Australian Government

International Air Services Commission

DECISION

Decision:	**[2009] IASC 216**
Variation of:	**[2006] IASC 129**
The route:	**Papua New Guinea (PNG)**
The applicant	**Qantas Airways Limited (ACN 009 661 901) (Qantas)**
Public Register File:	**IASC/APP/200922**

1 The application

1.1 On 16 July 2009, Qantas applied for a variation to Determination [2006] IASC 129 (the Determination), which allocates 1,000 seats of capacity per week on the PNG route, that would enable the airline to continue code sharing arrangements on Air Niugini services from Port Moresby to Sydney, Brisbane and Cairns. Qantas sought authorisation of the code share arrangements until 31 December 2012.

1.2 Under the code share arrangements, Qantas purchases a fixed number of seats (so-called hard block) on all Air Niugini services between Australia and PNG. Qantas also has the option of buying a certain number of additional seats (so-called soft block) of seats on the Air Niugini services. The number of seats in the blocks varies from flight to flight. The code sharing will be conducted pursuant to the existing code share agreement between the airlines and any subsequent agreement which replaces it, subject to Commission approval.

1.3 On 16 July 2009, the Commission published a notice inviting submissions about the application. The Australian Competition and Consumer Commission (ACCC) made a submission on 10 September 2009. All public material supplied by the applicant and submitter is filed on the Register of Public Documents. Confidential material supplied by Qantas is filed on the Commission's confidential register.

1.4 Qantas first entered into code sharing with Air Niugini in 1987 on the Cairns - Port Moresby sector. In 2002, the PNG government invited Qantas to consider options for ensuring the viability of Air Niugini's operations, as a result of the airline's financial difficulties. This led to the cessation of Qantas' own-aircraft operations and the current code share arrangements which commenced in September 2002. The arrangements resulted in a significant improvement in Air Niugini's financial position. Immediately prior to the 2002 code share agreement, there was a risk that the airline would exit the Australia-PNG route leaving Qantas as the sole carrier, along with the adverse consequences for competition. The arrangement has enabled Air Niugini to lease a Boeing 767 aircraft which can provide levels of service higher than that provided by narrow body aircraft.

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1.5 Air Niugini separately sought authorisation of the code share arrangements from the Independent Consumer and Competition Commission (ICCC) of PNG for a five-year period. Both Commissions had access to all material, including confidential data, provided by Qantas and Air Niugini and officials of the two Commissions worked jointly on the analysis. Commissioners from both bodies held a discussion about their positions.

2 Provisions of relevant air services arrangements

2.1 The use of code sharing to utilise capacity allocated by the Commission is consistent with the provisions of the Australia - PNG air services arrangements. Capacity marketed by Qantas under its designator on services operated by Air Niugini counts as the exercise of Australian capacity entitlements under the air service arrangements.

3 Current services

3.1 Air Niugini operates six Boeing 767 services per week between Port Moresby and Brisbane. It also operates two weekly Fokker 100 services and one weekly Boeing 757 service on the Brisbane-Port Moresby sector. The Qantas/ Air Niugini alliance faces competition on this sector from Pacific Blue's four weekly Boeing 737 services, which are operated under a code share agreement with Airlines of PNG. Air Niugini operates two Boeing 757 services per week between Port Moresby and Sydney and is the only operator on this sector. Qantas has a hard block of freight capacity on the Boeing 767 services but its freight sales are made using Air Niugini's designator and not by placing the Qantas code on freight sales.

3.2 Air Niugini operates nine Fokker 100 services and five Bombardier Dash 8 services per week on the Cairns – Port Moresby sector. Airlines of PNG competes on this sector operating seven Bombardier Dash 8 services per week.

3.3 HeavyLift Cargo Airlines operates scheduled all-freight services up to three times per week using Boeing 727 aircraft and plans to operate a fourth service from December 2009. Qantas recently handed back its allocation of freight capacity from the Commission and this capacity has now been allocated to Pacific Air Express. Pacific Air Express will operate one all-freight service per week using a Boeing 737 aircraft and it proposes to commence services by 31 March 2010..

3.3 There are also various charter services operated between points in Australia and mining operations in PNG.

4 Characteristics of the Australia – PNG route

Australia – Papua New Guinea Traffic Growth

Traffic Category	YE July 2006	YE July 2007	YE July 2008	YE July 2009
Direct Traffic	132,766	150,822	176,282	202,711
Beyond Traffic	22,398	25,428	26,218	30,470
Total	155,164	176,250	202,500	233,181

4.1 The Australia – PNG route has shown solid growth over the past few years and the past two years in particular. The average annual growth rate in total traffic for the two years ending July 2009 was approximately 15%. The growth in recent years represents a recovery in traffic levels, which declined significantly in the four years after 1999. Traffic on the route now exceeds the previous peak attained in 1999.

