South African Airways
Global Sales Development & Alliances
3rd Floor
Block C
Airways Park

Private Bag X13
OR Tambo International Airport
1627

South Africa

Tel: 27 11 978-2958
Fax: 27 11 978-1725
Email: marccavaliere@flysaa.com

04 July, 2012

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

Dear Ms. McIntosh,

Public Copy

Re: Review of code share arrangements between Qantas and South African Airways

Thank you very much for the productive meeting that took place between yourself, your colleagues from the IASC, and our South African Airways (SAA) delegation on 31 May 2012. SAA is aware of the forth coming resubmission of the application by QF, and SAA will also shortly be submitting an application for the extension of the code share to the South African Competition Commission.

The purpose of this letter is to further support the QF application, and to share with you additional (SAA-proprietary) information, which we hope will further justify your favourable consideration of the proposed code share extension.

The code share arrangement between SAA and QF commenced in January 2001 and has proved to be not only a successful arrangement between the airlines, but more importantly, has provided an increasing number of benefits and choices to the travelling public. This code share is based on a “hard block” arrangement, in which SAA operates the Johannesburg-Perth sector and QF operates Sydney-Johannesburg sector, with each carrier currently purchasing 40% of the capacity of the other airline’s cabin. At the time that the initial agreement was launched, neither of the two airlines were in a position to economically serve the Australian-South African market on their own, nor did the market enjoy the frequency of service that presently exists. At that time the two carriers were each operating only four services per week, Johannesburg (JNB)-Perth (PER)-Sydney (SYD).

As a result of the code share, both SAA and QF respectively have been able to increase their operations to/from Australia to South Africa. This has enhanced the options for customers in terms of both price and frequency of service. Without the introduction of the code share arrangement in 2001, in our opinion, it would only have been a matter of time before either SAA or QF withdrew from operations between Australia and South Africa.

As a further demonstration of what the code share agreement has allowed us to provide for the travelling public, SAA will be introducing a 7th weekly service from Johannesburg to Perth effective 17 August 2012. Again, without the effective code share arrangement in place (with the competitive framework between the two carriers) the public would not be gaining the benefit from an additional service (representing a 17% increase in frequencies.) And, as a further plus, SAA is offering a special introductory fare for this flight. In short, more service and more competitive fares.

Potential effect of non-renewal on the code share

In our submission to the South African Competition Commission, SAA will point out that the code share has been, and continues to be to the benefit of the travelling public by bringing greater competition and service to the market. Should the authorization to continue the code share not be granted, SAA would no longer be present to offer competitive prices on non-stop flights to / from Sydney, which would have an impact on SAA’s bottom line. By virtue of allowing QF to code share on SAA operations between Perth and Johannesburg, this has facilitated a steady growth on the route, which has subsequently enabled SAA to offer a daily service between the two destinations. Likewise, by allowing SAA to code share on QF operations between Sydney and Johannesburg a similar situation pattern has been the case. Should the IASC opt not to approve the arrangement going forward, the daily non-stop services would most probably cease as both SAA and QF would have great difficulty operating the same number of frequencies currently being offered in their respective markets. In this exceptionally high-cost environment, without the traffic support from each other, neither carrier could realistically sustain the current level of flight activity which will result in a reduced choice and increased cost to passengers, due to the lack of direct service competition.

Due to the loss of the QF feed traffic (which significantly mitigates the risk and the cost,) rather than increasing flights to daily as we have just done, it would force us to promptly and significantly reduce our flights. Without the QF-contributed traffic and contribution to the cost of the operation, SAA would be liable for a 100% of the operating costs, and demand would be too lean, taking into consideration that SAA would no longer be able to rely on QF's substantial customer base. We further hypothesise that QF would no doubt, suffer a similar impact.

A key contributing factor which further emphasizes the importance of sustaining the code share agreement is the rapid and dramatic emergence of 3rd Country, 5th & 6th Freedom[1] carriers both in Australia and in Southern Africa. These airlines have recently introduced capacity at such an exponential rate (far exceeding the true demand to/from their own home countries) that the impact has been comparable to a siphoning of the passengers away from the direct services. Since 2007, South Africa has seen a 78% increase in seat capacity from these 3rd Country carriers[2]. Australia itself has experienced a 47% increase from 3rd Country carriers[3]. Subsequently, this makes it even more difficult for the Primary Carriers[4] in the market, to compete effectively with our own non-stop services. Eliminating the code share agreement between our two carriers will only exacerbate the situation and hasten the reduction of non-stop flights between our two countries, as is already happening in other countries.

