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Submission to the ACCC in support of the Application for Authorisation of the Restated Joint Services Agreement

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EXECUTIVE SUMMARY

Application for Authorisation

This submission is made by Qantas Airways Limited (ABN 16 009 661 901) and its subsidiaries (**Qantas**) and British Airways Plc (ARBN 002 747 597) and its subsidiaries (**British Airways**) (together the **Applicants**) in support of an application for authorisation pursuant to section 88(1) of the Trade Practices Act to continue to give effect to the Restated Joint Services Agreement and any related and consequential coordination of schedules and pricing between the Applicants.

The Restated Joint Services Agreement governs the alliance between the Applicants referred to in this submission as the **JSA**, and provides for Qantas and British Airways to coordinate their business activities in relation to air services provided on routes from Australia to Europe and to and from mid-points. A detailed summary of the Restated Joint Services Agreement is set out at Appendix 1 to this submission.

The JSA has been in operation for over 7 years. It received authorisation from the then Trade Practices Commission in 1995 and again from the Australian Competition & Consumer Commission (**Commission**) in 2000. The current authorisation expires on 21 July 2003. The Applicants now apply for an unconditional reauthorisation of indefinite duration.

This submission explains the history and commercial background to the JSA and summarises, first, the likely competitive impact of the JSA in relevant markets and, secondly, the public benefits that will arise from reauthorisation of the JSA. Detailed independent economic analysis supporting these conclusions is set out in a report prepared by Network Economics Consulting Group (**NECG**) lodged with this submission.

Market performance since commencement of the JSA

In considering this application, the Commission must balance the extent (if any) to which the JSA is likely to lessen competition against the public benefits that have and will continue to result from the JSA.

In making this assessment, the Commission has the benefit of being able to assess over seven years of the JSA's operation. This history demonstrates that, since the formation of the JSA, the markets for air travel between Australia and Europe and South East Asia have been dynamic and competition has been intense. In particular:

- Despite substantial increases in costs, fares have reduced. Over the last 7 years the representative benchmark fare for travel between Australia and Europe monitored by the Commission during the first authorisation of the JSA has decreased in real terms by over 25%.

- At the same time as fares have reduced, carriers have competed vigorously to provide ever higher product standards.

- The market has grown significantly. ABS data shows that the number of passengers flying between Australia and Europe has increased by over 40% since 1995.

- Despite this growth, the market shares of the Applicants have declined whilst the combined market shares of Singapore Airlines, Malaysia Airlines, Thai Airways, Cathay Pacific and Emirates between Australia and Europe have nearly doubled.

- Emirates has been able to enter the Australia - Europe market and grow rapidly to account for over 4% of all traffic between Australia and Europe and both Gulf Air and Virgin Atlantic have announced that they intend to enter the market in the near future.

At the same time, the JSA has created cost savings and efficiencies that have been passed on to consumers through lower fares and has delivered a range of other benefits. These benefits include access for consumers to broader schedule choices, more flexible fare products and higher levels of customer support.

Future competitive effects of the JSA

Looking forward, the JSA will continue to allow both British Airways and Qantas to compete more effectively and to sustain a wider range of services than either carrier could sustain on its own. To understand how the JSA creates these effects, it is important to understand the underlying economics of the 'Kangaroo Route' between Australia and Europe via Asia or the Middle East.

The extreme length of the Kangaroo Route precludes non-stop operation, which means that any carrier based at one or other end of the route must operate extremely long services with a minimum of two separate legs or 'sectors'. For Qantas, the first sector is between Australia and a suitable mid-point. The second sector is from the mid-point to Europe. This second sector is intrinsically difficult to operate profitably because over half of Qantas' passengers disembark at the mid-point. Qantas must either operate the second sector with only a half full plane, or it must try to refill its plane at a mid-point where it has only a limited sales presence and competition from dominant local carriers, many of which enjoy government protection and support. This makes it difficult for Qantas to maintain profitability on the second sector of its Kangaroo Route services, particularly on 'thinner' sectors to continental Europe.

British Airways faces the same problem as Qantas, but from the opposite direction. Indeed, any carrier attempting to operate services between Australia and Europe from either end-point faces the same fundamental challenge – the second sector of its service will always be a long 'end sector', isolated from the airline's home sales presence and any source of feed and therefore difficult to operate profitably. Faced with this challenge, Air France, Alitalia, KLM, Lufthansa and Olympic have all been forced to withdraw from the Kangaroo Route over the past 7 years.

In contrast, a carrier whose hub is located at a suitable mid-point on the Kangaroo Route does not need to operate the Kangaroo Route as one long two sector operation. Instead, it carries passengers between Australia and Europe by combining any of the single sector flights that it operates between its hub and

Australia with any of the flights that it also operates between its hub and Europe. Each of these single sector flights can be supported with traffic feed from the mid-point carrier's hub. In this way, the economics of the Kangaroo Route strongly favour carriers that have a hub located at a suitable mid-point on the route, such as Singapore Airlines, Cathay Pacific, Malaysia Airlines, Emirates, JAL and Thai Airways.

