General Counsel
Brett Johnson

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Mr Chris Samuel
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International Air Services Commission
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Dear Mr Samuel

Submission in Response to (Draft) Determination [2012] IASC 106d

Qantas appreciates the opportunity to file this submission in response to the International Air Services Commission's (**Commission**) Draft Determination [2012] IASC 106d regarding Qantas' application for a new determination under section 7 of the *International Air Services Act 1992*.

In its Draft Determination the Commission proposes to allocate Qantas seven services per week on the South Africa route, with the condition, *inter alia*, that South African Airways (**SAA**) is authorised to code share on Qantas' flights operated to and from South Africa until 31 December 2014.

While Qantas accepts the terms of the Draft Determination which authorises the code share to 31 December 2014, we have serious concerns with some of the statements made by the Commission in the Draft Determination and address these concerns below.

The Counterfactual

In paragraphs 7.8 and 7.9 of the Draft Determination, the Commission notes that absent the code share, "*Qantas believes that neither party would be able to maintain the current number of frequencies in the medium to long term…*" and "*[t]he carriers' submissions seem to be based on an assumption that the level of passenger demand will decline (relative to 2012 levels) in the medium and long term without a home carrier at either end to provide traffic support. No evidence has been provided in support of this assumption.*"

On the Australia - South Africa route it is important to have a "home carrier" at each end of the route to stimulate demand within their respective home markets, especially for leisure traffic. In Australia, Qantas stimulates demand to South Africa through its promotions, marketing within Australia, its Frequent Flyer network and the connections it offers within Australia.

However, Qantas has a smaller presence in South Africa. While Qantas conducts promotions and marketing activity in South Africa, it does not have a significant Frequent Flyer base or the sales channels, marketing campaigns and promotional activities that it has in Australia. In addition, it does not have the network within Africa to draw passengers from.

Absent the code share, Qantas would have to fill approximately 40% more seats on the Sydney – Johannesburg route without building a comprehensive marketing, sales or network presence in South Africa to do so, which would not be commercially viable. It would therefore be difficult for Qantas to maintain the current demand on the route under the counterfactual scenario.

Bifurcation of the Counterfactual

In the Draft Determination, the counterfactual (being the likely future absent the code share) is bifurcated into two periods: the period up to the end of 2014 and the period beyond 2014.

The sole basis for the Commission's decision to bifurcate the counterfactual into two periods appears to be the Commission's assumptions about growth trends on the Australia – South Africa route. Specifically, the Commission considers it likely that after 2014 there is a greater prospect of two carriers offering parallel direct services.

Qantas does not believe that growth trends on the route mean that there is a greater prospect of two carriers offering direct parallel services.

The annual growth rates on the route since 2002 have fluctuated greatly – for example, in 2007 the growth in passengers was 12.4%, but in 2010 it was 0.0%. The average annual growth in passengers between 2002 and 2012 has been 3.6%, and between 2005 and 2012 it has been 5.7%. Growth is not guaranteed, particularly in the aviation sector which is particularly exposed to the economic environment and exogenous shocks such as disease, natural disasters (eg. volcanic events and earthquakes) and terrorism.

As Qantas has previously submitted, the great distance of the route means that it can be operated only with specialised large, long haul aircraft. These aircraft hold a large number of passengers (for example, Qantas' Boeing 747-400ER holds approximately 364 passengers). Therefore, capacity can only be adjusted up or down in large increments. Such aircraft are also purchased on long lead times and so any addition of aircraft to a route must be considered within Qantas' wider international and domestic network.

Qantas does not believe that the average annual growth rates on the route will justify another airline offering a direct parallel service at the frequency that would enable it to effectively compete. Even with a schedule of four frequencies a week, using a Boeing 747-400ER would increase the available seats by approximately 151,424 per year. Assuming an annual compounding growth rate of 5.7% in passengers in each of financial years 2012/2013, 2013/2014, and 2014/2015 this would increase the annual number of passengers by only approximately 36,016.

Furthermore, the Draft Determination neglects to address the fact that the code share has contributed to growth on the route by stimulating demand at both ends of the route, and providing passengers with greater competition and options.

Nature of Hard Block Code Share

- In its Draft Determination, the Commission noted that "*the hard block nature of the code share arrangement is generally considered to create stronger incentives for the code share partners to compete than free-sale type arrangements*" (paragraph 7.19).

  This statement materially understates the competitive nature of a hard block code share arrangement. A hard block code share can best be analogized to two airlines operating separate and distinct smaller competing flights within the body of a larger aircraft.

  Under a hard block code share, the marketing carrier pre-purchases a fixed number of seats at a fixed rate. It then "owns" those seats and is responsible for pricing, marketing and selling them independently. It cannot return the seats to the operating carrier and is exposed to losses if those seats are not sold. A hard block code share is two carriers competing absolutely independently on the route. The fact that the seats are on the same aircraft is irrelevant.

