

Mr Tim Grimwade
 General Manager
 Adjudication Branch
 Australian Competition and Consumer Commission
 PO Box 1199
 DICKSON ACT 2602

FILE No.
DOC:
MARS/PRISM:

Dear Mr Grimwade

Re-authorisation application for the Qantas –British Airways ‘Restated Joint Services Agreement’ (your ref A30226 and A30227)

I refer to Brian Cassidy’s letter of 12 May 2003 to the Secretary of the Department of Transport and Regional Services, Mr Ken Matthews, seeking submissions on the re-authorisation application for the Qantas –British Airways ‘Restated Joint Services Agreement’ (JSA)¹.

To enable full consideration of the implications of the JSA the application must be considered in the broader context of the state of the global aviation sector and the Government’s aviation policy intentions. DoTaRS welcomes the opportunity to provide this input to the ACCC’s consideration of the re-authorisation. This submission does not contain confidential information and can be placed on the Public Register.

Challenges facing the aviation sector

The aviation sector has faced considerable upheaval since the JSA was first authorized on 12 May 1995. Threats to international security and the downturn in many parts of the global economy have presented a severe shock to the aviation industry. Passenger numbers have declined, particularly in North American markets, due to perceived security risks, and in Asia, in response to the SARS epidemic.

Against this background many international airlines have suffered substantial losses and have rationalised services. Several European airlines, notably Swissair and Sabena, have faced bankruptcy, while others have faced severe losses. In the United States US Airways and United Airlines filed for Chapter 11 bankruptcy protection and several other airlines continue to struggle. The US Government has provided direct support of \$3.46 Billion to its 6 largest airlines since 11 September 2001, in addition to loan guarantees.² It is important to note that the Australian Government does not provide financial support to Australian international airlines.

The Australian domestic aviation market has also been markedly reshaped with the collapse of Ansett as Qantas lost its major competitor on domestic routes. The collapse also impeded access to feeder traffic for competing international carriers,

¹ While noting that the Restated JSA of 2000 had some differences to the original 1995 JSA, for the sake of simplification this submission will regard the JSA as having been in operation continually since 1995.

² US Airways has since successfully emerged from Chapter 11 protection.

AUSTRALIAN COMPETITION & CONSUMER COMMISSION
 19 JUN 2003

particularly in the Star Alliance. Concurrently, Virgin Blue has entered the Australian market as a value based airline and achieved steady growth in both services and profits.

Qantas has not been immune from the disruptions to the aviation market. On 7 May 2003 it announced a further downgrading to its profit forecasts and has taken steps affecting the positions of 3,200 staff. Nevertheless Qantas remains one of the few major international carriers to remain consistently profitable in the current downturn.

Alliances and consolidation

Consolidation of the airline industry and the expansion of airline alliances has been a feature of the industry since the late 1980's. Alliances offer airlines a variety of commercial benefits through code sharing, the integration of connecting services and facilities, common marketing and as a counter to the restrictions placed on the expansion of international aviation by bilateral aviation agreements.

Recently, the nature of alliances has evolved as airlines seek greater certainty and stability in the investments they are making in alliances. Alliances are changing from purely commercial agreements to the holding of equity in partner airlines. It is likely that this trend will continue as part of the continuing globalisation of the world economy and as pressure on the aviation sector continues. BA's shareholding in Qantas is an early example. The JSA underpins the close commercial and operational alliance between the two carriers.

Australia's aviation policy

The Government's international aviation policy was developed in response to the recommendations from the Productivity Commission's 1998 review of Australia's international aviation policy settings. The policy aims to increase competitive pressure on international routes in order to provide reasonably priced access to major trading partners and to avoid potential monopolies exploiting dominant positions on critical international routes. A key element of the policy has been the trading of 'fifth freedom' intermediate and beyond rights, which allow foreign carriers access to markets between and beyond Australia to stimulate competition on routes from key tourism sources for Australia.