The JSA helps the Applicants counteract these structural disadvantages by allowing them to coordinate passenger flows and support their services from both ends of the Kangaroo Route. Due to its presence in Europe, British Airways is able to contribute passengers to Qantas services on sectors between Europe and its mid-points, allowing Qantas to sustain a wider range of services than would otherwise be viable. At the same time, Qantas' greater traffic between Australia and its mid-points can be used to address British Airways' weakness that would otherwise make it difficult for British Airways to continue to operate these sectors.

By combining their traffic flows in this manner, the Applicants also have sufficient scale to support a 'mini-hub' in Singapore that neither carrier could create on its own. This mini-hub creates a source of feed for the Applicants at the mid-point and helps them maintain flights that would otherwise not be viable by allowing traffic from the Applicants' flights from each Australian port to connect with any of the Applicants' Singapore – Europe flights.

The JSA also enables the Applicants to:

- justify greater investments in aircraft;
- make significant cost savings in overheads, such as costly IT investments; and
- create a joint selling presence in Asia and establish joint facilities that neither could justify on its own.

Overall, the JSA has allowed Qantas and British Airways to maintain and even expand services on JSA Routes while other end-point carriers have been forced to withdraw. By allowing each of the Applicants to sustain more services than either could support on its own, the JSA results in greater capacity and a wider range of services being made available to consumers. This, in turn, creates higher levels of product and price competition than would exist without the JSA.

Public Benefits

In a future without the JSA where British Airways and Qantas could not support each other's services in the ways described above, it is unlikely that either Qantas or British Airways could sustain its current flight schedules. Qantas is likely to be forced to reduce services to Europe and rationalise services between Singapore and cities other than Sydney and Melbourne. British Airways would most likely reduce the number of its daily services from the UK to Australia.

By contrast, if the JSA is reauthorised, Qantas and British Airways believe that they are likely to be able to maintain and to expand their range of frequencies and capacities.

Overall, the JSA will continue to provide a broad range of public benefits, as described below.

- ***Product and Service Benefits*** The JSA continues to provide consumers with a range of benefits such as more destinations, broader schedule choices, more flexible fare products and higher levels of customer support.

- ***Cost Savings and Efficiencies*** The Applicants estimate that if the JSA is reauthorised, it should deliver significant savings in overheads such as IT and shared facilities. These savings are estimated to be worth at least $43 million for Qantas and [*CONFIDENTIAL INFORMATION DELETED*] million for British Airways in real terms over the next five years.

- ***Lower Fares*** The higher level of capacity made possible by the JSA means that the JSA is likely to result in greater availability of discount fares to consumers. In addition, the cost savings realised through the JSA and the ability to jointly manage inventory allows the Applicants to reduce fares in response to the high levels of competition on JSA routes without sacrificing product standards.

- ***Greater Net Exports*** The loss of the JSA would result in a reduction in foreign nationals carried by Qantas and therefore cause a loss of export earnings for Australia, estimated at approximately $418 million over the next 5 years in nominal terms. At the same time, many Australian consumers who would previously have travelled with Qantas would be forced to use other airlines. Depending on the extent to which the Applicants' reduced capacity resulting from loss of the JSA is replaced by foreign airlines, there may also be a significant increase in effective importation of services as Australian consumer expenditure is diverted from Qantas to foreign owned airlines. This increase in importation of services could be as much as $285 million in nominal terms over the next five years if the JSA is not reauthorised. Using a general equilibrium model of the Australian economy, NECG estimates that the gain in national income to Australia attributable to higher net exports under the JSA is likely to be between $165 and $301 million in real terms over the same period.

- ***Higher Employment*** The broader range of services supported by the JSA directly employs over 950 Australians. If the JSA is not reauthorised, a significant proportion of these jobs will be lost. There are also likely to be flow on effects for employment in the wider economy.

- ***Higher Levels of Tourism*** The higher level of capacity, lower fares, wider range of schedule choices and continuing presence and promotional expenditure associated with Qantas operating on JSA Routes in overseas markets mean that tourist numbers to Australia are likely to be higher with the JSA than without it. NECG calculates that due to capacity and promotion effects alone, loss of the JSA would be likely to lead to a reduction on average of between 3,800 and 10,700 tourists per year visiting Australia over the next 5 years. NECG therefore estimates that the loss in national income from lost tourism if the JSA is not reauthorised is likely to be between $58 and $353 million in real terms over 5 years, depending on the extent to which capacity that the Applicants are forced to withdraw would be replaced by other airlines.

- ***International Competitiveness of the Australian Airline Industry*** The success of Qantas as an international flag carrier is important to Australia. In the 2001-2002 financial year, Qantas accounted for approximately 2% of Australia's GDP, contributed $800 million to Australia's exports, purchased $2.4 billion of Australian goods and services and employed over 37,000 people. Overall, the JSA makes Qantas significantly more internationally competitive. Without the JSA, Qantas would be forced to withdraw a significant number of European services and reduce services between Australia and Singapore. This would materially weaken the Qantas international network which, in turn, would weaken Qantas' ability to remain a viable Australian owned and controlled international network carrier – something that is important to any country as geographically isolated and dependent on air transport as Australia.

To the extent quantifiable, NECG estimates the total net public benefit if the JSA is reauthorised to be in the range of $402 to $561 million in real terms over 5 years, depending on the extent to which the Applicants' reduced capacity arising from loss of the JSA is replaced by other airlines.

