QANTAS

23 November 2012

Ms Marlene Tucker
A/g Executive Director
International Air Services Commission
GPO Box 630
Canberra ACT 2601

Dear Ms ~~Tucker~~ Marlene

Review of code share arrangements between Jetstar and Japan Airlines

This letter seeks to vary the current authorisations so as to permit Qantas Airways Limited's (Qantas) wholly-owned subsidiary, Jetstar Airways (Jetstar) to continue code share with Japan Airlines (JAL) between Australia and Japan until 30 June 2017.

Demand weaknesses on the Australia-Japan route have been recognised by the Commission in each decision regarding the authorisation of the code share. Indeed, figures released by the Tourism Forecasting Committee (TFC) show that in the decade to Financial Year 2012, Japanese inbound tourism declined at an average annual rate of 6.3 per cent. Over the next decade, the TFC forecasts weak annual average growth of 1.6 per cent, declining year on year to 2022.

The data does not support the prospect of a strong recovery of the Australia-Japan routes. As traffic levels have been subdued for some time and are forecast to remain so going forward, this would suggest to the Commission that the characteristics of this route are unlikely to change markedly in the foreseeable future.

The Commission previously raised concerns over the impact of the code share arrangements on competition. The Qantas Group disputes the underlying assumption that code share arrangements are intrinsically anti-competitive. Code share arrangements allow competition on routes that may be unserved or are monopoly routes. Furthermore, a code share, such as the Jetstar/JAL arrangement, creates competitive tension as the carriers compete against each other to sell inventory, albeit on the same aircraft. The Jetstar/JAL code share allows JAL to maintain a presence on the critically important Japan-Australia route despite JAL no longer operating direct services to Queensland.

In respect of arrangements involving the Qantas Group, at no point have the terms and conditions of approvals given by the Commission been breached and there has never been a suggestion that we have not met fully the spirit or intent of the conditions.

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In addition to concerns over competitive detriment, the Commission noted that barriers to entry diminished the prospects of new direct competitors. However, with the liberalisation of the Australia-Japan air services arrangements, government initiatives to boost Japan's aviation sector and the return of capacity to the Commission by Qantas, the potential for new carrier entry is at the highest point since the Commission first authorised the code share arrangements.

An open skies agreement between Australia and Japan, signed in September 2011, has seen increased capacity made available, including unlimited capacity for carriers operating to points in Japan other than Tokyo. Furthermore, the treaty provides for designation of multiple carriers. Under these arrangements, there is no practical barrier to competitor entry on the Australia-Japan route.

Encouraging initiatives by the Japanese Government aimed at reinvigorating the country's aviation sector further enhance the prospects of competitor entry. Airfare pricing has been deregulated and the government has worked to increase the availability of landing slots and reduce landing fees.

In authorising the extension of the arrangements in 2010, the Commission noted that with the return of substantial capacity by Qantas due to the weak Japanese economy and its rationalisation of services, the potential for entry by a new carrier was significantly higher than previous determinations. Furthermore, in 2010, as part of a company-wide restructure programme, JAL suspended its direct Brisbane-Tokyo services.

We believe that continued and forecast weak market conditions, liberalisation of traffic rights providing unlimited capacity to points other than Tokyo and the availability of sufficient capacity for a new entrant to operate on the route should allay the Commission's previous concerns regarding competitive detriment of the code share arrangements and belie assertions of any significant recovery on the Australia-Japan route in the foreseeable future.

These conditions support the Commission extending its authorisation to permit JAL to code share on Jetstar operated flights on the Australia-Japan route until 30 June 2017.

Australia-Japan Route

In addition to the long run decline of this route over the last twenty years, there is a range of factors behind the significant decline of inbound Japanese tourism to Australia more recently.