4.2 In the year ending July 2009, around 233,181 passengers were carried in total on the route. Most of this traffic (87%) was between the two countries. Around 13% of passengers on the route flew from or on to destinations beyond Australia or PNG.

4.3 Focusing on the traffic between the two countries there were about 202,711 passengers on the route in the year ending July 2009. In other words, an average of about 1,950 passengers travelled each way each week between the two countries. Of this traffic, about 59% is made up of Australian residents, with PNG residents accounting for 41% of the end-to-end market.

5 Applicant's supporting arguments

5.1 Qantas's application contained arguments to support its case for an extension of the authorisation of the code share arrangements until 31 December 2012. Qantas also provided confidential data to the Commission.

Introductory remarks

5.2 Qantas stated that the code share arrangements offered the best prospects for maintaining the presence of two (sic) competing operating carriers and maximising public benefit on the route. It said the code share has kept the route profitable for Qantas while producing substantial consumer benefits. These have been achieved at the same time as additional competition was introduced by new and existing carriers and in the face of a decline in the market share of both Qantas and Air Niugini.

Nature of passenger demand on the route

5.3 Qantas advised that the PNG route is unique in many ways. The airline advised that around 58 % of the market was made up of travellers from Australia and that around 57 % of the Australian traffic was for business purposes. The vast majority of the passengers carried on the route have origins or destinations in one of the two countries, with relatively low passenger numbers travelling beyond Australia or PNG to third countries.

5.4 Qantas advised that the sector lengths on the PNG route were comparable to some Australian domestic sectors and thereby meant that the possibility of entry by competitors was relatively higher than on other international routes.

Yields

5.5 The high percentage of business passengers has continued to result in the attainment of relatively strong revenue yields on the route. A high proportion of business passengers require flexible fare conditions, which produce higher yields than fares sold with less flexible conditions.

5.6 Qantas advised that the increased capacity available on Air Niugini, Airlines of PNG and Pacific Blue had led to a greater proportion of low fare passengers on its services.

Competition

5.7 Qantas' performance on the route had been affected by the entry of Airlines of PNG in November 2005 and its expansion of services since that time. This airline now operates daily Dash 8 services between Cairns and Port Moresby, and code shares on four weekly Boeing 737 services between Brisbane and Port Moresby operated by Pacific Blue Australia.

5.8 The participation of Airlines of PNG and Pacific Blue Australia has produced a decline in the market share of Qantas and Air Niugini from their peak levels. Between 2006 and 2008, Qantas advised that its market share decreased almost eight percent while the alliance's combined passenger share fell between 2006 and 2008. Similarly, the increasing amount of extra capacity by the three competing operators had produced a drop in Qantas' seat factors, despite growth in the overall market. Between 2007 and 2008, Qantas said its average seat factor on the Australia – PNG route fell by four percentage points to 64%.

Pricing

5.9 Qantas and Air Niugini act independently of each other. They separately set prices, fares and associated rules, operate their own yield management systems and sell through their respective sales networks.

5.10 Qantas stated that the hard block element of the code share provides a significant incentive to compete with Air Niugini. The PNG carrier's fares are sometimes below the hard block seat price that Qantas pays Air Niugini for its code share seats.

Qantas has offered a number of special fare initiatives since February 2005, from both Australia and PNG. Qantas also introduced a simplified economy class fare structure in December 2006. Qantas said these special fares boost sales and/ or match competing fares.

Freight market

5.11 A hard block arrangement applies in relation to freight carried on six Boeing 767 services per week between Brisbane and Port Moresby. All space is sold under an Air Niugini flight designator, but Qantas actively sells freight space on these services. Although Qantas freight revenues had fallen for some time, there was a significant increase in 2006 as higher volumes were carried. Freight revenues and volumes have fallen again since then. Cargo rates have remained relatively stable since 2002, with a slight increase since 2007, although fuel surcharges had been imposed consistent with passenger surcharges.

5.12 Qantas stressed the importance of the wide-bodied aircraft for carrying palletised and containerised freight. The Boeing 767 aircraft carries up to seven tonnes of freight per flight. By contrast, narrow body aircraft such as the Boeing 737 and Boeing 757 aircraft have no container or pallet capability, so can carry only loose cargo. Specialised and higher value freight, such as seafood, could not be carried on a B737.

Situation without the code share arrangements

5.13 Qantas stated that ending the code share arrangements would increase average costs significantly for Qantas and Air Niugini and erode public benefits. Qantas indicated that it could re-enter the market if the code share arrangements were not authorised. It has a range of suitable aircraft types which would enable introduction of a high frequency service.

5.14 Qantas considered that its own-operated services would be profitable, but said this would affect the viability of both Air Niugini and Airlines of PNG. It is likely that Air Niugini would have to reduce its schedules if Qantas resumed services, with a consequent erosion in the viability of the Boeing 767 operations. The withdrawal of Qantas' brand would remove marketing and promotional support for Air Niugini's services.