A highly-probable end result would be only one carrier left selling direct services on the SYD-JNB route, and with reduced frequencies. SAA's reasoning for this is demonstrated below:

<u>Sydney-Johannesburg Operations</u>

a) For the period January-December 2011, in excess of 70 000 passengers travelled on the SA designator code, on the QF operated JNB-SYD vice versa operations. For a very high percentage of these passengers, Sydney was their final destination, with the other bound for other destinations either within or outside Australia.[5]

b) The QF service to Sydney provides the most direct route to Sydney and in terms of elapsed time, it is the most efficient flight that can be taken. It needs to be noted, that many passengers traveling on this flight commence their journeys in other African countries. It would not be viable for SAA to re-route them via Perth, as it then becomes a 2-stop

[1] 5th Freedom – The right to carry revenue traffic between any point of landing on flights between three or more treaty partners. 6th Freedom - Revenue traffic flown between two treaty partners, through carrier's home base
[2] Non Australian or South African carriers (Non Primary Carriers), and Source: PAX IS
[3] Source – IATA PAX IS
[4] Primary Carriers (P-C) – Carrier from either South Africa and/or Australia
[5] Source: IATA PAX IS

connection, making it uncompetitive vis-à-vis Qantas as well as the many 6th freedom carriers operating in the market.

c) The on-going expansion by 3rd Country, 5th & 6th Freedom carriers will make it particularly difficult for the Primary-Carriers to continue operating the non-stop services without the support of the code share agreement. As an example, Singapore Airlines (SQ) and Virgin Australia (VA) have recently signed a code share agreement which aggressively aims to carry South African traffic from Australia through Singapore; with the long-haul international flying being done by SQ. The more the traffic is diverted through other hubs, the more SAA and QF will have to reduce capacity in order to accommodate the lessening demand. The cessation of the code share would make both Australia and South Africa more reliant on indirect services, further strengthening the 3rd country carriers, and weakening the Primary-Carriers.

d) SAA predicts that within the foreseeable future no new carriers will introduce direct services between South Africa and Australia (especially now with the proliferation of 5th & 6th Freedom carriers,) and without the code share, it will significantly reduce the choice of direct services and "force" passengers to have to travel via 3rd country carriers. There is no South African carrier that has applied for any frequencies to commence operation to Australia, nor has been mention in the aviation circles of any new entrant on the South Africa- Australia market.

<u>Johannesburg-Perth Operations</u>

For the same reasons, SAA's operation to Perth would also be severely impacted based on the following economic rational:

a) The removal of the QF designator code on the PER flight, will result in a significant loss of the traffic that is provided through the QF code share. Operating a long-haul International flight at a load factor of less than 60%, at the current fuel prices is prohibitive and would force us to significantly reduce services, possibly below the level of being sustainable.

b) Australia is a large country with traffic originating from many cities such as Melbourne, Brisbane, and Adelaide etc. It is extremely difficult for an airline operating long haul international services to offer a sustainable operation without a feeder partner to collect and distribute passengers to domestic and regional destinations. Even though currently, SAA and QF do not exercise domestic code sharing, because of the code share relationship, SAA promotes it's interline partnership with QF, and uses QF to feed and distribute its passengers to other domestic cities.

c) Already, a substantial percentage (more than 40%) of the Australia to Sub Saharan Africa market is being transported on non-Australian / non-African 6th freedom airlines via 3rd-country connection points[6]. Without the continuation of the QF/SA code share agreement, their market share will continue to rise, jeopardizing the non-stop operations.

Perth and Sydney now both enjoy daily non-stop service to South Africa and beyond Johannesburg to the 52 points that we serve throughout Africa. These services to the Australian market are made available and sustained by the competitive presence of having both SAA and QF on the route.

The absence of the code share would most likely result in only one airline, QF, serving Sydney with non-stop service, and with fewer weekly flights. This would impact on the travelling public being relegated to having to connect more often on flights operated by the non-Australian / non-African 3rd country airlines. Jobs would be lost as the Primary Carriers of the market would be forced to cut their non-stop flights, with the undesirable outcome being that the home-country carriers are further weakened and shrink, as it would be one less direct destination that they are able to serve profitably.

