Australian Competition & Consumer Commission

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

Re: Application from Qantas for extension of authority to code share with Air Niugini

Thank you for your letter of 1 March 2012 inviting the ACCC to comment on Qantas' application for an extension of its authorisation to code share with Air Niugini on services between Australia and Papua New Guinea.

I am providing this submission on behalf of the ACCC and note that it has been considered by the ACCC's Adjudication Committee.

The ACCC understands that in circumstances where the IASC has serious concerns that the code share may not be of benefit to the public, the IASC may apply certain 'public benefit' criteria set out in paragraph 5 of the Minister's policy statement[1] (including competition benefits) in its assessment of code share proposals.

As you know, the ACCC has considered a number of applications for authorisation of arrangements between airlines under the *Competition and Consumer Act 2010* (the Act). Broadly speaking, the Act requires the ACCC to assess the public benefits and public detriments (including anti-competitive effects) of the arrangements in determining whether to grant authorisation. This submission sets out the analytical framework used by the ACCC to make these assessments, in order to provide the IASC with assistance in determining the likely competitive impact of the continuation of the code share arrangement between Qantas and Air Niugini and whether it is likely to be of benefit to the public.

[1] International Air Services Commission Act 1992 - International Air Services Policy Statement No. 5.

The market

The first step in assessing the effect of an arrangement between competitors is to consider the relevant market(s) affected by the arrangement. Typically, the ACCC considers the impact of arrangements between competing airlines on competition in the following markets:

- international air passenger transport services, with regard to particular product and geographic segments
- international air freight transport services
- Australian domestic air passenger transport services and
- booking and distribution services.

International air passenger transport services

Product dimension

The ACCC has previously identified separate product markets for leisure and business passenger services.[2] This approach is based on the view that there are limitations in demand and supply side substitutability which make it appropriate to distinguish between more price sensitive (leisure) passengers and more time sensitive (business) passengers. The ACCC understands that business travellers are relatively less price sensitive and relatively more concerned about factors such as travel time, flexibility, connectivity, convenience and comfort when compared to leisure passengers.

Given that business travel makes up an unusually high proportion of Australia-PNG air travel compared to other routes, and travel for tourism purposes makes up a low proportion of travel on these routes, it may be relevant for the IASC to consider the public benefits and/or effects on competition of the code share arrangements for these separate customer segments but with a particular focus on business travel.

Geographic dimension

The ACCC has previously considered both a point-to-point (or city-pairs) approach and a regional approach in defining the geographic scope of the market for international air passenger transport services.[3] In this regard, the ACCC notes that it is important to consider the extent to which passengers are likely to consider different destinations as close substitutes. A passenger travelling for business purposes is unlikely to consider alternative destinations as substitutes, whereas a passenger travelling for leisure purposes may choose a different holiday destination depending on price.

[2] ACCC, Determination for applications A91195 & A91196 lodged by Qantas & British Airways (2010); ACCC, Determination for applications A91227 & A91228 lodged by Virgin Blue & Air New Zealand (2010); ACCC, Determination for applications A91151-2 & A91172-3 lodged by Virgin Blue & Delta Air Lines (2009); ACCC, Determination for applications A91097 & A91098 lodged by Air New Zealand and Air Canada (2009).

[3] ibid

As the IASC would be aware, passengers are most unlikely to travel between Australia and PNG indirectly (for example via Asia) and few passengers travel on this route as part of a journey to a third destination. Indirect services are not always considered by passengers, in particular business passengers, to be relevant substitutes for direct services. This is particularly the case when passengers are travelling on short-haul routes, such as those between Australia and PNG. Based on the information available, the ACCC considers that it may be relevant for the IASC to consider the impact of the code share arrangements on the markets for:

- international air passenger transport services for business travellers on a city-pairs basis (Sydney-Port Moresby and Brisbane-Port Moresby) between Australia and Papua New Guinea; and

- international air passenger transport services for leisure travellers between Australia and Papua New Guinea (noting that this is a relatively small market in the context of overall traffic between the two countries).

International air freight transport services

The ACCC understands that the code share arrangements between Qantas and Air Niugini extend to the carriage of freight, and therefore the IASC will have regard to the impact of the codeshare on competition in this market.

The market for air freight transport is generally considered by the ACCC as much broader in geographic dimension than air passenger transport markets. This is because freight is often less time critical and indirect routes may be considered a viable alternative to direct routes. The ACCC notes that there may be greater potential for supply side substitution in the provision of freight transport services, as the majority of operators carry both passengers and freight.

Australian domestic air passenger transport services.

In other aviation matters, the ACCC has considered whether arrangements between competing airlines in respect of international air passenger transport services could also affect competition in the market for domestic air passenger transport services by directing feeder traffic to a particular carrier, at the expense of the competitive position of other domestic carriers.