This policy is primarily being implemented through liberalisation of the bilateral system and where possible pursuing a liberalised agenda in multilateral fora such as APEC, ICAO, OECD and GATS. In the bilateral context, Australia's policy seeks liberalised outcomes with bilateral partners through "opens skies" agreements. Where this is not possible or not in the national interest, Australia negotiates the most liberal outcome available. At this stage Australia's only open skies agreement is with New Zealand, however, the Government is actively seeking agreements with additional partners.

The Kangaroo Route

Currently nine carriers fly into Australia on the Australia-Europe 'Kangaroo Route'. Apart from Qantas, BA and Lauda Air, these are carriers based in intermediate points on the route, in the Middle East or Asia. The last decade has seen the departure of most European carriers from the route, with Alitalia, Lufthansa, KLM, Olympic, and

Air France/AOM ceasing to operate services to Australia. BA and Lauda Air are now the only European based carriers currently flying to Australia.

However, in excess of 30 airlines serve the Kangaroo Route. The majority of these, including most European airlines previously flying into Australia, serve the route using interline agreements with other airlines operating services to Australia from Asian collection and distribution points such as Singapore, Hong Kong, Bangkok and Kuala Lumpur. Under such agreements a European carrier, for example, would fly to a point in Asia, from where passengers flying on to Australia would travel the rest of the journey on an airline operating services to Australia. This enables carriers to access the Australian market and gain the economies offered by hub and spoke type operations without actually operating services here.

Australian based carriers

The Government continues to strongly support the maintenance and expansion of a strong Australian based aviation industry. The Government believes there is a substantial public benefit in having a strong Australian based aviation industry that is able to compete in the international market.

The benefits to Australia from a strong locally based industry are substantial, through providing access for Australian's to competitive passenger and freight air transport, retaining and growing employment and investment within Australia, and ensuring ready access to Australia for the inbound tourism market. Due to its geographical position Australia is an end point and often a marginal destination for foreign carriers. A strong locally based industry plays a vital role in providing market participants that have a long-term commitment to the Australian market and consistently promote Australia as an inbound tourism destination. The presence of Australian based carriers also ensures a level of aviation expertise and infrastructure investment is maintained in Australia, which is vital for the domestic aviation industry and the economy as a whole.

The Government encourages the entry of new carriers to the Australian market and has reduced foreign ownership restrictions for Australian based international airlines. Under the *Air Navigation Act*, foreign ownership of an Australian based international airline can be as high as 49%, the maximum foreign ownership limit which would be acceptable under many existing bilateral aviation agreements.

For domestic airlines, which do not need to have regard to bilateral agreements, ownership restrictions have been significantly liberalised. Australia has the world's most liberal domestic aviation market and there are no ownership barriers for domestic airlines with the exception of foreign ownership restrictions for Qantas under the *Qantas Sale Act*.

Australia's domestic aviation policy settings have ensured that Qantas, while dominating the domestic market following the collapse of Ansett, remains under threat of competition both from Virgin Blue and potential new entrants. The success of this policy is demonstrated by the strong performance and expansion of the initially 100% foreign owned Virgin Blue. Virgin Blue recently announced a \$158 million profit for the fiscal year ending March 2003.

COMMENTS ON THE JSA RE-AUTHORISATION APPLICATION

Product and service benefits

DoTaRS accepts that the JSA enables BA and Qantas to provide an increased level of services to their customers. Given the absence of a strong direct presence in the Australian market of European carriers, the JSA helps facilitate access from a broad range of European ports through BA's European network. However, it is also noted that the presence of third country carriers based at intermediate points in Asia and the Middle East, as well as alternative routes via Africa and the Pacific provides alternative access to a wide range of ports in Europe. The presence of European carriers using interline agreements through intermediate points provides a significant additional capacity to serve Australia from points in Europe.

Cost savings and efficiencies

DoTaRS supports the applicants' views on this matter. The JSA will continue to create cost savings and efficiencies which enable capital, personnel and equipment to be transferred to other markets or for other purposes. Competition on the Kangaroo Route from third country carriers provides downward pressure on fares, encouraging savings to be passed on to consumers.