5.15 Qantas suggested that without a code share agreement, it is likely that Air Niugini would have to move to narrow-body operations. Qantas said that the absence of a wide body operation would reduce belly hold freight capacity by up to 95 %, and it was unlikely that this capacity would be replaced by any other operator. This would have significant negative implications for the carriage of cargo.

Summary of claims against the paragraph 5 criteria

5.16 Qantas claims against the paragraph 5 criteria in the Minister's policy statement are as follows:

Competition benefits

5.17 Qantas advised that the hard block nature of the code share arrangements resulted in price competition with Air Niugini as it has to obtain a return on its pre-purchased seats. Qantas has an incentive to discount its prices as it would run the risk of losing money.

5.18 Qantas advised that it manages its block of seats by including them in its reservations system as if it operated virtual aircraft on the PNG route. The maintenance of separate seat inventories by Qantas and Air Niugini produces the effect of two smaller aircraft operating instead of one large aircraft. The two carriers set fares and fare rules independently, operate separate yield management systems and sell their products through their respective sales networks.

5.19 Qantas submitted that pricing was so competitive that Air Niugini sometimes sold seats below the hard block seat price payable by Qantas. At times, Qantas responded by selling fares at levels low enough to clear its seat inventory, while at other times the airline accepted this competitive disadvantage.

Tourism benefits

5.20 Qantas advised there is little scope to promote tourism to Australia by PNG nationals because of the characteristics of the PNG economy and the relatively small PNG population. Qantas suggested that Australian Bureau of Statistics data on the number of holidaymakers from PNG included a high proportion of Australian nationals resident in PNG. It also included holiday visits by Australian nationals and their children studying in Australia. Qantas said that the number of services on the route and the availability of competitive fares had enabled more PNG nationals to travel to Australia.

Consumer benefits

5.21 Qantas stated that the efficiencies obtained because of the code share arrangements have produced considerable consumer benefits. There is now a greater frequency of services and more capacity with a 46 % increase in the number of seats operated each week on the route by Air Niugini. This included the introduction of a twice-weekly Boeing 757 direct service on the Port Moresby-Sydney sector which replaced the previous service that involved a stop in Brisbane.

5.22 Qantas stated that convenient connections are offered for passengers transferring to and from domestic services as well as for passengers travelling to and from New Zealand and the United States.

5.23 Qantas stated that it regularly offered special fares to boost sales and/or match its competitors. Holiday traffic on the route originating in Australia rose by 50 % between 2006 and 2008.

Trade benefits

5.24 Qantas purchases approximately half of the Boeing 767 belly hold cargo space on a hard block basis, but does not code share. Instead, it sells cargo space under the Air

Niugini flight designator. As in its 2007 application, Qantas stressed the importance of the Boeing 767 aircraft in providing certainty for the carriage of freight in unit load devices (ULDs) such as pallets and containers. The belly hold of this aircraft can carry up to seven tonnes of freight in ULDs on the Port Moresby-Brisbane sector. Narrow bodied aircraft such as the Boeing 737 and Boeing 757 cannot carry ULDs and are restricted to the carriage of loose cargo.

5.25 Qantas advised that higher value freight, such as fresh seafood could not be carried on Boeing 737 aircraft. Qantas added that tuna exporters preferred the regularity of the Boeing 767 schedule and the ability of Qantas to tranship the freight to destinations in Asia such as Japan. Qantas added that exporters in Brisbane and Port Moresby have a choice of day of week for shipping freight and access to the regularity of the six weekly services, in contrast to all-cargo carriers.

5.26 Qantas stated that the code share reduced the risk and cost to airlines and therefore provided a greater opportunity to maintain stable cargo rates and stated that its base freight rates had risen only slightly since the code share was re-authorised in 2007.

6 Summary of submissions

6.1 The Australian Competition and Consumer Commission (ACCC) made a submission on 10 September 2009. The ACCC noted the entry of Pacific Blue Australia was a key development after the 2007 authorisation and said the airline had introduced price competition by offering fares considerably lower than those of the Qantas and Air Niugini. The ACCC acknowledged the increase in direct competition on the route, but said it would have concerns if the code share prevented or constrained the ‘further expansion or consolidation of other operators on the route’.

6.2 In response to this concern, the Commission notes that the code share itself does not act to prevent other carriers from taking commercial decisions such as expanding services.

7 Commission’s assessment

Assessment framework

7.1 Under section 15(2)(e) of the *International Air Services Commission Act (1992)* (the Act), a carrier cannot use allocated capacity to provide joint services with any other carrier without the prior approval of the Commission. Qantas therefore requires the Commission’s authorisation to enable it to code share on Air Niugini’s services.

7.2 Under the Minister’s policy statement, the Commission is normally expected to authorise applications for use of capacity to code share where this is provided for under the relevant air services arrangements. However, where the Commission is concerned that a code share application may not be of benefit to the public, it may subject the application to detailed assessment against the paragraph 5 public benefit criteria in the policy statement. The Commission must consult with the ACCC before doing so and has done so in this case.