  The price charged for a hard block is completely analogous to the cost of operating a separate smaller aircraft – it does not place a "floor" on the sale price.

- The Commission also noted that "*while the hard block code share arrangement can, in theory, promote competition between Qantas and SAA in the marketing and sale of direct services, in practice the intensity of the competition created in this duopoly environment, characterised by* *repeated interaction and little threat of competition from indirect competition or new entrants is likely to be very limited*" (paragraph 7.20).

Qantas rejects any contention that the "*intensity of the competition . . . is likely to be very limited*". Qantas and SAA engage in vigorous competition on this route, which is illustrated in Table 8 (Qantas Sale Activity: Australia to South Africa) of Qantas' Application. This shows repeated instances of price competition between Qantas and SAA.

There is very little interaction between the carriers. Repeat interaction is primarily at the operational level (eg. check-in counters, etc.) and does not have an impact on competition between the parties.

The above paragraph does not acknowledge that without the code share there would be only one (monopoly) carrier operating on the route.

- In paragraph 7.21 of the Draft Determination, the Commission states that "*the terms of the codeshare agreement (and, in particular, how the operating airline charges the marketing airline for its block capacity entitlement appear to substantially limit the intensity of competition between Qantas and SAA. Each airline determines the other's cost base on the route it operates as a pro rata share of total costs attributed to the flight.*"

  This statement is wrong. As we have set out for the Commission in considerable detail in our previous submission and have demonstrated using extracts from Qantas' route profitability system, the operating carrier (Qantas) charges the marketing carrier (SAA) for the block capacity on a straight cost pass through basis. There is no margin charged for the capacity.

  Therefore, the costs that the marketing carrier contributes to are the same costs that it would incur if it operated its own flight on the route. Operating a flight on the route necessarily involves investment in all of the fixed costs that the Commission highlights (such as aircraft insurance, in-flight entertainment, etc.).

  The statement in paragraph 7.21 appears to almost wilfully misunderstand the circumstances of the code share and the commercial realities of managing a committed inventory block.

- In paragraph 7.22, the Commission states that "*[w]hile each carrier makes its final pricing decisions independently of the other, it will do so in anticipation of the likely reaction of the other. The starting point for their price decisions is average total cost of the monopoly service provider (not incremental cost). This means that, while each airline has discretion at the margin to set the price of the seat below average total cost charged by the operating carrier, on average they must achieve fares that allow them to fully recover this cost, plus their own marketing costs, to at least break even. If they anticipate that any fare reductions are likely to be matched, the incentive to offer them will accordingly be reduced.*"

  The situation that the Commission describes in paragraph 7.22 is a characteristic of any duopoly situation, and not unique to a hard block code share.

  Further, paragraph 7.22 appears to be suggesting that the hard block code share sets a "price floor" under the prices at which the marketing carrier can sell its seats. As explained in Qantas' application, the hard block code share agreement does not create a "price floor". The price which SAA purchases seats is the operating cost of the aircraft – the same costs that SAA would incur if it operated its own flight.

  It is not credible to suggest that any operating carrier would sell a block of seats at "incremental costs". This would place the operating carrier at a material competitive disadvantage. Charging the marketing carrier actual cost permits the two carriers to compete as though they both operated smaller aircraft.

<u>The Future Beyond 2014</u>

In paragraph 7.35, the Commission predicts Qantas' likely responses absent the code share post-2014. Qantas refers the Commission to Qantas' Application where it outlined its potential responses absent the code share, specifically on the Perth – Johannesburg route. Qantas invites the

Commission to outline the evidence on which it has arrived at its conclusion regarding Qantas' likely responses on the Perth – Johannesburg route.

<u>Benefits from Approving the Code Share</u>

In paragraph 8.6, the Commission states that "*[w]hile the Commission's finding on competition benefits is finely balanced, the Commission considers that there are likely to be marginal public benefits gained from approving the code share until the end of 2014*".

> Qantas disagrees that there are likely to be only "marginal" public benefits gained from approving the code share until the end of 2014. In Qantas' application, we set out in detail the substantial public benefits arising from the code share, such as:
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> - The facilitation of competition via the code share and that absent the code share there would be only one (monopoly) carrier on the route;
> - The code share enables direct daily services between Sydney and Johannesburg, and (as of 16 August 2012) also direct daily services between Perth and Johannesburg;
> - The code share benefits business and time sensitive travellers who value the flexibility and choice that the code share allows them via direct daily services; and
> - Third country carriers provide a real competitive alternative for passengers.

If you have any questions or would like to discuss the above, please do not hesitate to contact me or Sarah Udy (02 9691 5667).

Yours sincerely

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