Conclusion

Overall, the JSA gives rise to a wide range of public benefits while creating little or no competitive detriment. The Applicants submit that the JSA should be reauthorised for an indefinite term.

1. INTRODUCTION

Application for Authorisation

1.1 This submission is made by Qantas Airways Limited ABN 16 009 661 901 and its subsidiaries (**Qantas**) and British Airways Plc ARBN 002 747 597 and its subsidiaries (**British Airways**) (together the **Applicants**) in support of an application for authorisation pursuant to section 88(1) of the *Trade Practices Act 1974* (**TPA**) to continue to give effect to the Restated Joint Services Agreement dated 3 April 2000, as amended, and any related and consequential coordination of schedules and pricing between the Applicants.

1.2 The Restated Joint Services Agreement came into effect in 2000 and replaced a similar agreement entered into in 1995 (the **Original Joint Services Agreement**). In this submission, the integrated alliance between the Applicants that was governed initially by the Original Joint Services Agreement and which is now governed by the terms of the Restated Joint Services Agreement, is referred to as the '**JSA**'.

1.3 The JSA will be terminated by the Applicants if this application for authorisation is not granted.

1.4 Under the JSA, the Applicants have implemented a benefit sharing arrangement in relation to their operation of services between:

(a) Australia and Europe;

(b) Australia and South East Asia; and

(c) Europe and South East Asia,

(together, the **JSA Services** or **JSA Routes**).

1.5 The JSA also provides for coordination by the Applicants of scheduling, pricing and sales in relation to services between Australia and Europe via any intermediate point, Australia and any intermediate points to Europe, and Europe and intermediate points to Australia, or such other routes as the Applicants may agree from time to time.

1.6 The key provisions of the Restated Joint Services Agreement are summarised in Appendix 1 of this submission and a copy of the agreement is attached to this submission at Appendix 2.

1.7 This submission explains the history and commercial background to the JSA and summarises, firstly, the likely competitive impact of the JSA in relevant markets and, secondly, the public benefits that will arise from reauthorisation of the JSA. Detailed independent economic analysis that supports these views is set out in a report prepared by Network Economics Consulting Group (**NECG**) lodged with this submission (**NECG Report**).

Confidentiality

1.8 The confidential version of this submission and its annexures include certain commercially confidential information. Disclosure of that information could result in material financial loss and prejudice the competitive position of the Applicants.

1.9 Pursuant to section 89(5) of the TPA, the Applicants apply for certain information contained in the confidential version of this submission to be kept confidential by the Commission and excluded from the register kept by the Commission in accordance with section 89(3) of the TPA. For convenience, the confidential information is indicated by the use of bold red square parentheses ([ ]) around confidential text or around the heading of a confidential table in the confidential versions of the submission and the NECG Report. This information has been deleted and replaced with '[***CONFIDENTIAL INFORMATION DELETED***]' in non-confidential public versions of the submission and the NECG Report, provided to the Commission.

Scope and Terms of Authorisation Sought

1.10 The JSA is pro-competitive. However, as the implementation of certain terms of the JSA constitute 'per-se' contraventions of the TPA, the Applicants are applying to the Commission for authorisation of the JSA pursuant to sub-section 88(1) of the TPA. The relevant tests for authorisation are set out in sub-sections 90(6) and 90(8) of the TPA.

1.11 The Applicants seek an unconditional authorisation of unlimited duration. In its determination of the application for authorisation of the JSA in May 2000[1] (**2000 Determination**) the Commission, while accepting that the JSA had delivered net public benefits since the date of the original authorisation, declined the Applicants' request for an authorisation of unlimited duration, citing uncertainty about the future type and extent of competition on JSA Routes.[2] The Commission's concerns have proven to be unfounded. Instead, the underlying trends observed in the first period of authorisation of the JSA have continued, most notably intense price and product competition, declining prices and the rise of the mid-point carriers at the expense of European carriers and the Applicants.

1.12 The need for the JSA is dictated by the structural features of the markets concerned. Qantas and British Airways face, and will continue to face, a significant disadvantage in comparison with mid-point carriers in serving the JSA Routes because of their geographic locations at either end of those routes. In addition, there is now over 7 years of historical data demonstrating that the JSA does not give rise to any competitive detriment while delivering substantial public benefits in a range of areas. There is therefore every reason to believe that the JSA will continue to deliver substantial net benefits for the foreseeable future.

1.13 Given these factors, the Applicants believe an authorisation of unlimited duration is justified. In the aviation industry many investments require very long lead times. Removing uncertainty as to the continuing authorisation of the relationship between Qantas and British Airways will enable the Applicants to plan for the future with confidence, particularly with respect to major investments in aircraft and IT systems which are being planned. An authorisation of unlimited duration will ensure that they are able to optimise their

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1 Commission Authorisation Number A30202.

2 2000 Determination, page 3.

investment decisions and continue to integrate their operations to the fullest extent possible, consequently delivering the greatest possible benefits to the public. In contrast, having to apply continually for reauthorisation of the JSA at relatively short intervals creates uncertainty and involves considerable resources in terms of time, cost and management resources (not only for the Applicants, but also the Commission) that might be better used elsewhere.