It is therefore likely that a non extension of the current authorisation, would lead to a much less efficient, less convenient and substantially less competitive air service product than what the market currently enjoys.

Pro-competitive structure of the code share

Under the terms of the base agreement, each of the carriers is bound to pay for the "hard block" seats regardless of whether they are able to sell their full compliment. In many instances, the marketing carrier is unable to sell its full allotment. Any of these unsold seats represents a direct loss to the marketing carrier, and as such provides considerable incentive for competitive pricing. Consequently, both SAA and QF have the strongest possible incentive to market and sell their seats on the code share aggressively, fully independent of, and in competition with each other.

Calculation of the Seat Cost & Published Fares

The "seat cost" is the price per seat that each airline charges the other; in other words, the "wholesale" price. For obvious competitive reasons, we cannot discuss between us the composition of our own respective operating costs, nor are we privy to the components or the details of how each of us calculates the cost of the seat price charge that we charge to the other.

[6] Source: IATA PAX IS

The actual process of negotiating a seat price cost is quite basic and straight forward. Carrier "A" advises carrier "B" of the price they want to charge for the seat. Carrier B, entirely on their own, decides whether or not their business model allows them to accept the price. If the "receiving" carrier can live with the price, they accept it and move forward. If the price is unacceptable, the carriers negotiate on the seat price until we reach an acceptable "wholesale" price for the seat.

With respect to SAA establishing our published fares, just as any business has to be mindful of its "cost of goods sold", SAA also has to consider the seat price when determining what fares to publish in the market. However, similar to the pricing practices at most airlines (or for that matter any company with a perishable product) we don't let the operating cost (or in this case, the seat price that we're charged by QF) create an expectation of breaking even or making a profit on every single seat of every flight of every day of the year. Rather, as with other airlines, we take more of a "full operating period" perspective; recognizing the seasonality of the business, most carriers hope to make a profit in some months (high season,) potentially post some loses in other months (low season) and ideally make a modest profit or breakeven over the course of the "full operating period"; generally a full operating year. Therefore on an exact day-to-day, seat-by-seat basis, there is no firm and fixed correlation between what SAA pays to QF for the seat price and what we charge as our published fares. (Consider that if that were the case, to the detriment of the travelling public, airlines would only operate on the peak days of the week during the high season.)

The freehand of competition governs our pricing. On the one hand, we have to pay a fixed amount for all the allocated seats on the aircraft, regardless of whether we use them. Hence, we have an incentive to price competitively to ensure that the perishable product is sold rather than cause a loss. On the other hand, if we cannot make a modest profit or breakeven during the full operating period, we would have to either renegotiate the seat price with QF, accept perpetual losses (unlikely), or leave the market.

Additionally, when evaluating the seat cost vs. published fares, we have to consider other factors such as:

a) the ultra long-haul flying and the current price of fuel make this an exceptionally and disproportionately expensive route to fly,
b) other unique challenges such as the (in) efficiencies of the aircraft available to fly the routes, crew considerations, seasonality of demand, etc.
c) even with the higher operating costs, under the code share, the expenses are still less than if each carrier were to operate on its own (prohibitively expensive.)

The above demonstrates that there are an array of factors which are considered and which influence the pricing methodology applied on the route.

Under the current code share agreement each carrier, entirely independent from the other:

a) Sets its own fares;
b) Determines its own fare classes and rules;
c) Operates its own independent revenue management systems; and
d) Sells its products through its respective independent sales networks including websites.

Fare Information

SAA and QF compete effectively with each other to the benefit of the travelling public. Both carriers offer completely independent fares in the market. SAA and QF, at certain times, will introduce special sale fares into the market.

Market Development and Promotion

Since the inception of the code share arrangement, SAA has been very involved with SA Tourism and a number of the Australian marketing agencies, in promoting Australia, both within Australia and South Africa. SAA and SA Tourism in Australia have jointly in the last four years, spent a substantial amount within Australia, actively promoting both Australia and South Africa. This spend would have been significantly less where it not for the fact that a direct competitive service is in place between the two countries.

In addition, SAA retains a separate public relations function and media website which helps promote SAA within Australia. As well as investing in PR, SAA invests bock locally and in South Africa, in sending a large number of media/trade and tourism organizations on familiarization trips, back and forth between South Africa and Australia.

