SAA cannot hand these seats back to Qantas. SAA accepts full commercial responsibility for the sale of these seats. SAA is exposed to losses if the seats are not sold. Both SAA and Qantas manage separate seat inventories within their own reservations systems. The code share arrangements, by ensuring the partners compete against each other do not create market circumstances detrimental to the interests of consumers or competing carriers.

The Commission holds a view that code share is a poor substitute for direct competition. That view can only be supported if the counterfactual is a market in which there is likely to be increased competition. This is not the case here.

[See Confidential Submission – Part 1]

The code share is structured to ensure the two airlines compete against each other for the sale of seats. However, the Commission asserts that cost recovery puts a floor under price and profit potential and this limits the ability of carriers to use loss leaders to attract market share. We find this observation by the Commission peculiar as a 'floor' is created whenever a business seeks to recover its cost of production. This is regardless of whether the business is recovering its own costs of production (in the case of Qantas) or costs passed onto it by a third party supplier (in the case of Qantas charging SAA a block price).

[See Confidential Submission – Part 2]

Hard block code share does not soften competition by any means. Rather, by allocating a fixed amount of capacity in advance and fixing the cost that is to be paid for that capacity, both parties to the arrangements have maximum incentive to market their services and set fares independently of the other. It is important that the Commission does not underestimate the competitive detriment of a "retreat to monopoly" on each route in the event the code share arrangement was not approved.

The Commission says common rating discourages competition between Qantas and SAA yet we are compelled to common rate to compete against price leading foreign carriers. Notwithstanding the Commission's view that time penalties may be smaller than those from Sydney and Perth indirect travel from Brisbane and Melbourne is still more inconvenient than via Sydney, yet Qantas is out-performed in these sectors despite common rating tariffs and despite the fact travel time is longer. The Commission should equally conclude that the behaviour of third country carriers is instrumental in setting floor prices in the Australian market.

Since the code share arrangements were first authorised in 2000 the Commission has imposed a minimum number of combined weekly services. Despite the fact very few other arrangements approved by the Commission contain similar constraints its intervention at the commencement of these arrangements was without experience of the code share in place.

The Commission accepts the Australia-South Africa market is small with limited growth capability nevertheless in each year since the inception of the arrangements with the single exception of 2005 the direct market has grown. There is no evidence the supply of capacity has been insufficient to serve the needs of the overall market and the Commission accepts the level of passenger traffic limits the potential for significant increases in capacity.

Positive externalities are derived from the code share arrangements. Competition is created by the code share where otherwise it would not exist. Trade and tourism are important third party beneficiaries.

The Commission has made it clear that it is not currently minded to extend approval of the code share beyond the end of 2012 and, implicitly the withdrawal of code share approval would likely result in monopolies for direct services on both the Sydney and Perth routes. The Commission also considers the most likely counterfactual absent the code share is a continuation of the current operations by the incumbent carriers however, it is more likely that one or more of the incumbent carriers will reduce services or withdraw entirely from the route.

The Commission encourages a scenario which would contradict established Government policy; go beyond the assessment of public benefit provided for in the Minister's Policy Statement, and result in outcomes demonstrably inferior to a continuation of the current arrangements. Any outcome which has a high probability of removing competition from the market implicitly contradicts Paragraph 5 of the Minister's Policy Statement which requires the Commission to maximise competition; consumer; tourism, and trade benefits and ensure the interests of the Australian aviation industry. A monopoly provider would attract significantly less attention than the current arrangements which deliver a contested market between the direct carriers; supplemented by powerful third country players, all operating transparently, openly and competitively in the public interest. In public policy terms this would be an extraordinary outcome.

The apparent ambivalence of the Commission to monopoly supply in the absence of code share approval concerns us deeply. The Commission has described a counterfactual in which competitive outcomes are inferior to continuation of the code share. Nor does it identify how the market would subsequently operate other than to speculate that at an indeterminate time other airlines might enter, with no indication which city pairs might be served; the level of frequency or capacity, or if the airline would be an Australian or a foreign carrier.

[See Confidential Submission – Part 3]

The Commission speculates about the possibility of new entrants. This is despite its own view the likelihood of significant entry in the short term is low and constraints such as regulatory hurdles; length of route; low levels of passenger traffic and limited potential for significant traffic increases; a journey profile which has not changed significantly over recent years, and a highly seasonal market make it unlikely that such non-stop entry would be attractive to any carrier, even without the code share in place.

In discussing the possibility that one of the incumbents may exit and another competitor enter the Commission states any new entrant is most likely to be an Australian or South African airline. Based on our experience of this market it is not clear to us who that might be. The Commission contemplates direct entry of a third country carrier despite the possibility being heavily constrained by the air services agreements. The Commission acknowledges such entry is by no means certain.