1.14 The Applicants note that section 91B of the TPA allows the Commission to review authorisations at any time if there is a material change of circumstances.

1.15 In the alternative, the Applicants seek a term of authorisation of not less than 10 years to provide the necessary certainty for the Applicants to continue to make joint investment decisions predicated on authorisation of the JSA, which in turn produce the public benefits described in this submission.

Proposed Alliance between Qantas and Air New Zealand

1.16 The Applicants note that this application is to be considered by the Commission contemporaneously with the application for authorisation lodged on 9 December 2002 by Qantas and Air New Zealand in respect of their proposed strategic alliance (**Air NZ Alliance**).

1.17 Both the Air NZ Alliance and the JSA are important to Qantas. However, the issues raised by the two alliances are separate and overlap in the markets affected is negligible. The applications for authorisation of each alliance should therefore be considered separately on their respective merits by the Commission. The reasons why the impact of the Air NZ Alliance on markets affected by the JSA is likely to be minimal are discussed in further detail in section 5 of this submission.

Uncertainty in International Aviation Markets

1.18 The Applicants acknowledge that they are lodging this application at a time of considerable uncertainty with respect to the international conflict in Iraq and the outbreak in Asia of Severe Acute Respiratory Syndrome (SARS). The combination of SARS and the war in Iraq has significantly reduced demand for JSA Services, at least in the short term, and is resulting in temporary capacity and frequency reductions for many carriers on JSA Routes. This could also have an impact on the timing and quantum of the net public benefits that result from the JSA.

1.19 However, this is unlikely to alter the underlying structure or performance of the relevant markets in the medium to long term. Accordingly, the economic analysis and conclusions on net public benefits presented in this submission and the NECG Report will remain relevant notwithstanding any short term uncertainty and volatility in demand for air services on JSA Routes.

2. THE APPLICANTS

Qantas

2.1 Qantas was incorporated in Queensland in 1920 and is Australia's only international and largest domestic airline. Qantas operates a domestic and international fleet of 194 aircraft linking 142 destinations in 32 countries. Qantas employs more than 37,000 people worldwide and is the 12th largest airline, on the basis of revenue passenger kilometres.

2.2 Qantas is one of Australia's 30 largest listed companies. Qantas' main business is the transportation of passengers and air freight. In addition to the core airline, Australian Airlines provides a number of international air services and the following Qantas subsidiaries operate regional airline services under the QantasLink brand: Eastern Australia Airlines Pty Limited, Sunstate Airlines (Qld) Pty Limited, Airlink Pty Limited and Impulse Airlines Pty Limited. The following Qantas subsidiaries provide inflight catering services: Qantas Flight Catering Limited, Caterair Airport Services (Sydney) Pty Limited, Caterair Airport Services Pty Limited and Snap Fresh Pty Limited. Qantas Holidays Limited operates holiday, tour and travel businesses.

2.3 Qantas also holds 46.32% of the shares in Air Pacific.

2.4 A copy of the Qantas Annual report for the year ending 30 June 2002 can be obtained from <http://www.qantas.com.au/info/about/investors/annualReports>.

British Airways

2.5 British Airways is incorporated in the United Kingdom, was privatised in 1987 and is listed on the London Stock Exchange. British Airways operates domestic and international passenger and freight services from its principal bases at Heathrow and Gatwick airports and other points in the UK.

2.6 British Airways is one of the world's leading airlines and operates a domestic and international fleet of 373 aircraft linking 159 destinations in 75 countries. In the 2001/2002 financial year, the British Airways Group carried more than 44 million passengers and employed more than 60,000 people worldwide. Its turnover for 2001/2002 was £8,340 million (€12,936.8 million) and it made a pre-tax loss of £200 million (€310.2 million).

2.7 British Airways currently has two Directors on the Qantas Board.

2.8 A copy of the 2001/2002 British Airways Annual Report can be obtained from <http://www.bashares.com/content/downloads/ar2002_overall.pdf.>

Competitor Profiles

2.9 Qantas and British Airways compete with more than a dozen airlines on the JSA Routes[3]. Competitor profiles have been prepared on some of the Applicants' major competitors on the JSA Routes and are annexed at Appendix 4.

3. THE JSA AND THE QANTAS/BRITISH AIRWAYS RELATIONSHIP

Overview

3.1 There are three important and complementary aspects to the relationship between Qantas and British Airways:

(a) the equity relationship;

(b) the bilateral JSA relationship; and

(c) the multilateral **one**world relationship.

Equity Relationship

3.2 In March 1993, British Airways acquired a 25% equity interest in Qantas from the Australian Government. Its current shareholding is 18.93% (it has been diluted as a result of capital raisings in which British Airways did not participate).

3.3 From the Australian Government's perspective, the sale of Qantas shares to British Airways in 1993 was intended to strengthen Qantas and the Australian aviation industry and benefit consumers by allowing strategic cooperation between Qantas and British Airways, including integration of their route networks and achievement of synergies in their respective operations.