7.3 As happened in the previous re-authorisation exercise, the Commission's review was conducted in parallel to a review by PNG's Independent Consumer and Competition Commission (ICCC) of an Air Niugini application to that body for authorisation of the conduct under the code share arrangements between the two airlines. The two authorities co-ordinated their respective review processes as was done in 2007. The two Commissions have exchanged data relating to the operation of air services on the route, including confidential information provided by Qantas and Air Niugini, with the prior agreement of the airlines. The Commissions discussed their analysis of the data in relation to the public benefit frameworks under their respective legislative frameworks. While there are differences between these frameworks, there are broad similarities in terms of assessing competition impacts and public benefits associated with the code share arrangements. However, each Commission has reached its own conclusions, consistent with its particular legislative requirements.

Detailed assessment

7.4 The Commission's assessment of the Qantas code share proposal against the paragraph 5 criteria in the Minister's policy statement is as follows:

7.5 Competition Benefits

(a) In assessing the extent to which applications will contribute to the development of a competitive environment for the provision of international air services, the Commission should have regard to:

- the need for Australian carriers to be able to compete effectively with one another and the carriers of foreign countries;
- the number of carriers on a particular route and the existing distribution of capacity between Australian carriers;
- prospects for lower tariffs, increased choice and frequency of service and innovative product differentiation;
- the extent to which applicants are proposing to provide capacity on aircraft they will operate themselves;
- the provisions of any commercial agreements between an applicant and another carrier affecting services on the route but only to the extent of determining comparative benefits between competing applications;
- any determinations made by the Australian Competition and Consumer Commission or the Australian Competition Tribunal in relation to a carrier using Australian entitlements under a bilateral arrangement on all or part of the route; and
- any decisions or notifications made by the Australian Competition and Consumer Commission in relation to a carrier using Australian entitlements under a bilateral arrangement on all or part of the route.

7.6 In 1992, the Commission authorised the code share arrangements between Qantas and Air Niugini on the Cairns – Port Moresby sector, which had been in place since 1987.

7.7 In 2002, the code share was extended to cover the Sydney and Brisbane sectors. The Commission has been concerned about the competitive impacts of the code share arrangements following the 2002 extension. In August 2002, in authorising the expanded code share arrangements, the Commission expressed concern about the possible implications for competition on the route. There have never been any third-country carriers operating on the route which could provide competition for Qantas and Air Niugini. Given its geographical position in relation to Australia, it is unlikely that any third-country carriers will enter the market in the near to medium term.

7.8 When the code share arrangements were implemented, Qantas ceased operating aircraft on the PNG route. Although the hard block nature of the code share arrangement creates some incentives for price competition between Qantas and Air Niugini, the degree of price competition is likely to be lower than when the two carriers were direct competitors. In 2002, there were some offsetting benefits through additional weekly services to Brisbane and Cairns and the introduction of the wide-body Boeing 767 aircraft, which provided improved service levels compared with the aircraft it replaced.

7.9 The overriding consideration in the Commission's August 2002 decision was concern about Air Niugini's poor financial circumstances. The Commission considered that there would be sharply reduced public benefits if Air Niugini was to cease operations on the Australia – PNG route. Competition would be greatly reduced, with only Qantas operating on the route, and there would be a risk of monopoly pricing as a result. There was likely to be a greater public benefit detriment from such an outcome than might be associated with the situation under the expanded code share.

7.10 Confidential data provided by Qantas and Air Niugini demonstrated that the carriers obtain relatively high passenger revenue yields on the PNG route. As discussed previously, this is driven by the unusually high proportion of business traffic on the route. Qantas has stated that its services on the PNG route attract a greater percentage of business travellers than on any of its other routes, both domestic and international.

7.11 The Commission considers that it is this large proportion of business travellers that enables the carriers to obtain such high revenue yields on the route. Business travel demand is far less sensitive to fare levels than the leisure market. The Commission considers that, as it anticipated, the expansion of the code share arrangements did little to facilitate competition between Qantas and Air Niugini. For some time after the new arrangements were implemented, revenue yields obtained were higher than might have prevailed in a more competitive market. However, the competitive situation improved noticeably with the entry of Airlines of PNG onto the route. This airline, while small, has offered important competition on both the Cairns (since late 2005) and Brisbane (since late 2006) to Port Moresby sectors.

7.12 At the time of the 2007 review, confidential data available to the Commission indicated that revenue yields fell significantly for passengers travelling on economy fares since Airlines of PNG entered the Cairns and Brisbane sectors. The Commission considered that this showed an improved level of competition in the market in the limited period following the entry following the entry of Airlines of PNG.