Events such as the Global Financial Crisis and natural disasters in both Japan and Australia have been to the detriment of tourism. However, these exogenous events are short-term in nature and serve only to exacerbate and highlight the changing underlying characteristics of the route. The rise of regional low cost carriers (LCCs), significant lack of investment in critical tourism infrastructure in Australia and changes in Japanese consumer travel trends towards more regional international destinations and high-end international destinations have served to irrevocably change the Australia-Japan route.

Japan is Australia's ninth largest route in terms of overall origin-destination (O/D) traffic, continuing the long-running declining trend observed in Qantas' last application to the Commission having then been ranked fifth.

Japanese inbound traffic is important to both the Qantas Group's operations and Australian tourism. The weakness of this route is of considerable concern. Over the past decade, the number of Japanese visitors travelling to Australia has almost halved (48 per cent). Although the fall in visitor numbers has been partially offset by an increase in Australian resident traffic, which has grown 80 per cent over the decade, this growth is from a low base, with outbound traffic constituting only 15 per cent of total traffic on the route in Financial Year 2012.

Reflecting the global economic environment, business travel on the Australia-Japan route has remained stagnant over the past three years and has declined over the past ten years. Over the past three years, education traffic has grown marginally (7 per cent) while visiting friends and relatives traffic has decreased (2.7 per cent).

Capacity

In March 2011, the Qantas Group responded to high jet fuel prices and natural disasters in both Australia and Japan by suspending direct Perth-Tokyo services (effective May 2011), temporarily down-gauging Qantas' Sydney-Tokyo service from a Boeing 747 to an Airbus 330 and temporarily reducing Jetstar services as part of broader measures to efficiently manage resources within the Group aimed at reducing costs.

In addition to the impacts of high jet fuel prices and natural disasters, the suspension of direct Perth-Tokyo services reflects the intensity of competition from mid-point carriers between Australia and Japan. With the ability to aggregate traffic through their regional hubs, mid-point carriers hold a comparative price advantage to direct carriers in being able to marginally cost extra sectors. Notwithstanding the inconvenience of one-stop travel, passengers are increasingly choosing to fly with these carriers.

JAL emerged from bankruptcy protection in 2011 after filing in early 2010. The airline suffered heavy losses as a result of a global turndown in demand for aviation during the Global Financial Crisis. This saw JAL undertake a process of wide-ranging rationalisation of services, including suspension of its direct Brisbane-Tokyo service and cancellation of 50 unprofitable domestic routes. Following a period of swift and effective government-backed restructuring, the airline relisted on the Tokyo Stock Exchange in September this year. Regional geopolitical tension with China and a weak global economic outlook have impacted the airline's share price and served to highlight the heavy exposure of legacy carriers such as JAL to economic fluctuations with a lessening prospect of growth.

The Australia-Japan route is extensively served by both direct and mid-point carriers including Singapore Airlines (serving five cities in Japan from Sydney), Cathay Pacific (serving six cities), JAL, Qantas and Jetstar. In 2012, 1 in 4 passengers were carried by a third-country carrier, increasing from greater than 1 in 5 the previous year. The next wave of growth in mid-point carriers is expected to come from China. The three Chinese carriers currently operating into Australia have significant networks to/from Japan from their respective hubs. China Southern operates to nine Japanese cities, Air China to seven and China Eastern to 14 destinations. Therefore, one-stop connectivity between Japan and Australia will improve as these carriers continue to add capacity, adding further to the competition already experienced from Singapore Airlines and Cathay Pacific.

Reflecting the difficult operating environment, load factors on the Australia-Japan route have remained stagnant and well within reasonable levels to cater for demand.

According to BITRE figures, load factors for the route were 73 per cent in Financial Year 2012, the same as the previous year (72.9 per cent).

Competitive Landscape

The Japanese aviation industry has been altered irrevocably with the introduction and rise of Low Cost Carriers (LCCs), which has seen the Australia-Japan route compete with a growing number of more accessible destinations in the region.

Growth in the LCC industry has been spurred by Japanese Government initiatives aimed at reinvigorating the country's aviation sector. Airfare pricing has been deregulated and the government has worked to increase the availability of landing slots and reduce landing fees.

