



**Australian
Competition &
Consumer
Commission**

GPO Box 3131
Canberra ACT 2601

23 Marcus Clarke Street
Canberra ACT 2601

tel: (02) 6243 1111
fax: (02) 6243 1199

www.accc.gov.au

Contact officer: David Jones
Contact number: 02 6243 1393

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Ms Sue McIntosh
Executive Director
International Air Services Commission
GPO Box 630
Canberra ACT 2601

Dear Ms McIntosh

Review of code share arrangements between Qantas and South African Airways

Thank you for the correspondence from your office dated 5 July 2012 seeking the ACCC's views on the application from Qantas for a new determination relating to share arrangements with South African Airways (SAA).

The ACCC understands that in its assessment of code share proposals, the IASC may apply certain 'public benefit' criteria set out in paragraph 5 of the Minister's policy statement¹ (including competition benefits) in circumstances where it has serious concerns that the code share may not be of benefit to the public.

As you know, the ACCC has considered a number of applications for authorisation of arrangements between airlines under the *Competition and Consumer Act 2010* (the Act). Broadly speaking, the Act requires the ACCC to assess the public benefits and public detriments (including anti-competitive effects) of the arrangements in determining whether to grant authorisation.

The ACCC made a submission in September 2011 in relation to similar arrangements between Qantas and South African Airlines. As was the case in the September 2011 submission, in order to assist the IASC in determining the likely competitive impact of the continuation of the code share arrangement between Qantas and SAA and whether it is likely to be of benefit to the public, this submission sets out the analytical framework used by the ACCC in considering aviation authorisations. In addition to the framework outlined in the September 2011 submission, this submission includes further input in relation to possible analysis of the degree of rivalry between the applicants and the counterfactual.

¹ International Air Services Commission Act 1992 - International Air Services Policy Statement No. 5.

The market

The first step in assessing the effect of an arrangement between competitors is to consider the relevant market(s) affected by the arrangement. Typically, the ACCC considers the impact of arrangements between competing airlines on competition in the following markets:

- international air passenger transport services, with regard to particular product and geographic segments
- international air freight transport services
- the sale of air passenger transport services and
- Australian domestic air passenger transport services.

International air passenger transport services

Product dimension

The ACCC has previously identified separate product markets for leisure and business passenger services on long haul routes.² This approach is based on the view that there are limitations in demand and supply side substitutability which make it appropriate to distinguish between more price sensitive (leisure) passengers and more time sensitive (business) passengers. The ACCC understands that business travellers are relatively less price sensitive and relatively more concerned about factors such as travel time, flexibility, connectivity, convenience and comfort when compared to leisure passengers.

Given the long haul nature of the Australia-South Africa route, it may be relevant for the IASC to consider the public benefits and/or effects on competition of the code share arrangements for these separate customer segments.

Geographic dimension

The ACCC has previously considered both a point-to-point (or city-pairs) approach and a regional approach in defining the geographic scope of the market for international air passenger transport services.³ In this regard, the ACCC notes that it is important to consider the extent to which passengers are likely to consider different destinations as close substitutes. For example, a passenger travelling for business purposes is unlikely to consider alternative destinations to be close substitutes.

The ACCC notes that passengers do travel Australia – South Africa indirectly (for example via Asia), meaning that at least some passengers consider indirect routes substitutes for direct routes. Based on the information available, the ACCC considers that it may be relevant for the IASC to consider the impact of the code share arrangements on the markets for international air passenger transport services between Australia and South Africa. In conducting this assessment it will be relevant to note the characteristics of different groups of passengers. For example, leisure travellers are generally relatively more price sensitive and relatively less concerned about factors such as travel time, flexibility, direct flights,

² ACCC, Determination for applications A91195 & A91196 lodged by Qantas & British Airways (2010); ACCC, Determination for applications A91227 & A91228 lodged by Virgin Blue & Air New Zealand (2010); ACCC, Determination for applications A91151-2 & A91172-3 lodged by Virgin Blue & Delta Air Lines (2009); ACCC, Determination for applications A91097 & A91098 lodged by Air New Zealand and Air Canada (2009).

³ *ibid*

connectivity, convenience and comfort when compared to passengers travelling for business.

International air freight transport services

The ACCC understands that the code share arrangements between Qantas and SAA do not extend to the carriage of freight and therefore, there is unlikely to be an impact on this market.

The sale of air passenger transport services

The ACCC understands that under the hard block code share arrangements between Qantas and SAA, each airline retains its independence in the marketing and sale of its own services. In view of this, the ACCC considers that the arrangements are unlikely to adversely affect competition in the market for the sale of air passenger transport services.

