DECISION

DECISION:	**IASC/DEC/9903**
VARIATION OF:	**IASC/DET/9402 AND IASC/DET/9616**
THE ROUTE:	**CHINA**
THE APPLICANT:	**QANTAS AIRWAYS LIMITED (ACN 009 661 901)**
PUBLIC REGISTER FILE:	**IASC/APP/99002**

1 The application

1.1 On 2 February 1999 Qantas Airways Limited (Qantas) applied to the Commission seeking a variation of the conditions of Determinations IASC/DET/9402 and IASC/DET/9616 to permit code sharing with China Eastern Airlines (China Eastern) on services on the China route.

1.2 Qantas is proposing to enter into a reciprocal blocked space/code share agreement with China Eastern. Qantas has informed the Commission that it will cease serving Beijing on its own services. It is terminating its three services per week in Shanghai and purchase capacity between Sydney and Beijing as well as Shanghai on China Eastern. China Eastern proposes to purchase an equivalent amount of capacity on Qantas services between Sydney and Shanghai. Each carrier will maintain its current three own aircraft services per week.

1.3 The Commission published a notice inviting submissions from interested parties about the Qantas application. A submission was received from the Australian Competition and Consumer Commission (ACCC) which did not oppose the application.

1.4 All non-confidential material supplied by the applicant and the ACCC is filed on the Register of Public Documents.

2 Provisions of relevant Air Services Agreements

2.1 The Memorandum of Understanding (MOU) between Australia and China of 26 March 1996 and the Air Services Agreement of 7 September 1984 provide for the operation of scheduled air services between the two countries in accordance with agreed capacity entitlements. The MOU allows for and encourages commercial cooperation, including code sharing, between designated airlines of the two countries.

3 Applicant's proposal and claims

3.1 Qantas has supplied the Commission with a copy of the proposed code share agreement with China Eastern, 3 March 1999 draft, (the codeshare agreement) on a commercial-in-confidence basis. A summary of the draft of the agreement was included in Qantas' application and is on the Register of Public Documents.

3.2 The proposed code share involves an exchange of a fixed amount of capacity between Qantas and China Eastern. From 28 March 1999, Qantas proposes to purchase 96 seats each way each week on China Eastern services between Sydney and both Shanghai and Beijing, while China Eastern will purchase 105 seats each way each week on Qantas services between Sydney and Shanghai. Qantas has submitted that as the proposed exchange involves an approximately equal exchange of available seat kilometres, there will be no monetary settlement between the code share partners.

3.3 Qantas is seeking the flexibility to increase the number of seats exchanged to 180 each way each week, and to allow the number of frequencies on which it code shares with China Eastern to be increased beyond three a week, so long as the maximum number of seats per week does not exceed 180.

3.4 Qantas submits that despite steady growth in the origin/destination market between Australia and China, a reduction in its own services from four to three per week and the withdrawal of Ansett International and China Southern Airlines, it has not been able to meet its financial targets. This has been supported by confidential details of Qantas' financial performance on the route which have been supplied to the Commission.

3.5 Qantas has already announced that it is ceasing own operations to Beijing from 28 March 1999. While Qantas submits that this decision will significantly reduce its operating costs, it has not linked this to approval of the code share.

4 Other submissions

ACCC

4.1 In accordance with the Memorandum of Understanding between the Commission and the ACCC, implemented to minimise duplication between the two bodies, the Commission sought the ACCC's view on the code share proposal.

4.2 While the ACCC does not oppose the application, it has made a number of comments:

- based on the figures submitted by Qantas, it is likely that seat factors on direct services would increase to very high levels and that this would lead to a greater number of passengers travelling on indirect services. Alternatively, an increase in seat factors could lead to Qantas and China Eastern increasing the number of direct services. In light of the latter possibility, the

Commission may wish to withhold approval for the flexibility to increase code share seats sought by Qantas;

- the main indirect route to Shanghai is via Hong Kong using Cathay Pacific/Dragonair. As Cathay Pacific is now an alliance partner of Qantas in **one**world, the Commission may wish to take this into consideration when assessing the potential for sixth freedom carriers to provide a strong competitive force. Given the capacity restrictions to Hong Kong, there are few opportunities for Ansett International to increase its interline connections over Hong Kong and this may ultimately impact on Ansett International's ability to re-enter the China market; and

- the six services are spread over five days rather than six and the public benefit might be better served if the proposed code share operated on different days.

4.3 As a general comment on code share operations, the ACCC has raised concerns about the level of consumer awareness. It has suggested the commissioning of an IASC approved survey by the airlines of passengers, or alternatively, that the airlines be asked to demonstrate the effectiveness of their compliance with the IASC's condition that passengers be informed about code share operations at the time of booking.

