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Ms Sue McIntosh
Executive Director
International Air Services Commission
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Dear Ms McIntosh

Review of code share arrangements between Qantas and South African Airways

Thank you for your correspondence of 18 August 2011 seeking the ACCC's views on the application from Qantas for a five year extension of its code 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 statement[1] (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. This submission sets out the analytical framework used by the ACCC to make these assessments, in order to provide the IASC with assistance 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.

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:

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

- 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 for leisure travellers between Australia and South Africa and

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[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

- international air passenger transport services for business travellers on a city-pairs basis between Australia and South Africa.

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, the airlines retain their independence in the marketing and sale of their own tickets. In light of this, the arrangements are unlikely to have an impact on this market.

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.

In its application for review, Qantas submits that 'behind the gateway points Qantas and Virgin compete for SAA beyond traffic within the Australian, South African and New Zealand markets'[4] and 'the Virgin Group has an interline agreement with SAA covering domestic on-carriage within the Australian market.'[5] However, the ACCC notes Virgin Australia has subsequently provided a submission which states that its interline agreement with SAA has been inactive since V Australia withdrew services to Johannesburg in February 2011 and in addition, the interline arrangement is unilateral so that Virgin Australia does not sell any SAA traffic beyond Perth.[6]

In light of the submission by Virgin Australia, it may be relevant for the IASC to consider the effect of the code share arrangements on the market for Australia domestic air passenger transport services.

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

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[4] Qantas, Application for review of code share arrangements between Qantas and South African Airways, 18 August 2011, p.5.
[5] Qantas, Application for review of code share arrangements between Qantas and South African Airways, 18 August 2011, p.3.
[6] Virgin Australia, Submission re review of code share arrangements between Qantas and South African Airways, 6 September 2011, p.2.

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 2010, based on the market dynamics prevailing at the time of that assessment

- SAA commences new services between Sydney and Johannesburg – in September 2010, the IASC considered this unlikely in light of the growth of the Perth-Johannesburg route, SAA's increases in frequency and capacity, SAA's overall financial position and its interline arrangement with the Virgin Group implemented in April 2009

- Qantas commences new services between Perth and Johannesburg – again, in September 2010, the IASC considered this unlikely due to increases in Qantas' frequencies on the Sydney-Johannesburg route and the apparent commercial attractiveness of the arrangement with SAA on the Perth-Johannesburg route

- one of either Qantas or SAA withdraw from the Australia – South Africa route, leaving one direct operator – Qantas submits that this is a highly probably outcome[7] while Virgin Australia regards this as highly improbable[8]

- one of either Qantas or SAA withdraw from the Australia – South Africa route, attracting a new Australian or South African entrant – Virgin Australia takes this view, noting that the route offers a relatively balanced mix of inbound and outbound travellers, and a solid business component driven by the mining sector that assists in offsetting the seasonal nature of the leisure segment.[9]

The ACCC notes that certain aspects of the route remain similar to the time of the last approval in 2010, including the airlines' frequencies and the amount of available capacity. However, there have also been some developments during this time, including the withdrawal of V Australia's services from Melbourne to Johannesburg in February 2011 and, as a consequence, the fact that Virgin Australia's interline arrangement with SAA is inactive.

With 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 September 2010 as to warrant departing from the view that neither Qantas nor SAA would significantly change their operating patterns.

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[7] Qantas, Application for review of code share arrangements between Qantas and South African Airways, 18 August 2011, p.3.
[8] Virgin Australia, Submission re review of code share arrangements between Qantas and South African Airways, 6 September 2011, p.2.
[9] Virgin Australia, Submission re review of code share arrangements between Qantas and South African Airways, 6 September 2011, p.2.

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 marginalisation[10]
- 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 will at least maintain a degree of rivalry between the airlines.

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).

[10] 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

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.[11]

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.

The ACCC understands that the market share of third country carriers has remained relatively constant over the past few years, with Qantas and SAA retaining a significant market share.

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

- the geography of the route – the distance between the two countries necessitates the use of 'specialised, mission specific long haul aircraft.'[12]

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.[13]

The ACCC remains of the view that there are a number of characteristics about the Australia-South Africa route which impact on the extent of competition and therefore, considers that the IASC would need to be satisfied that the code share arrangements will continue to result in strong public benefits before allowing them to continue.

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

[12] Qantas, Application for review of code share arrangements between Qantas and South African Airways, 18 August 2011, p.1.

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

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.[14]

In this case, Qantas has sought approval to continue the code share arrangements for a further five years, arguing that 'rolling short term determinations do not give [them] the investment certainty [they] need to develop the route over the long term and to effectively address the persistent challenges of the operating environment.'[15]

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 five years, and how these would contribute to the public benefits of the arrangements and/or improve performance on the route.

The ACCC notes that on 24 August 2011, the South African Competition Commission issued a notice announcing its decision to continue to grant exemption under the South African Competition Act for the code share arrangements between Qantas and SAA until 31 December 2012.

Given the uncertainty around the likely counterfactual (and therefore the extent of public benefits) and the potential competition issues outlined above, the ACCC suggests that it may be appropriate for the IASC to consider a further short-term period for any approval of the code share arrangements.

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.[16]

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

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[14] 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.
[15] Qantas, Application for review of code share arrangements between Qantas and South African Airways, 18 August 2011, p.2.
[16] 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.

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.

The ACCC notes that the exemption granted by the South African Competition Commission is subject to a number of conditions, including that Qantas and SAA continue to price and sell their airline tickets independently, and do not share or pool revenue.

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 Darrell Channing on 02 6243 4925.

Yours sincerely

Dr Richard Chadwick
General Manager
Adjudication