We are also deeply concerned about the broader policy implications of the draft decision which we believe is consistent with the approach adopted in recent years where the Commission has become increasingly prescriptive in its decisions in respect of this market. Despite these interventions, the market characteristics persist as they have done for the last decade. V Australia's failed entry confirmed the characteristics of the route and underlined the likelihood this route will commercially support only a small number of direct carriers and in that structure code share is critically important to maintaining competition on the route.

The Commission's conclusions rely overly on its observation of V Australia's time in the market. The simple fact is V Australia did not sustain its position in the market and therefore should not be considered a benchmark to judge the long term characteristics of the market.

There is no evidence whatsoever to support the Commission's assertion the code share arrangements may have contributed to V Australia's losses on the route and to its eventual withdrawal. [See Confidential Submission – Part 4]

The Commission observes V Australia's direct Melbourne service proved attractive and demonstrated real competitive pressure will only come from direct services. In drawing this conclusion the Commission may well have put more weight on the fact the offering apparently was not sustainable. The single most important event on the route in recent years was not the entry and subsequent departure of V Australia; it was the increase in negotiated bilateral capacity in 2008 which enabled Qantas to move to daily services and for SAA to increase its capacity. During this period Qantas and South African Airways introduced more new capacity than V Australia operated at its peak, capacity which in large part is still being operated long after V Australia's departure. Little credit or recognition is given to that investment.

The Commission in describing V Australia's withdrawal points to costs incurred for promotion, marketing, systems and timetables and realignment of operations to service a new route. Such costs are by no means remarkable or unique to start-up and are understood by businesses operating in the wider economy. Inevitably such costs must be factored into decisions to enter markets. Importantly it remains a factor for Qantas and SAA as we continue to invest, promote and develop the market.

Legitimate market forces have framed this market and it is disingenuous not to recognise or give credit to the investment the incumbent carriers have made since 2000 in the development of the market. Elsewhere in the Minister's Policy Statement there is a clear presumption in favour of incumbent carriers to ensure investment and efficient use of capacity is encouraged and protected. The same principle should also factor in Paragraph 5 considerations.

Finally, the Commission suggests disbanding the code share between SAA and Qantas would 'free up' SAA to enter into an arrangement with Virgin via other Australian cities. It is not obvious to us why substituting one code share arrangement for another would materially promote competition, or whether it should even be open to the Commission to speculate over such possibilities.

If the Commission believes there are distortions in the market and there are carriers willing to enter the market, then the market should be allowed to operate more freely, not by removing beneficial codes and creating a monopoly but by removing the capacity cap. The mandatory minimum capacity requirements do not allow market forces to develop and may have been a more relevant consideration in V Australia's case than some other factors.

In a market where seasonal demand fluctuates by up to 5,000 passengers between the highest and lowest months, inefficient excess capacity is mandated by the Commission. The fact the Commission does not use such an approach in any other market suggests legitimate questions can be asked about its application in the South Africa market. In the event a monopoly is established, the incumbent carrier would be free to reduce capacity without intervention by the Commission - the very issue under consideration.

New carriers are highly unlikely to enter a market where profligate levels of mandated capacity are operated with no regard to profitability, seasonality or externalities. Nor are they likely to enter a market where mandated capacity levels rather than market forces sets the supply parameters. Such an outcome heavily favours incumbents and reduces the prospect of legitimate profit or return on investment for new entrants. This is reflected in the Commission's own view that entry into the direct markets may be unlikely with or without code share in place and it sends a potentially negative message to new investors.

The Commission considers the condition to maintain minimum levels of combined capacity is necessary and cites the experience of the code share between 2008 and now as evidence that competition under the code share will only occur when there is pressure for the airlines to sell seats. However, it is more likely the fall in average load factors between 2008 and 2010 was a result of the increase in negotiated bilateral capacity which saw Qantas and SAA operating 40 per cent more capacity on 2008 levels rather than the condition relating to minimum levels of combined capacity.

The Commission endorses short term approvals because there may not be of benefit to the public over a longer period if circumstances changed. This is a highly predictable route and all the available data suggests its profile is highly unlikely to change.

Code share remains an essential component of the global aviation industry. It is used and endorsed extensively by regulators and its importance is emphasised by guidance in the Minister's Policy Statement. We urge the Commission to review the draft Decision and to remove the capacity cap in favour of a more market based approach; to retain the code share arrangements, and to authorise them as proposed for a period of five years.

We would be happy to meet with the Commission to further discuss our concerns.

Yours sincerely

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