Lower Fares

DoTaRS does not maintain data on international airline fares. However, anecdotal evidence suggests that prices have consistently reduced in real terms over the last 30 years. Technological improvements, reduced regulation and competition have all played a role in this. It is difficult to attribute lower fares to specific factors such as the JSA. The Kangaroo Route is highly competitive and it is likely that in the absence of the JSA, competition would continue to maintain downward pressure on ticket prices.

Greater net exports and higher employment

DoTaRS considers that any developments that reduce an Australian based carrier's market share to the benefit of non-Australian carriers is likely to have a negative impact on net exports and employment. In the absence of the Commission identifying significant alternative economic benefits it is likely that a decision not to renew the JSA would have such an impact.

Higher levels of tourism

DoTaRS notes that Qantas has been a vigorous supporter and promoter of inbound tourism. The substantial marketing of Australia as a destination for European travellers undertaken by Qantas may decline should the re-authorisation be denied, as Qantas has indicated it would rationalise its European services. It is unlikely that foreign competitors would increase spending to market the Australia, leading to a possible decline in tourism growth.

Market definition

As the JSA is well established there is little to suggest that its renewal will lead to a significant decrease in competition on the European and South-East Asian routes. Indeed, anecdotal evidence suggests that competitors from airlines based from intermediate points on the Kangaroo Route are increasing their interest in the Australian market. The United Arab Emirates, for example, has sought increased capacity for its carriers into Australia and has gained an approximately 50% phased

increase over existing capacity. It is expected that Emirates Airlines will take up all the additional capacity as it becomes available and serve the 15 European points on its network through its Dubai hub. Gulf Air and Air Mauritius are also looking to enter or expand their presence in the Australian market. DoTARS considers that unutilised capacity under existing bilateral agreements and expansion by foreign carriers offer scope for continued and possibly growing competition.

Barriers to entry

Australian aviation policy is aimed at liberalising access for foreign carriers to Australia and has reduced ownership restrictions for new Australian based international airlines. While the JSA enables the applicants to strengthen their position against foreign carriers, Australia’s existing bilateral agreements provide significant opportunities for airlines from third countries to enter the Australian market. As well, a substantial level of potential available capacity on the Kangaroo Route remains unutilised. DoTaRS also notes there is no barrier to other new or existing market participants developing arrangements similar to the JSA, subject to ACCC approval.

Current levels of competition and market share

Qantas is by far the largest player in the Australia- Europe market. It currently has just over one third of the market and its level of market share is continuing to grow slowly. Despite the level of market share exercised by the JSA partners their position is not dominant and their total market share remains at less than 50% (See Table 1).

Table 1: Percentage of market share for services to Australia from Europe 2001-03

(Year ending)	Feb 2001	Feb 2002	Feb 2003
Qantas	33.1%	34.4%	35.3%
British Airways	7.5	7.4	7.2
JSA Total	40.6	41.8	42.5
Singapore Airlines	15.8	17.7	17.9
Malaysia Airlines	8.9	9.2	7.7
Thai Airlines	3.6	4.3	4.4
Cathay Pacific Airways	4.6	3.8	4.3
Emirates	3.4	3.8	5.6
Lauda Air	2.6	3.1	3.8
Japan AirLines	2.5	3.0	3.0
Air New Zealand	3.2	2.5	2.5
Other	14.9	10.8	8.2

Source: Data held by Department of Transport and Regional Services, Aviation Statistics section.

Over 30 airlines offer services to the Australian market through interline arrangements with carriers directly serving Australia through offshore collection and distribution points. However, the proportion of the market held by these carriers is declining over time while airlines such as Emirates and Singapore Airlines which are based from intermediate points and fly between Australia and Europe are expanding their presence in the Australian market.

Price and quality

Quality of service is difficult to define, relying on a number of factors including, but not limited to, cabin service and configuration; airport handling facilities; service frequency; flight delays; flight duration; and range of destinations available. The

Department agrees with the applicants contention that the synergies between Qantas and BA allowed by the JSA have led to decreased delays and improved connections. In terms of flight frequency it is unclear to what extent competitors would pick up any reduction in services by the applicants should the JSA cease. Any consideration of service levels must also take account of ticket price. Given the subjective nature of service quality DoTaRS makes no further comment.