5 Characteristics of the Australia - China route

5.1 Currently, Qantas is operating three services a week between Sydney and Beijing via Shanghai. China Eastern is operating three services a week on the same routing and Air China is operating four services a week on routes involving Beijing, Shanghai, Guangzhou and Melbourne and Sydney.

5.2 In the year ended 30 November 1998, traffic on the Australia - China route totalled approximately 360,400 passenger movements. Of these passenger movements 55.7% were passengers with a destination of either Australia or China, travelling directly between the two countries (direct traffic). A total of 36.6% of movements involved passengers travelling indirectly between the two countries (indirect traffic). The remaining 7.7% of the movements involved passengers travelling directly between Australia and China to and from countries beyond China or Australia (beyond traffic).

5.3 Overall traffic between Australia and China grew by 22.9% in the year ending November 1998. Direct traffic grew by 61.0%, indirect traffic declined in absolute terms and beyond traffic grew strongly, albeit from a small base.

5.4 Details of the passenger movements on the route between the years ended 30 November 1995 and 30 November 1998 are summarised below.

Table 1: Australia - China Passenger Movements for years ended 30 November 1995 to 30 November 1998

Traffic category	Year ended November 1995	1996	1997	1998		Compound annual growth rate 95-98
Direct traffic	48,100	76,200	139,400	200,600	(55.7%)	61.0%
(Annual % change)		(+58.4%)	(+82.9%)	(+43.9%)		
Indirect traffic	140,700	153,200	134,100	132,000	(36.6%)	-2.1%
(Annual % change)		(+8.9%)	(-12.5%)	(-1.6%)		
Beyond traffic	5,200	7,300	17,500	27,700	(7.7%)	74.6%
(Annual % change)		(+40.4%)	(+139.7%)	(+58.3%)		
Total traffic	194,000	236,700	291,100	360,400	(100.0%)	22.9%
(Annual % change)		(+22.0%)	(+23.0%)	(+23.8%)		

Note: Data in this table have been derived from information supplied by the Australian Bureau of Statistics and include both scheduled and charter traffic. Figures may not add to totals due to rounding.

5.5 In the year ended 30 November 1998, Australian residents comprised 51.1% of the combined direct and indirect passenger traffic. Australians visiting China did so for holiday (35.3%), business (27.0%) or visiting friends and relatives (25.7%). In the same year, Chinese visitors travelled to Australia for business (33.6%), holiday (23.0%) or visiting friends and relatives (17.7%).

5.6 While growth in the China market has been strong in recent years, the latest traffic data from ABS indicate that during 1998 direct and indirect traffic growth slowed to 9.8% in September, 3.5% in October and declined by 6.9% in November. This compares with double digit growth for each of these months during 1997.

5.7 Confidential data available to the Commission indicate that in general fares have declined substantially between 1995 and 1999.

5.8 Qantas has achieved reasonably high average load factors on the route and the withdrawal of Ansett and China Southern is likely to sustain those load factors. Reductions in the growth of the market appear to be matched by reductions in capacity.

6 Legislative framework

6.1 The legislative framework for varying determinations made under the *International Air Services Commission Act 1992* (the Act) provides that carriers to whom a determination allocates capacity may, at any time, apply to the Commission, under section 21 of the Act, for the determination to be varied. Under section 24(1), the Commission must make a decision either confirming the determination or varying the determination as requested in the application.

6.2 Under section 24(2), the Commission must not make a decision varying the determination in a way that varies, or has the effect of varying, an allocation of capacity unless the Commission is satisfied that the allocation, as so varied, would be of benefit to the public.

6.3 In exercising its powers, the Commission must take account of the objects of the Act as set out in section 3 and of the requirement of section 6(3)(b) that the Commission have regard to Australia's international obligations concerning the operation of international air services.

6.4 Section 6(3)(a) also requires the Commission to comply with policy statements made by the Minister under section 11. The current Policy Statement dated 23 April 1997, as amended on 9 March 1999, includes criteria to be applied by the Commission in assessing the benefit to the public of allocations of capacity and of variations to existing determinations.

6.5 A carrier cannot use allocated capacity by providing services jointly with any other carrier without the prior approval of the Commission. The Act, as amended with effect from 25 January 1999, defines “joint international air services” as including, but not limited to, code sharing, blocked space arrangements, joint pricing, revenue and cost sharing, revenue and cost pooling, or the sale of capacity to another airline.

7 Commission's assessment

7.1 The Commission will normally determine whether or not an application to code share should be approved utilising the public benefit criteria contained in paragraph 5 of the Policy Statement. This is consistent with the objects set out in section 3 of the Act.

7.2 The Commission’s task is to determine whether the Determinations, as varied, would be of benefit to the public. This means that the Commission should decide whether, following the proposed variations, there would at least be the same level of public benefits as before the variations. If not then the application should be rejected. The Commission does not see this as requiring a finding that the variations themselves result in increased benefits.

