QANTAS

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19 OCT 2010
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Mr Michael Bird
Executive Director
International Air Services Commission
GPO Box 630
CANBERRA ACT 2601

Dear Mr Bird

Review of code share arrangements between Jetstar and Japan Airlines

This letter seeks to extend and vary the current authorisations that permit Qantas' wholly-owned subsidiary, Jetstar Airways (Jetstar) to code share with Japan Airlines (JAL) on selected Jetstar services.

In accordance with the Jetstar/JAL Codeshare Agreement, Qantas seeks an extension of the authorisations that enable JAL to code share on Jetstar's services between Cairns and Tokyo for a further two year period.

We also seek a variation to the current authorisation for code sharing between Sydney-Gold Coast and Osaka, to remove the ability to code share on Sydney-Gold Coast services and enable JAL to code share on Gold Coast-Osaka services only.

Qantas seeks a further variation of the current authorisations to enable JAL to code share on Jetstar's Cairns-Osaka and Gold Coast-Tokyo services.

Background

The Jetstar – JAL Codeshare Agreement has been in place since 2007, initially encompassing Sydney-Osaka-Brisbane-Sydney, which was varied to Sydney-Osaka-Gold Coast-Sydney, and then expanding to include Cairns-Tokyo services from 2008.

In December 2008 the International Air Services Commission (the Commission) approved Jetstar's code share with JAL on these services until 31 December 2010.

In approving the extension of the arrangements, the Commission noted that, given the continuing weak outlook for the route, it saw little potential for adverse competitive outcomes to develop from continuing its authorisation of the code share arrangements for a further limited period.

Australia-Japan Market

Although the Australia-Japan route continues to be a significant aviation market for Australia, conditions have continued to deteriorate since the Commission last re-authorised the code share arrangements in 2008.

Japan is Australia's sixth largest route in terms of overall origin-destination (O/D) traffic and ranked fifth for inbound visitors. However, both total passenger numbers and Japanese visitors have continued to decline for the fifth consecutive year.

These passenger market trends reflect Japan's poor economic performance, increasing destination competition and exchange rate movements, in addition to the impact of H1N1 influenza.

The Japanese inbound market is important to both the Qantas Group's operations and Australian tourism. As a result, the significant weakness of this market is of considerable concern. Over the past ten years, the number of Japanese visitors travelling to Australia has fallen by 55 percent, with a 47 percent decline in visitor arrivals since July 2007.

Although the fall in visitors has been partially offset by the increase in Australian resident traffic, which has grown by 17 per cent since July 2007, the outbound market constituted only 31 percent of total traffic on the route in the year to June 2010. Resident departures fell by 5 percent in the year to June 2010, following steady numbers in 2009 and 22 per cent growth in 2008.

While the weakness of the Japanese economy over the past decade has had a uniformly dampening effect on Japanese outbound tourism, this trend has been further exacerbated by the negative impact of the global financial crisis. The deteriorating conditions saw Japan's economy contract by more than 5 percent in 2009, although the International Monetary Fund has forecast only moderate GDP growth in 2010.

Relative exchange rate movements have also heavily influenced Japanese leisure travel patterns in recent years. The exchange rate between the Japanese yen and the US dollar has been favourable for Japanese tourists, with the yen recently reaching 15 year highs against the US dollar, continuing the trend of visitation to destinations such as China and Korea which have their exchange rates closely linked to the US dollar.

The cost of an Australian holiday for a Japanese tourist has fluctuated in recent years. In the early stages of the global financial crisis, the Australian dollar declined significantly against the Japanese yen (38 percent) and has reduced in value by 12 percent against the Japanese yen in the three years to December 2009. Although this has increased the attractiveness of travel to Australia, it has not resulted in an increase in visitor traffic.

Japanese outbound tourism, particularly the school excursion market, was also affected by the outbreak of H1N1 influenza. This contributed to a significant softening of passenger traffic between Australia and Japan, resulting in Jetstar cancelling approximately one third of services to Japan in mid 2009.

Against the background of these market conditions, the Tourism Forecasting Council's (TFC) outlook for visitor arrivals from Japan are forecast to remain at around 2009 levels over the next ten years.

Competitive Environment

Capacity

As a result of the ongoing weakness of the Japanese market, the Qantas Group rationalised its operations to Japan in 2008. This involved a number of changes including the suspension, reduction and re-allocation of services more appropriately within the Group.

In Northern Winter 2008, Qantas suspended Melbourne-Tokyo services and reduced Sydney-Tokyo services from nine services per week to daily. Jetstar also suspended Cairns-Osaka-Nagoya services and took over Cairns-Tokyo services formerly undertaken by Qantas.

Since these changes, Qantas has maintained its schedule on the Sydney-Tokyo and Perth-Tokyo routes, while Jetstar has increased its Gold-Coast-Tokyo and Cairns-Tokyo services from five flights per week to daily.

Jetstar reintroduced services between Cairns and Osaka from April 2010, operating four flights per week.