Australian Domestic Market

Qantas currently has a dominant position in the Australian domestic market, particularly for Business Class travel in which it has no direct competitor. Its international operations provide a feeder service for domestic travel on the airline (and vice-versa). Should the Commission undertake analysis of the impact of the JSA on domestic market it may be appropriate to consider the implications of lack of competition in the domestic Business Class market segment for international Business Class travel.

Market power

The JSA is an established part of the aviation market in Australia. There is little to suggest its renewal will significantly extend Qantas and BA's market power, as is supported by the continuing interest of foreign carriers in the Australian international market.

Key points

- The JSA has become an established feature of the Australian international aviation market over the past 8 years.
- On the face of it, strong competition continues on the Kangaroo Route. While only nine carriers offering services on the route currently fly into Australia, more than 30 airlines offering air services to the market through interline agreements.
- This reflects the current trend towards cooperation between airlines in order to rationalise and improve services through interline agreements and airline alliances. The JSA facilitates Qantas and BA's ability to strongly compete in the developing global aviation market.
- The Commission noted that uncertainty in the continuing level of competition on the Kangaroo Route was of key concern in its April 2000 authorisation of the JSA. The apparent continuing competition in a difficult aviation market should provide an opportunity for the ACCC to assess the longer term direction of competition in the market.
- The Qantas/BA JSA provides the airlines with considerable efficiencies and enables them to offer a wide range of services on the Kangaroo Route. The applicants have suggested a broad range of consumer benefits for the ACCC to consider.
- In the absence of the JSA the presence of Qantas on the route may be reduced, which may lead to some loss of employment and a negative impact on the tourism industry. Qantas is a strong promoter of the Australian tourism product.
- The Government has indicated that it supports the retention of a strong and competitive aviation industry in Australia. Australia's interests are served by one or more viable Australian based international carriers.

- In addition to the contribution to the economy through passenger and freight services international carriers help provide the economies of scale for investment in aviation infrastructure and intellectual capital, including training.
- The geographical location provides airlines based from points between Europe and Australia with a natural advantage by facilitating economically efficient hub and spoke operations from an intermediate point. The JSA allows the applicants an operating framework which enables them to more effectively compete against these airlines.
- The aviation industry is currently facing considerable challenges globally. Any decision which could lead to further upheaval in the Australian aviation sector should be avoided in the absence of a demonstrated net positive benefit for the aviation sector and the economy as a whole.
- It is likely that any significant change to the JSA arrangements may result in short term upheaval for consumers and the applicants. Longer-term implications in a perennially volatile industry are uncertain.
- Australia has among the most liberal aviation policies in the world and encourages new participants and competition, in both the international and domestic sectors. These policy settings provide a considerable buffer to any anti-competitive advantage the JSA may allow.

Conclusion

DoTaRS considers that unless significant impacts on competition are identified the benefits offered by the JSA in the public interest warrant its re-authorisation. The JSA appears to provide benefits to consumers (subject to the ACCC's analysis) and enables Australia's sole current international carrier to provide a competitive presence on the Kangaroo Route. While not wishing to comment on the impact of the JSA on competition in detail, DoTaRS considers Australia's aviation policies and the capacity allowed for in current bilateral aviation agreements allow increasing capacity and competition on the Kangaroo Route.

Nonetheless, given the volatility of the global aviation industry, re-authorisation of the JSA should be subject to a fixed period review. This will enable the Commission to assess competition impacts on a regular basis and ensure the re-authorisation remains appropriate to contemporary market conditions. While recognising the ACCC can review the authorisation at any time, a fixed time expiry provides some certainty to the market. Recognising the cost to the applicants and Government in assessing the JSA, DoTaRS considers a re-authorisation period of 5 years is appropriate.

Should you wish to discuss this submission please call Richard Wood in the Aviation Markets Branch on 6274 7413.

Yours sincerely



Nick Bogiatzis
Assistant Secretary
Aviation Markets

14/6/03