7.3 However, the Commission must make its assessment having regard to the practical realities of the market in which the applicant is operating and the state of the market at the time that it is making its decision.

7.4 This means that in this case the Commission must compare the position as it exists without approval of this application with the position if the application were approved. There are two relevant factors in this regard:

- Qantas has previously announced its decision to discontinue own aircraft services to Beijing from 28 March 1999; and

- Qantas has submitted that it has so far been unable to meet its financial targets on the route.

7.5 The Commission accepts that the previously announced decision to discontinue own aircraft services to Beijing from 28 March 1999 was made on the basis of sound commercial considerations.

7.6 The Commission has considered Qantas' claims concerning its financial performance on the route. Although Table 1 indicates strong traffic growth, as noted in paras 5.6 - 5.8, growth has declined markedly and yields are weak.

7.7 Although the task of the Commission is to determine the overall effect of the proposal in terms of public benefit, it is convenient to set out the Commission's consideration of public benefit using the structure of paragraph 5 of the Policy Statement. In practice, each element of public benefit impacts on the others and cannot be neatly compartmentalised.

Public benefits

Tourism Benefits

> *The extent to which proposals will promote tourism to and within Australia. The Commission should have regard to:*
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> - *the level of promotion, market development and investment proposed by each of the applicants; and*
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> - *route service possibilities to and from points beyond the Australian gateway(s) or beyond the foreign gateway(s).*

7.8 In support of its application Qantas has provided evidence demonstrating that, while Chinese origin traffic continues to grow strongly, yields remain low. Qantas submits that this is due to strong competition from direct and indirect operators and keen pricing available to alternative destinations. Qantas maintains that the code share will enable Qantas and China Eastern to more effectively sell Australia as a tourist destination as each of them will be marketing six services a week.

7.9 The practical effect of the proposal on tourists from Shanghai to Australia is that they will have a wider spread of frequencies at lower excursion fares. This is because the proposal allows those choosing either airline to undertake return travel on a choice of 5 days a week whereas if the proposal were not approved they would be constrained to 3 days a week at the lower fare.

7.10 The practical effect of the proposal on tourists from Beijing to Australia, Qantas having withdrawn its own services from the route, is that they will have the choice of a Qantas ticket at prevailing excursion fares.

7.11 The Commission is aware that the extent to which these benefits will be realised by tourists in the future will be dependent upon the degree to which competitive fares remain at or near current levels.

7.12 The Commission considers that although there will be no increase in actual services operated, there is likely to be a small benefit to tourism through each of Qantas and China Eastern being able to market six services a week instead of three.

Consumer Benefits

> *The extent to which proposals will maximise benefits to Australian consumers. The Commission should have regard to:*
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> - *the degree of choice (including, for example, choice of airport(s), seat availability, range of product);*
> - *efficiencies achieved as reflected in lower tariffs and improved standard of services;*
> - *the stimulation of innovation on the part of incumbent carriers; and*
> - *route service possibilities to and from points beyond the Australian gateway(s) or beyond the foreign gateway(s).*

7.13 Qantas submits that Australian business travellers will have direct access to the primary business destination, Shanghai, on six services per week and code share access on three services per week to Beijing. In addition, Qantas frequent flyers will earn points on the Qantas code share services operated by China Eastern.

7.14 The increased choice available to Australian travellers on lower excursion fares will be of benefit provided each airline continues to price its fares independently and competitively.

7.15 The Commission concludes that, as the proposed code share will result in a wider spread of services being offered by the airlines over the week, there will be a small increase in consumer benefits, provided that code share passengers are aware of the airline/s on which they will be travelling.

Trade Benefits

> *The extent to which proposals will promote international trade. The Commission should have regard to:*
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> - *the availability of frequent, low cost, reliable freight services for Australian exporters and importers.*

7.16 The proposed code share arrangements do not encompass freight capacity.

Competition Benefits

> *The extent to which proposals will contribute to the development of a competitive environment for the provision of international air services. The Commission should have regard to:*

- *the need to develop strong Australian carriers capable of competing effectively with one another and the airlines of foreign countries;*

- *the number of Australian carriers using capacity on a particular route and the existing distribution of capacity.*

- *the extent to which applications are proposing to provide capacity on aircraft they will operate themselves as, in the long term, operation of capacity on own aircraft is likely to result in more competitive outcomes;*

- *the provisions of any commercial agreement between an applicant and another airline affecting services on the route but only to the extent of determining comparative competition benefit between competing proposals;*

- *any determinations made by the Australian Competition and Consumer Commission or the Australian Competition Tribunal in relation to a carrier operating or proposing to operate on all or part of the route; and*

- *any decisions on notifications made by the Australian Competition and Consumer Commission in relation to a carrier operating or proposing to operate on all or part of the route.*

7.17 Qantas states that the code share partners will price and sell capacity, including all code share capacity, independently. It maintains that it will continue to compete with China Eastern, as well as with Air China and sixth freedom operators, such as Cathay Pacific/Dragonair, Thai Airways International and Singapore Airlines.