3.4 In 1992 the then Federal Minister for Finance, the Honourable Ralph Willis stated:

> '...*the Government was motivated in taking this course [conducting a trade sale] by a concern to achieve a close alliance with another international airline so as to ensure a long term future for Qantas in the world of mega airlines likely to provide increasingly severe competition*'[4]

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3 Carriers operating flights between Australia and Europe include Singapore Airlines, Thai Airways International, Cathay Pacific, Emirates, Garuda, Japan Airlines, Malaysia Airlines, Austrian/Lauda Airlines, Royal Brunei Airlines, United Airlines, South African Airways, Air New Zealand and Korean Airlines. Many more airlines compete through the use of codeshare arrangements, including Lufthansa, Virgin Atlantic, Gulf Air, KLM, Air France, SAS (Scandinavian Airlines), Swiss International Airlines, Alitalia, Aeroflot, Finair, American Airlines, Air Mauritius and Turkish Airlines.

4 Address by the Hon R Willis, MP, Federal Minister for Finance to IIR Aviation Reform Conference, 22 September 1992.

3.5 It is clear that the Australian Government still views the British Airways relationship in this manner. Foreign Minister Alexander Downer recently observed that British Airways' stake in Qantas had given Qantas better links to Europe, better codesharing arrangements and facilities and a capital injection.[5]

The Joint Services Agreement

3.6 It was a term of the sale and purchase agreement between the Australian Government and British Airways that British Airways enter into a commercial agreement with Qantas. This led to the Original Joint Services Agreement which was authorised in 1995 for a period of 5 years, subject to certain conditions. Under the Original Joint Services Agreement, the Applicants agreed to coordinate business activities regarding their routings, fares, frequencies, aircraft types, product specifications, aircraft configurations, connection requirements and other aspects of their operation and marketing of JSA Routes.

3.7 In April 2000, reflecting the continuing success of the alliance, the Applicants agreed to expand the arrangements under the Original Joint Services Agreement. The resulting Restated Joint Services Agreement contemplated that, among other things, the Applicants could extend their coordination and benefit sharing to any part of their respective networks. In practice though, the Applicants have not chosen to expand the routes to which benefit sharing arrangements are applied.

3.8 The JSA received an unconditional authorisation from the Commission in May 2000. At the time, the Commission noted that:

> *'there has been no lessening of competition over the period of the [Original] JSA'*
>
> and
>
> *'Qantas and BA have been able to reduce fares in response to increased competition from sixth freedom carriers as a result of cost savings made under the [Original] JSA*[6].

3.9 In 2000, the Commission limited the authorisation period to just over three years, largely because of perceived uncertainties in the aviation industry. The expiry date for the authorisation was set at 21 July 2003, to coincide with the expiry of the Commission's authorisation of the alliance between Singapore Airlines, Ansett Australia, Ansett International and Air New Zealand (**SQ/AN/NZ Determination**)[7].

3.10 The only amendments to the JSA since 1999 have been the following:

(a) the benefit sharing model was amended by agreement dated 27 September 2001. A copy of this agreement is included with the copy of the Restated Joint Services Agreement attached at Appendix 2; and

(b) changes in the JSA Routes operated by the Applicants have resulted in consequential changes to the sectors in respect of which the benefit sharing model is applied. The sectors in respect of which the benefit sharing model currently applies are set out at Appendix 3.

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5 'Qantas taking over Air NZ? It is just rot', *Daily Telegraph*, 24 December 2002, page 23.
6 2000 Determination, page 3.
7 A90649, A90655.

3.11 Extracting maximum synergies from the relationship facilitated by the JSA has taken time. The alliance continues to broaden and deepen as the Applicants 'learn from doing' and find new ways to deliver efficiencies and benefits. Since 1995, the Applicants have worked steadily to achieve closer and more effective coordination and deliver benefits to the Applicants and to consumers. Some of the major practical commercial steps taken over that period to implement the JSA vision are detailed below.

Coordinated Network Development

3.12 Before the JSA, Qantas and British Airways' networks duplicated each other substantially, yet provided few logical connections. Since the implementation of the JSA, Qantas and British Airways have worked together to develop their networks to ensure that as many of their services as possible meet at common mid-points at coordinated times to allow easy hubbing between flights. This allows passengers to transfer easily between flights, increasing the range of cities between which the Applicants can offer customers convenient 'one stop' services and creating efficiencies by allowing the Applicants to distribute traffic optimally across their services.

3.13 The JSA has allowed Qantas and British Airways to reduce the number of inefficient 'end tags'[8] that each previously operated in the other's home market. Under the JSA, the preferential access that British Airways gives Qantas to its short haul European network means that a Qantas customer travelling to, say, Manchester can transfer easily at London from a JSA plane to a British Airways connection. Qantas has therefore been able to terminate loss-making end tags, such as the end tag that it previously operated from London to Manchester. Similarly, British Airways has been able to rationalise inefficient and loss-making end tags, such as extensions of London-Sydney flights to Melbourne. These and similar changes have allowed the Applicants to achieve significant improvements in aircraft utilisation and corresponding cost savings with no loss in customer service levels.

3.14 At the same time, the increased connectivity between British Airways and Qantas services and the building of the Singapore mini-hub have allowed the Applicants to increase the number of one stop services they are able to offer per week between Australia and Europe from 82 at the start of the JSA, to 105 in 1999, to 123 today. Over the same period, the number of connections able to be made at the Applicants' mid-points between JSA Services per week has increased from 68 in 1995, to 83 in 1999, to 158 on current schedules.[9]

Joint Management Structures

3.15 Joint network development has been facilitated by the establishment of a dedicated alliance management team made up of Qantas and British Airways staff. Located in Qantas' Mascot offices, this team has responsibility for optimising the joint operation of JSA Routes. A manager from this team is also located in the British Airways Waterside offices in London to coordinate joint commercial activity relating to JSA Services.