Since the Commission last reauthorised the arrangements the Japanese LCC market has grown with three new entrants – Jetstar Japan, Air Asia Japan and Peach. Both Air Asia Japan and Peach offer regional international services while Jetstar Japan has indicated its intention to commence international services. An additional seven LCCs serve Japan with regional international flights and four of the top five outbound Japanese tourist destinations are within 3,000 km of Tokyo (Taiwan, Hong Kong, China and Korea).[1]

Route Performance

The Commission will be aware from the confidential data Jetstar is required to provide as a condition of its code share approvals that its performance has been impacted as a result of natural disasters, regional geopolitical tensions and continuing economic uncertainty.

Variations Sought

Qantas holds the following Determinations under section 8 of the International Air Services Commission Act 1992 (the Act), which allocate capacity on the Australia-Japan route:

- Determination [2007] IASC 108 (valid to 9 August 2013 and request for renewal to 8 August 2018 was submitted to the Commission on 3 September 2012);
- Determination [2011] IASC 128 (valid to 30 June 2017); and
- Determination [2012] IASC 102 (valid to 22 February 2022).

In the event that the Commission renews Determination [2007] IASC 108, we request a variation to the above Determinations to enable Jetstar to use the capacity in code share services with JAL from 1 January 2013 until 30 June 2017.

A signed copy of the latest Annex 1A to the Jetstar/JAL Code Share Agreement is attached as an addendum to this letter. As there are confidentiality restrictions contained within the Agreement, this material is provided to the Commission on a strictly commercial-in-confidence basis. Currently, under the code share agreement, the city pairs covered are Gold Coast to Tokyo (Narita) and Osaka and Cairns to Tokyo (Narita) and Osaka.

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[1] YTD, 2012, http://www.tourism.jp/english/statistics/outbound.php

The code share arrangements will be limited to the carriage of passengers. Jetstar will control and market all cargo capacity on its flights.

Benefits of the Code Share Arrangements

The Qantas Group considers that the code share arrangements meet the requirements of the *International Air Services Commission Act 1992* and the terms of the Minister's Policy Statement for favourable action by the Commission.

The code share arrangements serve to benefit the public and contribute to the development of a competitive environment on the Australia-Japan route. Both airlines sell and price independently of each other. The ability of JAL to display its code on Jetstar services provides a greater incentive for it to promote travel between Australia and Japan than simple interline arrangements. While the cessation of JAL's direct Brisbane-Tokyo route removed its direct presence in Queensland, the code share with Jetstar allows JAL to maintain a significant indirect presence on these critically important routes.

Conclusion

The Australia-Japan route has continued its downward trend since the Commission last reauthorised the code share arrangements. The route has been impacted by continuing weak global economic conditions, a series of natural disasters and regional geopolitical tensions. This difficult operating environment has seen rationalisation of services by all three direct carriers servicing the route.

The structure of the arrangement offers the best prospect of viable operations on the relevant routes and maximisation of the public benefit by maintaining vigorous competition between the two carriers and maximising the degree of choice available to consumers.

The Commission previously limited the duration of the code share arrangements due to "concerns about the potential longer term impact of the arrangements on competition if the market recovers unexpectedly strongly" and the "little foreseeable prospect of new direct competitors" (2007 IASC 204). It is unlikely that the route will significantly rebound in the foreseeable future. Inbound Japanese tourism growth is forecast to remain stagnant at worst, anaemic at best. Furthermore, with the liberalisation of air services arrangements between Australia and Japan, government initiatives to boost Japan's aviation sector and the return of capacity to the Commission by Qantas, the potential for new entry is greater than at any other time the Commission has considered this code share application. Given these conditions, Qantas believes that authorisation of the code share to 30 June 2017 is prudent.

We would be pleased to further discuss this matter should the Commission require.

Yours sincerely,

Tony Wheelens

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