Australian domestic air passenger transport services.

In other aviation matters, the ACCC has considered whether arrangements between competing airlines in respect of international air passenger transport services could also affect competition in the market for domestic air passenger transport services by directing feeder traffic to a particular carrier, at the expense of the competitive position of other domestic carriers.

The counterfactual

The ACCC applies a 'future with-and-without test' to identify and weigh the public benefit and public detriment generated by an arrangement for which authorisation is sought. Under this test, the ACCC compares the public benefit and anti-competitive detriment generated by an arrangement in the future if authorisation is granted, with those generated if authorisation is not granted. This requires the ACCC to predict how the relevant markets will react if authorisation is not granted.

The ACCC notes that the counterfactual in this case may involve one of several different scenarios, including:

- neither Qantas nor SAA significantly change their operating patterns - this was the conclusion reached by the IASC at the time of extending approval in February 2012, based on the market dynamics prevailing at the time of that assessment
- SAA commences new services between Sydney and Johannesburg
- SAA enters into a new interlining arrangement with a domestic carrier to provide flights between Sydney and Perth, with passengers then completing the Perth - Johannesburg leg with SAA
- Qantas commences new services between Perth and Johannesburg
- one of either Qantas or SAA withdraw from the Australia – South Africa route, leaving one direct operator
- one of either Qantas or SAA withdraw from the Australia – South Africa route, attracting a new Australian or South African entrant

Based upon the information available, the ACCC has not reached a concluded view on the most likely counterfactual in this case. It will ultimately be a question for the IASC to determine whether the current market dynamics are sufficiently different from those prevailing in February 2012 as to warrant departing from the view that neither Qantas nor SAA would significantly change their operating patterns.

Public benefits

In its assessment of applications for authorisation of arrangements between competing airlines, the ACCC has identified a number of public benefits that are likely to arise from such arrangements, including:

- new and enhanced products and services, such as; new services, increased connection options, reduced travel and connection times, and enhanced frequent flyer programmes and passenger lounge access
- cost savings and efficiencies
- lower fares; by better coordination of available capacity on domestic sectors to realise higher load factors, and the reduction of double marginalisation⁴
- increased tourism
- increased competition (that is, the alliance will increase the competitiveness of the airlines)

The ACCC notes that many of these benefits have been identified in arrangements which involve a deeper level of cooperation than code sharing – for example, coordination of schedules and/or revenue sharing. This finding is consistent with that of regulators in other jurisdictions such as the United States Department of Transportation.

In considering the public benefits of the code share arrangements between Qantas and SAA, the ACCC has focused on the potential competition benefits, as the ACCC understands the IASC must consider these as part of the benefit criteria set out in the Minister's statement. The assessment of competition benefits will depend on the likely counterfactual.

If the counterfactual involves no change to the airlines' existing services, or the withdrawal of one of the airlines from the route such that there is a single direct operator, then continuation of the code share arrangements is unlikely to lessen competition benefits since the hard block nature of the code share may maintain a degree of rivalry between the airlines.

The ACCC understands that under the code share agreement, Qantas and SAA sell capacity to each other as a hard block of 40% of seats on each flight operated.⁵ The cost of this block of seats is proportional to the cost of operating the flight.⁶ The block payment does not affect the marginal cost of seats sold and therefore is unlikely to artificially create a 'price

⁴ A situation that occurs where suppliers of vertically related or complementary products independently charge a price which includes a mark-up over their costs to maximise their individual profits and do not take account of the impact of these prices on demand for the other airline's services. The net result is higher prices on connecting routes than if the two firms were to coordinate their pricing, for example, through a cooperation agreement or alliance

⁵ Qantas, Qantas/SAA code share - Application for new determination and code share condition, 4 July 2012, p.7.

⁶ Qantas, Qantas/SAA code share - Application for new determination and code share condition, 4 July 2012, p.7.

floor'. . In other words, since the party purchasing seats from the flight operator must pay for all seats regardless of whether they are sold, it is unlikely that this arrangement would deter either party from selling seats to passengers at discounted fares if it is otherwise in the airline's interest to do so.

However, as with any hard block arrangement, the need to periodically renegotiate the price at which blocks of seats are sold from one airline to the other is a relevant consideration.. For example, if the discounting of fares by the purchasing carrier is in any way likely to adversely affect the terms on which it is likely to acquire seats in the future (including the number of seats) then this may adversely affect competition over the longer term.

Public detriments

In assessing applications for authorisation, the ACCC needs to consider the extent to which arrangements between competitors may result in any public detriment, in particular, if the arrangements would result or would be likely to result in a lessening of competition in the relevant market(s).