It may be relevant for the IASC to consider any effect of the code share arrangements on the market for Australia domestic air passenger transport services.

Booking and distribution services

In certain circumstances, an airline alliance might impact suppliers of booking services to the public and distribution services to airlines, such as travel agents or online booking agencies. The ACCC understands that under the hard block code share arrangements between Qantas and Air Niugini, the airlines retain their independence in the marketing and sale of their own tickets. The arrangements are therefore unlikely to have an impact on these suppliers.

The counterfactual

The ACCC applies a 'future with-and-without test' to identify and weigh the public benefit and public detriment generated by an arrangement for which authorisation is sought. Under this test, the ACCC compares the public benefit and anti-competitive detriment generated by an arrangement in the future if authorisation is granted, with those generated if authorisation is not granted. This requires the ACCC to predict how the relevant markets will react if authorisation is not granted.

The ACCC notes that the counterfactual in this case appears complex and somewhat uncertain. Possible outcomes without the code share arrangements include one or both of Qantas and Air Niugini operating separately on these routes, possibly with reduced aircraft size and reduced frequency. In considering whether its likely that both airlines may continue operating services on the routes, the IASC will need to take into account available allocated capacity, the growth of the route since the code share arrangements started and the likelihood the airlines will operate services on the same or different routes.

The commercial response of Qantas and Air Niugini if the codeshare arrangement were to cease would also be likely to affect the commercial decisions of Virgin Australia and Airlines PNG, as the other airlines operating in the relevant market(s). It may be relevant for the IASC to consider the views of these airlines as to the likely competitive outcome with and without the codeshare arrangement.

Based upon the information available, the ACCC has not reached a concluded view on the most likely counterfactual in this case, and this will ultimately be a question for the IASC. In this context the ACCC notes that it may be relevant to take into account the circumstances in which the code share arrangement originally arose following financial difficulties faced by Air Niugini and the withdrawal by Qantas of services it previously operated on these routes.

Public benefits

In its assessment of applications for authorisation of arrangements between competing airlines, the ACCC has identified a number of public benefits that are likely to arise from such arrangements, including:

- new and enhanced products and services, such as; new services, increased connection options, reduced travel and connection times, and enhanced frequent flyer programmes and passenger lounge access
- cost savings and efficiencies
- lower fares; by better coordination of available capacity on domestic sectors to realise higher load factors, and the reduction of double marginalisation[4]

[4] A situation that occurs where suppliers of vertically related or complementary products independently charge a price which includes a mark-up over their costs to maximise their individual profits and do not take account of the impact of these prices on demand for the other airline's services. The net result is higher prices on connecting routes than if the two firms were to coordinate their pricing, for example, through a cooperation agreement or alliance.

- increased tourism
- increased competition (that is, the alliance will increase the competitiveness of the airlines)

The ACCC notes that many of these benefits have been identified in arrangements which involve a deeper level of cooperation than code sharing – for example, coordination of schedules and/or revenue sharing. This finding is consistent with that of regulators in other jurisdictions such as the United States Department of Transportation.

The ACCC notes Qantas's submission that the code share arrangements are integral to the continued frequent operations of large B767 aircraft, with significant freight capacity, on these routes. It may be relevant for the IASC to consider the likelihood of such freight services continuing in their present form with and without the codeshare arrangements as part of its assessment.

In considering the public benefits of the code share arrangements between Qantas and Air Niugini, the ACCC has focused on the potential competition benefits, as the ACCC understands the IASC must consider these as part of the benefit criteria set out in the Minister's statement. The assessment of competition benefits will depend on the likely counterfactual.

If the counterfactual involves the eventual withdrawal of one of the airlines from the route such that there is a single direct operator, then continuation of the code share arrangements is unlikely to lessen competition benefits since the hard block element of the code share will at least maintain a degree of rivalry between the airlines. On the other hand, if both airlines could be expected to operate competing services on these routes in the absence of the code share arrangements, then the continuation of the codeshare may not result in a net public benefit compared to the situation without the codeshare arrangements, particularly if the codeshare arrangements were to continue to contain the elements that caused concern for the IASC in its 2009 determination. It may therefore be relevant for the IASC to examine Qantas's and Air Niugini's incentives to operate separately on these routes in the absence of the codeshare arrangements. The ACCC notes in this context that the circumstances of both airlines and of competition on these routes appear to have changed significantly since the arrangements were first authorised.

Public detriments

In assessing applications for authorisation, the ACCC needs to consider the extent to which arrangements between competitors may result in any public detriment, in particular, if the arrangements would result or would be likely to result in a lessening of competition in the relevant market(s).