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8 An end-tag is an extension flown at the end of a route, usually to allow a carrier to serve a second city.

9 This calculation has been made on the basis of the Applicants' normal schedules. As noted in section 1, the combined effects of the war in Iraq and the outbreak of SARS have required the Applicants to implement temporary capacity and frequency reductions on some JSA Routes.

3.16 In addition, the Applicants have established a 'Joint Services Committee' comprising senior managers from both companies who meet quarterly and hold monthly conference calls to review the JSA Services' business performance. This committee is also responsible for agreeing the joint business plan, including aircraft schedules and associated targets.

3.17 The executive management of both companies also meets periodically to agree strategic direction for the JSA Services and other working groups are established as necessary to fulfil particular tasks.

Standardisation and Joint Development of IT Systems

3.18 The ability of the Applicants to jointly manage their networks for maximum efficiency was initially limited by differences between each company's IT systems. To overcome these limitations, Qantas and British Airways have collaborated on and jointly developed some of their most important and critical IT systems, including inventory, yield management, reservation and departure control systems.

3.19 Flight inventory systems enable airlines to manage their different fare classes. Yield management systems are used to forecast demand, analyse sales and adjust inventory levels of different fare classes in response to demand as the departure date approaches. Reservation systems are the interface between an airlines' inventory system and sales agents and direct consumers - they are the means by which airlines keep track of bookings and the issuing of tickets and tell agents and customers what seats are available. Departure control systems use data kept in the reservations system to facilitate check in and loading and departures of aircraft, including crucial functions such as weight and balance load control to ensure that loads in aircraft are safely and optimally distributed.

3.20 Each of these IT systems is fundamental to the efficient and profitable operation of an airline and to the ability of an airline to offer high levels of customer service. The collaboration of Qantas and British Airways under the JSA has enabled them to develop leading edge applications at lower cost and less risk than would otherwise have been the case. For example, since 1995, Qantas and British Airways have jointly invested over $[*CONFIDENTIAL INFORMATION DELETED*] million in the successful development and implementation of new Origin & Destination Yield Management systems. Qantas migrated its reservation, inventory and departure control systems to the QUBE platform, which was based on British Airways systems, and has since undertaken a major project with British Airways to develop the next generation of these systems in collaboration with Amadeus.

Joint Yield and Inventory Management

3.21 Qantas and British Airways have worked together to continuously improve their yield and inventory management. One of the early steps in this process involved the adoption of common systems to facilitate joint yield and inventory management. Since then, the Applicants have worked together to jointly develop those systems to industry leading standards.

3.22 The British Airways capacity (inventory) management team for JSA Services is collocated with the Qantas capacity management team at the Qantas offices in Mascot. Fortnightly conference calls are held between Qantas and British Airways management teams to discuss and coordinate overall management and pricing of the JSA Routes.

Joint facilities

3.23 Over the course of the JSA, the Applicants have developed joint sales teams, joint management teams and joint airport operations teams in Singapore and Bangkok. This gives each airline a level of presence at mid-points of JSA operations that neither airline could justify on its own. In addition, the Applicants cooperate in a range of other ways throughout the world, including:

(a) sharing use of a range of IT facilities and hardware;

(b) constructing joint lounges in airports throughout the world (such as Singapore, Bangkok and Hong Kong) to offer customers facilities that neither airline could justify on its own;

(c) sharing or collocating telephone sales teams in Malaysia, New Zealand, Singapore, Italy, Germany, France and Thailand; and

(d) collocating management teams in 19 countries around the world.

Codeshares

3.24 The Applicants have entered into bilateral codeshare agreements on all JSA Routes and the routes listed in Appendix 5.

oneworld Marketing Alliance

3.25 The **one**world marketing alliance founded by British Airways, Qantas, American Airlines Inc, Canadian Airlines International Ltd and Cathay Pacific Airways Limited, was created in September 1998 and has grown to 8 members with the addition of Finnair, Iberia, Aer Lingus and Lan Chile and the withdrawal of Canadian Airlines after its purchase by Air Canada.

3.26 **one**world is a multilateral marketing alliance. It provides for a range of joint customer service and marketing measures, such as mutual recognition of frequent flyer programs and reciprocal access to lounges and check in facilities between the member carriers.

3.27 Except where a further bilateral, integrated alliance exists (such as the JSA), **one**world carriers compete head to head on routes where their networks overlap. Thus, for example, Cathay Pacific and Qantas directly compete on routes to Hong Kong and British Airways and Cathay Pacific compete between the United Kingdom and Hong Kong.

3.28 Therefore, while the **one**world marketing alliance complements the equity and bilateral relationship between Qantas and British Airways, it is very different in character and scope and could not deliver the same type or extent of public benefits as the integrated JSA. The reasons for this are discussed in further detail in section 2 of the NECG Report.