In previous authorisation matters involving arrangements between competing airlines, the ACCC has identified anti-competitive detriments in situations where there are barriers to entry and/or an absence of competitive constraints, such that the participating airlines would have the ability to raise fares and/or reduce capacity or service quality.⁷

If the counterfactual involves one of the airlines commencing new services on the city-pair where it currently does not operate, then the continuation of the code share arrangements is likely to lessen competition benefits by preventing direct competition between the airlines.

In its previous submissions to the IASC on the code share arrangements between Qantas and SAA, the ACCC has identified competition concerns with the Australia – South Africa route. These concerns have arisen from the fact that Qantas and SAA have been the only two direct operators on the route, flying to separate points in Australia.

As outlined in previous submissions to the IASC, the ACCC considers that the third country carriers operating one stop services between Australia and South Africa provide only a limited competitive constraint on Qantas and SAA. The considerably longer travelling times offered by these third country carriers place them at a competitive disadvantage to the direct carriers, especially in relation to time sensitive passengers.

Additionally, the ACCC has previously found that barriers to entry are relatively high in the aviation sector, including investment in aircraft, plant and technology; and government regulations and licensing.

It is arguable that new entrants seeking to provide direct services between Australia and South Africa route face barriers to entry arising from:

- the regulatory environment – the air services arrangements limit the route to Australian and South African airlines and

⁷ See, for example, Determination for applications A91227 & A91228 lodged by Virgin Blue & Air New Zealand (2010).

- the geography of the route – the relative isolation of the two destinations and the great distance of the route mean that it can only be operated with specialist large, long-haul aircraft.⁸

The ACCC notes that there are no examples of sustained successful entry for direct services between Australia and South Africa in the past five years.⁹

Period of approval

The ACCC notes that since 2000 the IASC has maintained short-term periods of approval of the arrangements (one or two years at a time) because of concerns about the potential for adverse public benefits to arise from them should circumstances change over the approved period. The ACCC has adopted a similar approach in aviation matters where the decision to grant authorisation has been finely balanced.¹⁰

In this case, Qantas has sought approval to continue the code share arrangements for a further three years, until 31 March 2016, arguing that airlines make investment decisions over long lead times and that approval of the code share for three years will assist Qantas and SAA to commit further investment on the Australia – South Africa route.¹¹

The ACCC has previously granted longer-term authorisations for arrangements (in other industries) involving factors such as significant investment in infrastructure and long term contracts. In this case, it is not clear to the ACCC what types of investment are likely to be made by Qantas if the code share arrangements are approved for three years, and how these would contribute to the public benefits of the arrangements and/or improve performance on the route.

Conditions of approval

The ACCC notes that the IASC has also maintained various conditions of approval designed to encourage competition between the code share partners, such as minimum numbers of weekly frequencies which must be operated, and independent pricing. Again, the ACCC has adopted a similar approach in aviation matters where the decision to grant authorisation has been finely balanced.¹²

The ACCC considers that the issues which led the IASC imposing conditions on past approvals appear to persist in the current environment. In the absence of any information indicating that the conditions has been ineffective or created an unreasonable burden on the airlines, the ACCC suggests that it may be prudent to maintain similar conditions on any approval to ensure the maximum level of competition between the code share partners.

⁸ Qantas, Qantas/SAA code share - Application for new determination and code share condition, 4 July 2012, p.5.

⁹ V Australia commenced services between Melbourne and Johannesburg in March 2010 and withdrew those services in February 2011.

¹⁰ For example, in 2010, the ACCC granted conditional authorisation for an alliance between Virgin Australia and Air New Zealand for three years, in light of the fine balance between public benefits and detriments.

¹¹ Qantas, Qantas/SAA code share - Application for new determination and code share condition, 4 July 2012, p.16.

¹² For example, in 2010, the ACCC granted authorisation for an alliance between Virgin Australia and Air New Zealand for three years subject to conditions which, broadly speaking, require the alliance partners to maintain and grow capacity on a number of routes where competition concerns were identified.

Role of the ACCC

I note that any decision by the IASC to approve the code sharing arrangements between Qantas and SAA does not provide any protection for the airlines under the *Competition and Consumer Act 2010*, and does not prejudice any possible future consideration of code share operations by the ACCC.

I hope that this submission assists you in your consideration of the application from Qantas. If you wish to discuss any aspect of this submission further, please do not hesitate to call David Jones on 02 6243 1393.

Yours sincerely

A handwritten signature in blue ink, appearing to be 'R Chadwick', with a long horizontal line extending to the right.

Dr Richard Chadwick
General Manager
Adjudication