In previous authorisation matters involving arrangements between competing airlines, the ACCC has identified anti-competitive detriments in situations where there are barriers to entry and/or an absence of competitive constraints, such that the participating airlines would have the ability to raise fares and/or reduce capacity or service quality.[5]

If the counterfactual involves both airlines operating services on the routes, then depending upon the likely frequency and capacity of those operations, the continuation of the code share arrangements may be expected to lessen competition benefits by preventing direct competition between the airlines.

The ACCC has previously found that barriers to entry are relatively high in the aviation sector, including investment in aircraft, plant and technology; and government regulations and licensing. The ACCC recognises that the short-haul nature of the Australia–PNG routes may make it easier for new entrants to commence services or existing players to expand, as they may be able to redeploy aircraft used for existing operations. The ACCC notes the two examples of sustained and apparently successful entry for direct services between Australia and Papua New Guinea in recent years, albeit on a relatively small scale, namely Virgin and Airlines PNG.

In 2009, the ACCC submitted to the IASC that it would have concerns if the codeshare arrangements prevented further expansion of other operators on the route. The careful examination of the effect of the codeshare arrangement on the ability of these new entrants to compete is likely to be relevant to the IASC's assessment as to whether the code share arrangements will continue to result in sufficiently strong public benefits to allow them to continue. The ACCC considers that it may be relevant for the IASC to consider the impact these entrants have had on the route (for example, any effects on pricing, margins, capacity, frequency and choice for consumers) and the degree to which they have been successful in winning and/or increasing market share.

Period of approval

The ACCC notes that in 2009 the IASC approved the arrangement until June 2012 rather than providing approval for 5 years as sought, in part because of concerns about the potential for adverse public benefit effects to arise from them should circumstances change over the approved period. The ACCC has adopted a similar approach in aviation matters where the decision to grant authorisation has been finely balanced.[6]

In this case, Qantas has sought approval to continue the code share arrangements for a further five years, arguing that this will better enable it to plan and invest with certainty.

The ACCC has previously granted longer-term authorisations for arrangements (in other industries) involving factors such as significant investment in infrastructure and long term contracts. In this case, it is not clear to the ACCC what types of investment are likely to be made by Qantas if the code share arrangements are approved for five years as opposed to three, and how these would contribute to the public benefits of the arrangements and/or improve performance on the route.

[5] See, for example, Determination for applications A91227 & A91228 lodged by Virgin Blue & Air New Zealand (2010).
[6] For example, in 2010, the ACCC granted conditional authorisation for an alliance between Virgin Australia and Air New Zealand for three years, in light of the fine balance between public benefits and detriments.

Given the uncertainty around the likely counterfactual (and therefore the extent of public benefits) and the potential competition issues outlined above, the ACCC suggests that if the IASC is minded to approve the code share arrangements, it may be appropriate to consider a further short-term period for any such approval.

Conditions of approval

The ACCC notes that the IASC has also maintained various conditions of approval designed to encourage competition between the code share partners, such as minimum numbers of weekly frequencies which must be operated, and independent pricing. Again, the ACCC has adopted a similar approach in aviation matters where the decision to grant authorisation has been finely balanced.[7]

The ACCC considers that the issues which led to the IASC imposing conditions on past approvals appear to persist in the current environment. In the absence of any information indicating that the conditions have been ineffective or created an unreasonable burden on the airlines, the ACCC suggests that it may be prudent to maintain similar conditions on any approval to ensure the maximum level of competition between the code share partners.

In its 2009 decision, the IASC noted that it had concerns about the flexibility for Qantas to adjust the number of seats it purchases from Air Niugini under the hard block arrangement to suit demand, with the added flexibility to add to this seat capacity under a further soft block arrangement. The IASC was concerned that this arrangement put comparatively little pressure on Qantas relative to Air Niugini's situation, likely resulting in higher margins for Qantas compared with Air Niugini. The IASC indicated that by the time of the 2012 review it wanted to see a better match between the volume of seats purchases by Qantas across the week and in both directions in order to improve the competitive situation.

The ACCC acknowledges the concerns raised in the IASC 2009 decision about about the nature of the hard block element of the code share arrangement, and encourages the IASC to explore this and take into consideration Air Niugini's views.

Role of the ACCC

I note that any decision by the IASC to approve the code sharing arrangements between Qantas and Air Niugini does not provide any protection for the airlines under the *Competition and Consumer Act 2010*, and does not prejudice any possible future consideration of code share operations by the ACCC.

[7] For example, in 2010, the ACCC granted authorisation for an alliance between Virgin Australia and Air New Zealand for three years subject to conditions which, broadly speaking, require the alliance partners to maintain and grow capacity on a number of routes where competition concerns were identified.

I hope that this submission assists you in your consideration of the application from Qantas. If you wish to discuss any aspect of this submission further, please do not hesitate to call David Jones on 02 6243 1393.

Yours sincerely

Dr Richard Chadwick
General Manager
Adjudication