7.13 In 2007, there was also some evidence that Air Niugini business class travellers had benefited from slightly lower fares. However, the data showed that Qantas business class passengers had not benefitted from similar improvements. In 2007, the Commission anticipated that revenue yields obtained by Qantas and Air Niugini would continue to show a declining trend over time given the potential for new entrants. The Commission was surprised to see confidential data indicating that Qantas' revenue yields have actually risen over the last 12 months in spite of the global financial crisis, the reduction in fuel prices, the strong growth in passenger demand on the route and the addition of substantial new capacity by its code share partner and other competitors.

7.14 The Commission recognises that consumers have a choice regarding the airline from which to purchase a fare. Many passengers are prepared buy a Qantas ticket, despite Qantas' fares being generally higher than the Air Niugini for travel on the same product on the same aircraft. There are clearly other factors which influence some travellers to buy Qantas fares despite a sometimes substantial price premium over Air Niugini fares.

7.15 An important reason may be the manner in which Qantas tailors its supply to underlying demand which varies by day of week and direction of travel. This means that the arrangements work to Qantas' advantage in matching its supply of seats to the considerable demand variations on the route on different days in the week.

7.16 In 2007, the Commission made clear its view that the daily variation in block arrangements inherently favour Qantas relative to Air Niugini. Of the two partners, Air Niugini is likely to be placed under more pressure to price competitively to sell its seats than Qantas, particularly on days of low demand when Qantas buys a smaller proportion of the seats on the aircraft.

7.17 Another feature of the code share agreement in favour of Qantas is its option to purchase further seats up to an agreed limit on each Air Niugini flight within a soft block of seats. Qantas has more flexibility in managing the supply of seats it has available for sale. It can purchase more seats if its hard block is likely to be fully sold, or not do so if the hard block is only partially sold. Given this flexibility in supply, and the overall matching of hard seat block sizes to day to day demand, the Commission considers that Qantas can generate strong returns without the need to discount fares significantly.

7.18 In granting the 2007 authorisation, the Commission said that the arrangements would be more competitive if the Qantas hard block seat numbers were larger and more uniform across flights on different days, with smaller or no soft block components.

7.19 The Commission re-affirms its 2007 view that the imbalances in the seat hard block sizes, and the flexibility afforded to Qantas by the soft block arrangements, work to the advantage of Qantas relative to Air Niugini and reduces the level of competitiveness between the code share carriers.

7.20 In 2007, Qantas advised that it would take the Commission's views on this issue into account when the code share arrangements were renegotiated with Air Niugini, while aiming to achieve an outcome which was in Qantas' commercial interests.

7.21 The Commission is disappointed that there is little evidence of any action by Qantas that addressed these concerns. Qantas' hard block allocations are a relatively small (much less than half) proportion of the Air Niugini aircraft capacity. The Commission's position remains that superior competition outcomes would be achieved if Qantas has a substantially higher (even if not equal) proportion of the aircraft capacity allocated as a hard block. The Commission notes Qantas' advice that it has the ability to enter the market with regular services operated by its own-aircraft. This advice supports the view that Qantas has the commercial ability to successfully market much higher levels of capacity on its code share operations on the PNG route.

7.22 An issue which can potentially influence fare levels is the level of aircraft load factors. Where load factors are high, airlines are under little pressure to compete with each other by discounting to fill seats which might otherwise be left empty.

7.23 The Commission notes that overall load factors are not very high on the Australia – PNG sectors. However, the broad picture disguises some differences between Qantas and Air Niugini. Qantas reports higher load factors than Air Niugini. This is related to the fact that Qantas purchases a relatively small fraction (much less than half) of the seats available on Air Niugini's services.

7.24 Qantas is therefore able to achieve a higher load factor for the same number of seats sold as Air Niugini and so is often under less pressure than Air Niugini to sell seats on any particular flight. On the other hand, Air Niugini has the majority of aircraft seats on its inventory and is likely attain a lower seat load factor. This is likely to be a further factor in the price differential between Qantas and its competitors.

7.25 The Sydney and Brisbane sectors therefore continue to raise competition concerns for the Commission. The Commission notes the positive effect from the entry of Pacific Blue Australia because of the additional services and frequencies delivered as well as the increased range of fares and product choice.

7.26 Although Pacific Blue Australia's Boeing 737 aircraft operate four weekly services, the Commission would need to see ongoing evidence of improved fare levels on the dominant Qantas/Air Niugini alliance before it is satisfied that there are no longer significant competition concerns associated with the code share arrangements. The confidential data provided in relation to the most recent 12 months indicates that Qantas has significant pricing power.

7.27 An issue the Commission has considered is the likely competitive situation in the absence of code share approval. The Commission would authorise continuation of the code share if it assesses that there could be the same or fewer public benefits in the absence of the code share. The Commission had serious concerns in 2002 and 2007 that Air Niugini could exit the Australian market if the code share arrangements were not authorised. This raised the possibility that Qantas would be left as a monopoly provider on the route and public benefits could be lessened as a result. An important objective in approving the expanded code share was to avoid this outcome.

7.28 Air Niugini's published financial statements indicate that the carrier has recovered from its poor financial state since 2002. The airline is now in a better financial position than it was in 2002, despite making a loss in 2008.

