Review of Qantas Letter 2 October 2012:

Comments from Christopher Pleatsikas

6 November 2012

My comments are organized according to the order of the Qantas remarks as presented in the letter of 2 October. The specific paragraph numbers mentioned below refer to paragraph numbers in the Draft Determination.

Comments on "The Counterfactual"

The number of passengers, absent the code sharing agreement, will of course depend, among other things, on the promotional activities of the airlines. If Qantas and SAA were to significantly reduce these activities compared with the current situation, passenger levels could decline, although travel by a significant fraction of passengers, including some leisure passengers (e.g., associated with passengers visiting relatives), may not be highly correlated with promotional spending and some promotional spending may not be dependent on the existence of the code share agreement.

In addition, there are likely to be other means by which Qantas and SAA could encourage passenger traffic in the absence of the code sharing agreement. In Australia, SAA's most obvious strategy would be to pursue some type of arrangement with Virgin Australia for connecting traffic. There are other domestic airlines within South Africa (and other national airlines flying to South Africa) that may assist Qantas in building passenger traffic from Johannesburg.

In the absence of any analysis of the cost and effectiveness (in terms of passenger revenue generation potential) of the options available to Qantas (or SAA), it is certainly not possible to determine whether, as Qantas contends, that "[i]t would therefore be difficult for Qantas to maintain the current demand on the route under the counterfactual scenario."

Comments on "Bifurcation of the Counterfactual"

While I have an insufficient basis at this time to opine as to whether entry after 2014 is likely, it appears that Qantas has framed its response to this issue in terms designed to make entry appear less likely. To be specific, Qantas has implied that an entrant would utilize a very large aircraft (747-400) and the pool from which it would draw passengers would be confined to the anticipated increment in passenger traffic over the 2012-2015 period. Use of a smaller aircraft with an entrant attempting to draw from the entire passenger base would make the financial feasibility of entry seem more reasonable.

Comments on the "Nature of Hard Block Code Share"

It is clear that the author of the letter does not understand the economic meaning of "repeated interaction" and its competitive implications (particularly in a duopoly – see also comments on paragraph 7.22).

In reference to comments in the Qantas letter on paragraph 7.21, it is certainly possible that there has been a misunderstanding on the part of the Commission as to which categories of costs include fixed components, how substantial these fixed costs are and whether, under what circumstances and to what extent costs vary in each cost category included in the calculation of the costs each carrier charges to the other for "hard block" seats. This problem, to the extent there has been any misunderstanding, could be remedied by the provision of much more detailed information on costs by Qantas. While it is possible that there may be some fixed costs that may be appropriate for allocation to the route, allocating other types of fixed costs to the route might unnecessarily reduce price and non-price competition.

As to Qantas' comments on paragraph 7.22, I think the term "price floor" has been misinterpreted, although it is a vague term and so may be prone to be misinterpretation. The average per seat charges by Qantas to SAA (and vice versa) for the "hard block" seats should not be viewed as an absolute price floor in the sense that no seats would ever be sold at less than the implied per seat charge. However, over the long run, any price charged by one airline to the other would be viewed as a "price floor" in the sense that the purchaser of "hard block" seats would attempt to set passenger revenues so as to recover "hard block" costs. In addition, in a duopoly, such a price floor, in conjunction with repeated interaction, could reduce price and non-price competition.

Moreover, once an airline commits to a route, it faces (in the short run) just incremental costs. Since the assets (hardware, software and personnel) can be redeployed while incurring relatively low sunk costs for each specific destination, incremental costs (which could include the rental cost of the aircraft[1]) are an appropriate metric to determine whether the route is profitable (if one uses the perspective of each route as incremental to the organization) and, consequently, an appropriate basis for setting "hard block" charges. It is possible that Qantas is misinterpreting the term "incremental" in this context.

[1] Depreciation and amortization charges may be unduly influenced by tax and accounting considerations and therefore may not reflect the economic life of the assets or be consistent with an efficient rental charge.