No Constraining of Capacity

As with many markets, competition in the airline industry is driven substantially by capacity. The higher the level of capacity relative to demand, the higher the pressure on the fares. Competition regulators have therefore raised concerns where code share arrangements have the effect of constraining capacity on the route.

Average over all load factors achieved on the code share routes over the life of the current code share agreement show clearly that the code share arrangements have not had the effect of constraining capacity on the code share routes; as highlighted earlier in the letter, 44% of the market between Australia and Sub Saharan Africa currently travels on services operated by 6th freedom operators.

The market between Australia and South Africa has grown on average by 5% year on year over the last three years[7], this despite the economic downturn which is substantially effecting travel world-wide.

Other Considerations

In addition to the two Primary-Carriers in the market, airlines of third-country origin are now carrying and connecting an increasing amount of 6th freedom traffic over their own home countries. Presently, these airlines are redirecting as much as 30% (Australia to Southern Africa) and 44% (Australia to Sub Saharan Africa) of the traffic away from the Primary Carriers by flooding the market with a tremendous over-capacity of deeply discounted coach seats[8]. This number can be expected to further increase proportionately to the granting of additional frequencies to the 6th Freedom airlines. The net effect is an erosion of service by the Primary-Carriers in the market (the carriers of the respective origin and destination countries.) Emirates now operates 70 frequencies and offers 28,400 seats per week from Australia[9]. Singapore Airlines operates 102 frequencies with 33,315 seats[10]. It has been reported that SQ is aiming to increase its weekly services to Australia to 112, an increase of 9.8%[11].

South Africa itself is already experiencing the negative impact. The rising cost of fuel combined with the increasing capacity from 6th freedom carriers has forced numerous airlines (Malaysia Airlines, TAP Airlines, Iberia and Jet Airways) to cancel their services to South Africa. Other countries such as India, Canada and Austria have also experienced the effects of excess 6th freedom capacity redirecting traffic to a third-party country. Emirates Airlines currently operates 185 flights per week (55,000 seats) out of 10 cities in India[12].

South Africa has recently had its own fatality. The impact of the 6th freedom carriers on the Cape Town – London route has forced SAA to cancel our non-stop CPT-LHR service after 24 years of operation. The end result is a loss of jobs, loss of revenue to the country; and to the travelling public, the loss of convenience, choice and non-stop service. Sadly, without supporting the efforts of the primary market carriers (including competitive code share agreements,) more of the same is likely to occur. For these additional important considerations, we believe that reauthorization of the QF/SAA code share agreement is clearly in the best interest of the travelling public for both countries.

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[8] Source: IATA PAX IS
[9] Source: Sydney morning Herald – 17 June 2012 and IATA PAX IS
[10] Source: IATA PAX IS
[11] Source: Sydney morning Herald – 26 June 2012
[12] Source: IATA PAX IS

Conclusion

For all the reasons outlined here, SAA is of the opinion that its code share arrangement with QF leads to substantial public benefits. Code sharing remains one of the most effective “enabling” arrangements in the global aviation industry, and it has been proven that code-shares in themselves are not anticompetitive, nor diminish the extent of competition in the market. On the contrary they assist airlines to share the financial risk of operating services and afford customers more flexibility and travel options. With the current high price of fuel, it is highly unlikely that a competitor will enter the market, and certainly from the South African side, there isn’t any candidate that would have an appetite for the risk. In addition SAA believes that the non-renewal of the code share will directly impact on staffing and job opportunities in both South Africa and Australia.

South Africa and Australia are both members of the Commonwealth, and South Africa is one of Australia’s largest trading partners within Africa. Competitive and direct air service play an essential role in ensuring that trade between the two countries continues to expand. A priority mandate of the South African government is that we explore all opportunities to further develop the commercial, trade and tourism interests between our nations. Fundamental to that mission is the enabling abilities of the two national airlines.

SAA is seeking the IASC’s support in re-approving the code share agreement to enable both SAA and QF to continue offering non-stop services, offering maximum frequencies and competitive pricing, which links and contributes substantially to the economies of both countries.

As articulated during our meeting in Canberra, we would ask the Commission to favourably review the circumstances and grant authorisation for the Parties to continue with the code share arrangement.

Yours Sincerely,

Marc Cavaliere

Head – Global Sales Development & Alliances