7.29 The introduction of competition from Airlines of PNG, and subsequently of Pacific Blue Australia, has led to a reduction in Air Niugini's revenue yields, as Air Niugini has responded with reduced fare levels. Along with lower fares, mainly for economy passengers, there is increased choice of carrier, higher frequency of services and choice of time of travel.

7.30 The Commission considers that, if code share approval is not granted, Qantas is likely to re-enter the Sydney and Brisbane sectors, but is unlikely to operate to and from Cairns. The larger city pairs generate more traffic and are attractive because of the high business component and the attractive revenue yields which accompany it. Qantas' application states that it has suitable aircraft to commence a high frequency service on the route. To achieve the frequency needed to serve the business market, Qantas would probably offer daily or near daily services to and from Brisbane and Sydney. It would be likely to use a narrow-body Boeing 737 aircraft, because a wide-body aircraft would add excessive amounts of capacity to the route. However, even the introduction of the Boeing 737 could see a substantial increase in capacity.

7.31 It is likely there would be changes on the route by PNG carriers if Qantas were to enter the market. This could mean Airlines of PNG withdrawing and Air Niugini reducing frequencies. Even with less flying, Air Niugini's operations on the Sydney and Brisbane sectors would be unlikely to be profitable. Eventually, Air Niugini may have to withdraw from the Sydney and Brisbane sectors, with the prospect that Qantas may have a monopoly position on the route. Essentially this is the scenario which the Commission was concerned could develop in the absence of code share approval when considering the situation in 2002.

7.32 As noted above, there could be a period of improved public benefits in the short term, but the loss of PNG carriers or reduced services would erode public benefits as choice of carrier and frequency diminished. The longer term public benefit outcome is likely to be worse than under the code share.

7.33 The broader financial impact on Air Niugini could be serious, as there is limited scope to deploy its large Boeing 767 aircraft into its other international routes, which are all fairly small. The Commission again observes that the Boeing 767 may not be an ideal size for the small Australia – PNG passenger market, although it plays an important role in the freight market, as discussed below. The aircraft is large for what is a comparatively thin passenger route and provides little flexibility to match frequency to changing demand. The Commission understands that Air Niugini has a proposal to replace its existing B767 with a newer Boeing 767 aircraft.

<u>Other Benefits</u>

7.34 *Tourism Benefits*

(b) In assessing the extent to which applications will promote tourism to and within Australia, the Commission should have regard to:

- the level of promotion, market development and investment proposed by each of the applicants; and
- route service possibilities to and from points beyond the Australian gateway(s) or beyond the foreign gateway(s).

7.35 Total traffic levels on the Australia – PNG market grew by approximately 32% since the last review. Tourist traffic to Australia makes up only a small proportion of the market. PNG visitor traffic accounts for just over 40% of the total market and a large proportion of this is for non-tourism purposes including business, visiting friends and relatives, attending conventions and educational institutions. In the Year Ending July 2009, less than seven percent of total traffic was from PNG origin passengers arriving for holiday purposes and much of this may have been by expatriate Australian citizens living in PNG. The small tourism element in the total market means that this criterion is of relatively minor significance in the assessment of public benefits derived from the code share arrangements.

7.36 The relatively low average income levels of PNG residents means that only a small proportion of the population is a realistic target market for tourism to Australia and for the foreseeable future. However, the presence of both code share partners in promoting travel to Australia is likely to have been a positive factor in the development of the small market that does exist. The presence of Airlines of PNG and Pacific Blue Australia in the market would have increased the tourism marketing effort.

7.37 Withdrawal of code sharing approval may not improve the situation, particularly if there are reduced services to Australia, Brisbane in particular, in the wake of Qantas' re-entry to the market as there may be lower promotional support for tourism from Air Niugini and Airlines of PNG as a consequence.

7.38 The code share arrangement facilitates some travel to and from points beyond gateways. For example, Qantas draws some tourist traffic via Brisbane and Sydney to and from other Australian cities, and some traffic flows behind Australia to and from third countries such as New Zealand and beyond PNG to other countries. However, these are small segments of the total market.

7.39 *Consumer Benefits*

(c) In assessing the extent to which the applications will maximise benefits to Australian consumers, the Commission should have regard to:

- 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 standards of service;
- 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).

7.40 There was a reduction in the degree of choice when the expanded code share arrangements were introduced in September 2002. Qantas withdrew from the route, leaving consumers with no choice of carrier. Service frequencies to Sydney also fell from six to two per week. There were some offsetting benefits. There was a small increase in frequencies to Brisbane and Sydney and Air Niugini introduced a Boeing 767 aircraft which had improved onboard service levels compared with the Airbus aircraft which it replaced.

7.41 Until mid-2005, there was little evidence that efficiencies generated by the code share arrangements were passed on to consumers in the form of lower fares. Instead, the efficiency gains were accompanied by higher revenue yields.