In January 2010, Japan Airlines Corp filed for corporate reorganisation in order to gain access to financing after sustaining significant losses against a background of falling passenger numbers and increased competition. JAL is currently undertaking a major restructuring of its operations with the assistance of a state-backed turnaround fund, the Enterprise Turnaround Initiative Corp of Japan (ETIC).

According to JAL's reorganisation plan, a number of measures will be implemented in order to return to profitability including optimisation of JAL's domestic and international route network, focusing on the elimination of unprofitable routes. This strategy has resulted in plans to discontinue services on 15 international routes and 30 domestic routes, including the suspension of JAL's Tokyo-Brisbane services.

JAL will continue to operate daily services from Tokyo to Sydney, with its lower cost subsidiary airline, JALways.

Despite capacity reductions on the Australia-Japan route, load factors have remained well within reasonable levels to cater for demand. According to BITRE figures, load factor for Japan services was 71.7 percent in 2008, increasing by a small amount to 75.7 percent in 2009.

Competitive Landscape

As highlighted above, the Qantas Group and Australia more generally, face intensifying competition from short haul destinations such as Korea, which has been facilitated by the growing presence of low cost carriers in the region. Growing competitive activity from low cost carriers is likely to increase pressure on Australia's market share of Japanese tourists in the short to medium term.

Since the Commission's last reauthorisation of the arrangements, the number of low cost airlines serving Japan with international flights has more than doubled to six carriers. In addition to the incumbent low cost carriers, Air Asia X will commence services between Tokyo Haneda and Kuala Lumpur in December 2010, becoming the first low-cost overseas carrier to serve the Japanese airport, with plans to expand its Japan network to three additional destinations by 2012.

All Nippon Airways (ANA) recently announced the establishment Japan's first low cost carrier via a partnership with Hong Kong-based First Eastern Investment Group. The new airline will be based at Osaka and operate both international and domestic short-haul routes from the second half of 2011. JAL has also identified the possibility of establishing a low cost carrier as part of its reorganisation plan.

The Japanese Government has demonstrated support for the growth of low-cost carriers, indicating that Japan will consider incentives to encourage low-cost carriers. In addition, the Japanese Government plans to allow airlines to set international fares under a ceiling subject to its authorisation from 31 October. The opening of a new runway at Tokyo's Haneda Airport, which has curfew restrictions and has close proximity to central Tokyo, allows for further growth and the launch of more international routes.

Route Performance

Prior to the rationalisation of the Qantas Group's operations to Japan, significant losses were being sustained in order to maintain the level of services. Since then, Jetstar has experienced periods where operating conditions on the route have been difficult, although the commercial performance has improved overall.

As the Commission is aware from the six-monthly data Jetstar is required to provide as a condition of its code share approvals, Jetstar's yields remain subdued on all the Japan services under the authorisation.

The difficult operating environment on the route has also affected JAL, as the Tokyo-Brisbane service was one of the unprofitable routes to be suspended under the reorganisation plan.

Variations Sought

Qantas seeks to vary Determinations 124 (2006), 117 (2006) and 127 (2008) on the Japan route to enable JAL to code share on Jetstar services operated pursuant to these determinations and in accordance with the Jetstar/JAL Codeshare Agreement of 9 February 2007.

A signed copy of the amended Annex 1A will be forwarded to the Commission as soon as it available.

The variation is proposed with effect from 1 January 2011 to 31 December 2013.

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

Benefits of the Code Share Arrangements

Qantas considers that the variations requested meet the requirements of the *International Air Services Commission Act 1992* and the terms of the Minister's Policy Statement for favourable action by the Commission.

The code share arrangements with JAL will enable Jetstar to continue to access JAL's powerful distribution capability, including its wholesale and retail presence in the Japanese market.

Access to JAL's distribution networks and marketing of Jetstar's services by both airlines will stimulate more inbound tourism from Japan than would be achieved by Jetstar alone. This will also provide a more stable basis for the long-term sustainability of the Japan-Australia route.

The ability of JAL to display its code on Jetstar's services will provide it with a greater incentive to promote travel between Japan and Australia than simple interline arrangements.

Competition on the route will continue through the presence of both airlines in selling capacity and pricing independently of each other.

Conclusion

Since the Commission's re-authorisation of the Jetstar-JAL code share arrangements in 2008, conditions in the Japan market have continued to deteriorate. This necessitated the rationalisation of the Qantas Group's services to Japan.

The route has experienced difficult operating conditions since 2008, with the continued decline of traffic levels and the negative impact of the global financial crisis. Along with the changes to the competitive environment, such as the growth of low cost carriers in the region, the pressure on the viability of the Japan route in the medium to longer term will increase.

The arrangements will continue to be an important factor in enabling the Qantas Group to maintain a reasonable level of capacity on the Australia-Japan route under difficult market conditions. In addition, they will continue to deliver public benefits.

It is our view that the arrangements will produce a superior outcome for the Australia-Japan market more broadly – particularly in terms of encouraging inbound visitor growth, than would be the case if JAL were unable to code share on Jetstar's services.

We would be pleased to provide further assistance to the Commission should it be required.

Yours sincerely

RWood

Robert Wood
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Qantas Airways