4. THE FUTURE WITH AND WITHOUT THE JSA

Overview

4.1 When assessing the effect on competition in relevant markets and the public benefits associated with proposed conduct, the likely state of the relevant markets with and without that conduct must be compared. In order to do this, the Applicants have predicted:

(a) how they and other market participants are likely to behave if the Commission reauthorises the JSA (the **Factual**); and

(b) how they and other market participants are likely to behave if the Commission does not reauthorise the JSA (the **Counterfactual**).

4.2 In order to be as accurate as possible in their predictions of the future with and without the JSA, Qantas and British Airways have individually considered what they would be likely to do if the JSA were not authorised and what they plan to do if it continues. Using their existing fleet and network planning frameworks, the Applicants have each analysed the feed, marketing contribution and other network benefits that are facilitated by the JSA. The net impact of changes to these factors on contribution margins and route profitability – key drivers of decisions whether to enter or exit a route or to expand or reduce capacity – has then been used by each party to determine what their respective counterfactual schedules would most likely be. The resulting combined Counterfactual schedule has then been used by NECG as a basis for assessing benefits and detriments.

4.3 Understanding the impact of the loss of the JSA on the Applicants' respective businesses requires an appreciation of the underlying economic characteristics of the Kangaroo Route, the disadvantages that would be faced by Qantas and British Airways in separately competing on that route and the manner in which the JSA helps counteract those disadvantages. We therefore turn briefly to a discussion of the nature of the Kangaroo Route before describing the Counterfactual in detail.

Nature of the Kangaroo Route

4.4 The term 'Kangaroo Route' is used in this submission and in the NECG Report to refer to what is in fact a bundle of routes between Australia and Europe via Asia or the Middle East.[10] These are the longest high frequency commercial aviation routes in the world. The extreme long haul nature of the Kangaroo Route means that aircraft must stop at a mid-point to refuel and change crew. Since this makes it impossible to operate services non-stop, the Kangaroo Route must always be operated as a combination of at least two separate flight sectors.[11]

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10 This term may sometimes be used more narrowly in other contexts to describe routes between Australia and Europe via South East Asia. Also, while much of the analysis presented here and in the NECG Report focuses on the westbound Kangaroo Route(s) to Europe from Australia, primarily for the reason that these routes account for the majority of passenger traffic, routes to Europe via the United States are viable substitutes for travel to Europe and are included within the definition of the Europe-Australia passenger and freight air services markets adopted for the purposes of this application (refer to section 5).

11 A 'sector' is any portion of a journey from when an aircraft takes off to when it next lands. Sectors are also commonly referred to as 'legs' of a journey.

4.5 How this combination of sectors on a journey between Australia and Europe is created will depend on where the carrier is based. A carrier based at one or other end of the Kangaroo Route (an **end-point carrier**) such as Qantas or British Airways must operate the Kangaroo Route by flying first to a mid-point, refuelling and then continuing the same service on to the ultimate destination. This mid-point will be in either Asia or the Middle East.

4.6 By contrast, a carrier that has its hub of operators at a mid-point between Australia and Europe (a **mid-point carrier**) has no need to utilise an extremely long two sector flight in order to operate the route. Instead, it can carry passengers on the Kangaroo Route by combining any of the independent single sector flights that it operates between its hub and ports in Australia with any of the flights that it also operates from its hub to parts of Europe.

The Challenge for End-Point Carriers

4.7 The second sector, or 'end sector' of a two sector Kangaroo Route service is intrinsically difficult to operate profitably. Typically, a two sector service will leave the carrier's hub with a full load of passengers, however at the mid-point many passengers will disembark, leaving the end-point carrier with only a partly full plane for the end sector to the flight's ultimate destination. For example, almost half of Qantas' passengers who travel to Singapore leave Qantas there and do not continue on or connect to a JSA flight to Europe.[12] End-point carriers therefore suffer a fundamental disadvantage in seeking to sustain services over the Kangaroo Route, as they can never refill their planes at the mid-point as easily or with as high yielding passengers as mid-point carriers.

4.8 Over the life of the JSA, yields on the Kangaroo Route have progressively reduced. At the same time, mid-point carriers with the advantage of well located hubs and often also buoyed by government support, have continued to strengthen and grow. The result is that end-point carriers have found it increasingly difficult to remain viable on the Kangaroo Route, with carriers such as Air France, Alitalia, Lufthansa, Olympic Airways and KLM being forced to cease services to Australia. Today, the only European carriers on the Kangaroo Route are British Airways and Austrian Airlines/Lauda Air.

The Advantages of Operating the Kangaroo Route from a Mid-Point Hub

4.9 As described in detail in section 3 of the NECG Report, the hub and spoke model is the pre-eminent model for international aviation, particularly for long-haul operations. Hub carriers focus traffic around a central hub, to which traffic from multiple destinations is brought and then distributed to other destinations. Each flight in a hub carrier's network is able to draw on feeder traffic from a wide range of destinations, rather than having to rely on local traffic. Hub systems therefore create economies of density and make services to a wider range of destinations viable.

4.10 The majority of passengers on the Kangaroo Route are carried by mid-point carriers. As noted above, in contrast with the difficulties end-point carriers face in operating extremely long two sector flights, mid-point carriers can operate each sector of Kangaroo Route flights separately, drawing feed for each destination from the whole of the carrier's home hub network.