7.42 The most significant development for Australian consumers of Qantas has been the introduction by the code share partners of improved tariff structures, with more flexible fare types and lower fare levels mainly for economy class travellers following the entry of Airlines of PNG. Consumers now have a choice of direct carrier with alternative service arrangements, and increased options of days and times of travel particularly to/from Cairns but also to and from Brisbane.

7.43 As noted above under the competition benefits criterion, there was a declining trend in the revenue yields obtained by Qantas at the time of the last review. It could have been expected that revenue yields would have declined further with the continued addition of capacity marketed by Airlines of PNG and Pacific Blue. This expectation was supported by the fact that revenue yields were relatively high, despite having fallen from its peaks. However, Qantas' revenue yields have actually gone up since the last review.

7.44 The Commission notes that yields have gone up at a time when Qantas' yields on other international routes have fallen and at a time when its fuel costs have dropped. The Commission is unable to conclude that Qantas has passed on any efficiencies from the code share arrangements to its consumers.

7.44 As noted above under the Tourism criterion, there are possibilities for travel to and from points beyond gateways within Australia and PNG, as well as to countries beyond. However, only a small component of the market takes advantage of these options. These possibilities would be broadly the same in the absence of code sharing provided frequency levels were maintained.

7.45 *Trade Benefits*

> (d) In assessing the extent to which applications will promote international trade, the Commission should have regard to:
>
> - the availability of frequent, low cost, reliable freight movement for Australian exporters and importers.

7.46 Qantas sells about half the freight space available on Air Niugini's Boeing 767 aircraft, but uses the Air Niugini flight designator. Qantas and Air Niugini stressed the importance of the Boeing 767 aircraft for the movement of PNG international freight. Qantas said much of the freight on the aircraft is carried on unit load devices which cannot be carried on narrow-bodied aircraft such as the B737. The airlines' position is essentially that the Boeing 767 operations are underpinned by the code share agreement, and that without the code share agreement, Air Niugini 'would substantially lose the capacity to offer air freight services'.

7.47 The Commission agrees with the airlines' position that passenger carriers have the ability to offer lower cargo rates than dedicated freighter service providers. The Commission also accepts the advantages of being able to offer containerised and palletised air freight services. In general, passenger air carriers have the ability to offer air freight services at lower cost than dedicated air freight carriers because belly hold cargo capacity is a ‘by-product’ rather than the core product, which is passenger capacity.

7.48 However, the Commission does not accept Air Niugini’s position that Qantas would stop serving the freight market if the application is rejected. This is because Qantas should be free to sell freight space using the Air Niugini designator in the same manner it does at present, with the only difference being that Qantas would not be selling space under the auspices of a code share agreement.

7.49 The Commission also notes advice from Air Niugini that the freight it carries is primarily inbound to PNG with ‘only a small amount of freight outbound’. This indicates that the impact on PNG export industries of the cessation of Boeing 767 services to Australia would be relatively small. The Commission also notes that the volumes and revenues obtained from air freight have been in decline since 2006. Advice from Air Niugini indicated that total tonnage uplifted on the route fell by nearly 50% between 2006 and 2008. This further weakens the case for linking the code share approval decision to the carriage of air freight in Boeing 767 aircraft.

7.50 The Commission notes that dedicated freight capacity is available on the route, with currently one dedicated freight carrier and another one scheduled to start services in the near future, with a combined allocation of 100 tonnes per week. These services provide the facility for the carriage of containerised and palletised freight. This means that larger freight items should be capable of being carried on these operations in the absence of the Boeing 767. However, the presence of the Boeing 767 does provide some competition for dedicated operators, placing downward pressure on freight rates.

7.51 Taking account of all these factors, the Commission attaches little weight to this criterion.

7.52 *Industry Structure*

(e) The Commission should assess the extent to which applications will impact positively on the Australian aviation industry.

7.53 The code share arrangements have had a positive impact on the Australian aviation industry through the generation of profits for Qantas on the route. On the other hand, they have involved the loss of flying by Qantas, which has reduced the participation of Qantas staff on the route. However, there is unlikely to have been any significant impact on overall employment levels as a result of the code share arrangements.

8 Conclusion

8.1 In 2007, the Commission concluded that the expanded code share arrangements had achieved the important objective of restoring Air Niugini to sound financial health. In the first three years after those arrangements were implemented in 2002, the recovery in Air Niugini's finances seemed to come at the cost of reduced competition, with only one carrier on the route, and reduced frequency of service to Sydney. The combined hard-block/soft block nature of the code share arrangements provided only limited competition between Qantas and Air Niugini. The variable size of the Qantas hard blocks, which are matched to daily demand patterns, has enabled Qantas to sell its seats without the need to discount fares significantly, especially in business class. Initially, the threat of entry by other carriers appeared to have placed little or no price restraint on Qantas and Air Niugini. The absence of any significant presence of third country carriers taking passengers via other countries has also contributed to the lack of competitive pressure on the code share partners.