7.18 The ability to market additional services between Australia and China will enhance Qantas' ability to compete with those sixth freedom carriers offering daily connections from Sydney to both Shanghai and Beijing provided Qantas continues to price competitively.

7.19 The Commission considers that a limited fixed block space arrangement such as that proposed, with no exchange of revenue, is unlikely have a significant negative impact on competition.

Industry Structure

> *The extent to which proposals will impact positively on the Australian aviation industry.*

7.20 Qantas submits that higher passenger loads as a result of the code share will improve the viability of its operations on the route and support its ability to expand services as market conditions improve.

7.21 The Commission is satisfied that the proposal will allow Qantas to concentrate on the higher yielding business market to and from Shanghai and to reduce its operating costs. This should improve the viability of its operations on the route and to this extent the proposal will benefit the Australian aviation industry.

Other matters

7.22 The ACCC has expressed concern about seat factors rising to very high levels on the route. It has suggested that the Commission might withhold the approval sought by Qantas to increase code share seats to 180 each way each week.

7.23 If the flexibility sought by Qantas to increase the number of code share seats were to enable it to extend the code share across more services, then increasing the number of services should serve to lower seat factors on the route.

7.24 If, on the other hand, the code share partners use the flexibility to increase the extent of the seat exchange on existing services, the amount of capacity operated on the route will remain the same. There could be some increase in seat factors as a result of greater marketing opportunities available to the airlines as a result of the code share.

7.25 The ACCC commented on the proposed services being over five days instead of the potential of six days. The Commission agrees that it would be of greater benefit to the public to have the six services spread over six days. However, it is not for the Commission to dictate the schedule by which an airline should operate on a route. The Commission’s role is to assess the airline’s proposal against public interest criteria and approve or reject it.

7.26 Regarding the ACCC’s general comment concerning consumer awareness , this is a matter that is relevant to all airlines involved in code sharing and not just one airline on a particular route. The Commission has a program for monitoring compliance with all conditions it imposes.

7.27 The Commission concludes that it should approve the code share, subject to certain conditions referred to below.

8 Role of the ACCC

8.1 Nothing in the Commission's decision should be taken as indicating either approval or disapproval by the ACCC. The Commission's decision is made without prejudicing, in any way, possible future consideration by the ACCC of the code share agreement or operations under it.

9 Other Issues

9.1 On 22 March 1999, Qantas provided the Commission with a draft copy of the proposed code share agreement. Qantas has undertaken to supply the Commission with a copy of the full finalised code share agreement as soon as possible.

9.2 The Commission would expect to receive a copy of the finalised code share agreement for approval prior to the commencement of code share services and will include a condition in its decision to that effect.

9.3 When approving joint services, the Commission normally includes conditions that the Australian carrier must price and sell its services on the route independently, that it must not share or pool revenues and that it must take all reasonable steps to ensure that passengers are informed, at the time of seat reservation, of the carrier actually operating the flight. The Commission will include such conditions in the determination.

10 Decision (IASC/DEC/9903)

10.1 In accordance with section 24 of the Act, the Commission varies Determinations IASC/DET/9402 and IASC/DET/9616 as requested by Qantas by *permitting* Qantas to operate services jointly with China Eastern from the date of this decision as follows:

- the capacity may be used by Qantas to provide services jointly with China Eastern in accordance with:
  - the draft code share agreement forwarded to the Commission on 22 March 1999, subject to the following conditions:
    - : a copy of the final signed code share agreement must be forwarded to the Commission prior to the commencement of code share services for the Commission's approval and subject to such additional conditions as the Commission may require;
    - : the maximum number of seats exchanged with China Eastern over all Qantas services on the Australia- China route shall not exceed 180 per week each way; and
    - : any other variations to the number of code share seats or services require the prior approval of the Commission;
  - any new joint service agreement between Qantas and China Eastern for operations on the Australia-China route, whether or not it replaces the existing agreement, with the prior approval of the Commission;
- to the extent that the capacity is used to provide services jointly with China Eastern:
  - Qantas must price and sell its services on the route independently;
  - Qantas must not share or pool revenues; and
  - Qantas must take all reasonable steps to ensure that passengers are informed at the time of seat reservation, of the carrier actually operating the flight.

Dated: 22 March 1999

Russell Miller Chairman	Michael Lawriwsky Member	Stephen Lonergan Member