8.2 However, the entry of Airlines of PNG to the Cairns and Brisbane – Port Moresby sectors changed the competitive situation for the better. There was evidence that fare levels fell significantly ,particularly for economy passengers, although the route remained profitable for Air Niugini and Qantas.

8.3 The Commission has also noted the entry of Pacific Blue Australia in alliance with Airlines of PNG to the Brisbane – Port Moresby sector. There is now a much wider range of fare types and levels available within the market compared to when the code share arrangements were initiated in 2002. The additional choice of carriers also provides consumers with a wider choice of times to travel, in-flight experiences and different aircraft types.

8.4 The entry of Pacific Blue Australia has had less impact on revenue yields of Qantas and Air Niugini than the Commission might have expected. Nevertheless, it provides an important competitive presence. The combined market share of the Qantas/Air Niugini alliance actually went up in the Year Ending July 2009. Whereas in 2007, there was a clear downward trend in revenue yields, over the last 12 months, Qantas has been able to increase revenue yields obtained from its passengers on the route.

8.5 This upward trend in yields strengthens the concerns of the Commission regarding the ability of Qantas to use the authorisation to act in a manner that is detrimental to overall public benefits.

8.6 There is scope over the next two years for Pacific Blue Australia to establish itself more strongly in the market and deliver a product that will better appeal to the key business segment of the market. The Commission notes that Pacific Blue Australia has been operating for a limited period, and its less than daily operations may have affected its ability to penetrate a market that is dominated by passengers with a need for flexible timings and conditions.

8.7 The Commission would therefore wish to review the evidence at the time it is considering renewal of the current determination, which expires on 30 June 2012. The Commission wants to limit the period of continued code share authorisation against the possibility that less desirable public benefit outcomes develop over the next year or two.

8.8 At the time of the next review, the Commission expects to see a better match between the volume of seat purchases by Qantas across the week and in both directions in order to improve the competitive situation. The manipulation of the balance of seats means that there is comparatively little competitive pressure on Qantas relative to Air Niugini's situation. This is likely to be resulting in higher margins for Qantas compared with Air Niugini. The Commission will regard this as a significant factor in its decision making at the next review.

8.9 The code share arrangements have also played an important role in maintaining the operation of wide-body services on the route. The greatest public benefit has been to exporters and importers through the capacity of the Boeing 767 to move larger freight items and unit load devices. There is a substantial level of freight on the route, including time-sensitive products such as fish and other fresh food. The loss of wide-body capability would be likely to adversely affect the movement of this freight in the absence of an alternative option emerging. However, the Commission notes that freight tonnages carried by Air Niugini on the route have been in decline, falling from 5,059 tonnes to 2,709 tonnes between 2006 and 2008.

8.10 The Commission again considers that removal of code share approval could potentially lead to a less competitive situation than now prevails. In the short-term, there could be higher public benefits as Qantas re-enters the market in its own right, increasing choice of carrier and frequency on the route. Air fares would be expected to fall as carriers fought for market share. However, within a relatively short time, there would probably be a rationalisation of operations, with the most likely scenario being the exit of small carriers and reduced frequencies by Air Niugini, at least on the Sydney and Brisbane sectors. This could lead to higher fares and reduced public benefits.

8.11 On 19 November 2009, the Commission issued Draft Decision [2009] IASC 216 proposing to authorise code sharing until 30 June 2012 with certain conditions. No submissions were received.

8.12 The Commission will authorise the code share arrangements until 30 June 2012. The Commission will maintain its standard conditions of approval of the code share, together with requirements for Qantas to report its number of seats available and sold, as well as passenger revenue yields.

9 Decision [2009] IASC 216

9.1 In accordance with Section 24(1) of the Act, the Commission varies Determination [2006] IASC 129 by *deleting* the conditions inserted by Decision [2007] IASC 213 and *adding* the following conditions:

- "the capacity may be used by Qantas to provide services jointly with Air Niugini until 30 June 2012 in accordance with:
  - the code share agreements dated 11 October 2001 and 30 August 2002, as amended;
  - or any subsequent code share agreement between Qantas and Air Niugini for operations on the Australia – PNG route with the prior approval of the Commission;
- under any code share agreement with Air Niugini:
  - Qantas must price and sell its services on the route independently of Air Niugini;
  - Qantas must not share or pool revenues on the route with Air Niugini;
- Qantas must take all reasonable steps to ensure that all passengers are informed, at the time of ticket reservation, of the carrier actually operating the flight;
- Qantas must submit to the Commission reports each six months on the monthly number of code share seats available for sale and sold by it on each of Air Niugini's operated services on the Brisbane – Port Moresby, Sydney - Port Moresby and Cairns - Port Moresby sectors; and its yields per revenue passenger kilometre inclusive of relevant levies such as fuel surcharges for all passenger classes on these services."

Dated: 17 December 2009

Philippa Stone	Ian Smith
Member Presiding	Member