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12 [*CONFIDENTIAL INFORMATION DELETED*]

How Does the JSA Address the Applicants' Competitive Disadvantages?

4.11 By operating in alliance, the Applicants have been able to remain competitive on the Kangaroo Route and to overcome some of the difficulties inherent in operating two long sector services from end-points on the Kangaroo Route. This could not have been achieved by either carrier on its own. Authorisation of the JSA allows the Applicants to do this because it gives each carrier the ability and financial incentive to:

(a) support Kangaroo Route services from both ends of the route to alleviate the 'end sector' problem for each airline – British Airways supports the route with single sector passengers between Europe and the mid-points, whilst Qantas contributes single sector passengers between Australia and the mid-points;

(b) combine and coordinate traffic to create a 'mini-hub' in Singapore where Qantas and British Airways can provide feed to each other's flights. Neither British Airways nor Qantas has sufficient traffic on the Kangaroo Route to properly support such an operation on its own; and

(c) combine resources to create joint sales and support operations in Singapore, Bangkok and elsewhere in Asia, which allows Qantas and British Airways to support their Kangaroo Route services at their mid-points (including by generating local traffic) more effectively than would be viable for either carrier on its own.

Key Features of the Factual and Counterfactual

4.12 If the JSA were not reauthorised, the Applicants would have to cease operating their JSA Services as an integrated alliance. However, for the purposes of this submission it is assumed that British Airways would retain its shareholding in Qantas, its right to appoint two directors to the Qantas Board and the Applicants would remain members of the **one**world marketing alliance.

4.13 Under the Counterfactual, Qantas and British Airways would directly compete on overlapping routes. Competition and rivalry on these routes is likely to mean that the sphere of their cooperative activities would be reduced to the core of activities provided under **one**world, such as reciprocal recognition of frequent flyer benefits and lounge access. Even on routes where their networks do not overlap, codesharing is considered unlikely, since Qantas and British Airways would each seek to maximise its own traffic on the long haul sectors on which their services overlap. Thus, for example, Qantas would be unlikely to grant codesharing rights to British Airways on Singapore - Perth services because of the likelihood that this would assist British Airways to 'steal' passengers from Qantas on the London - Singapore sector.

4.14 Overall, the competitive environment is likely to be similar to the existing commercial relationship between Cathay Pacific and Qantas, which despite their membership of the **one**world marketing alliance, compete vigorously on overlapping routes.

4.15 Absent the JSA, a reduction in the services operated by Qantas and British Airways between Australia and Europe is inevitable. This would result from:

(a) reduced feed contributed from one airline to the other;

(b) reduced connectivity; and

(c) the flow on effect to the networks of the Applicants from removing weakened spokes from the Applicants' 'mini-hub' in Singapore.

4.16 Specifically, Qantas anticipates that, in the absence of the JSA, it is likely that it would be forced to withdraw at least ten services per week between Australia and Europe, and rationalise its services between Singapore and Australia.

4.17 Similarly, absent the JSA, in the medium term British Airways would most likely reduce its daily 'through' services to Australia on the Kangaroo Route from 3 to 2. In the longer term,[13] British Airways would most likely further reduce its through services to Australia to one daily [*CONFIDENTIAL INFORMATION DELETED*], plus 2 daily services from London terminating in Singapore and Bangkok respectively.[14]

4.18 In contrast, with the JSA, the Applicants believe that they would be able to maintain and expand capacity. In the longer term, it is likely they would jointly increase frequency by 13% and capacity by 19% over the next five years[15] as compared to the current schedule. These levels equate to a 60% increase in frequency and at least a 54% increase in the Applicants' capacity to Australia compared to the same period if the JSA is not reauthorised.[16]

4.19 A detailed explanation of the current Factual and Counterfactual schedules for Qantas and British Airways and the manner in which those schedules were developed is set out in section 7 of the NECG Report.

5. COMPETITION IN THE RELEVANT MARKETS

Market Definition

5.1 Having regard to previous determinations of the Commission and the analysis set out in section 4 of the NECG Report, the Applicants submit that the Australian markets primarily affected by the JSA are:

(a) the markets for the provision of passenger air services between:

(i) Australia and South East Asia; and

(ii) Australia and Europe,

(together, the '**JSA Passenger Air Services Markets**'); and

(b) the markets for the provision of freight services between:

(i) Australia and South East Asia; and

(ii) Australia and Europe,

13 In this submission, 'long term' is used to refer to a time frame of 4 to 5 years.
14 Refer to 'Expected factual and counterfactual frequencies',, section 7.2.3, NECG Report, Table 47.

(together, the '**JSA Freight Markets**').

5.2 Although British Airways is precluded from operating domestic Australian passenger air services,[17] it may also be relevant to discuss domestic air passenger services in Australia for the purpose of considering the impacts of the JSA on domestic competition. The Commission took this approach in the SQ/AN/NZ Determination.[18] The market for travel distribution services in Australia has also been considered on previous occasions. Accordingly, potential impacts on domestic air passenger services and travel distribution services are also considered below and in the NECG Report.

5.3 The Applicants consider it extremely unlikely the JSA could have any adverse impacts in ancillary markets such as for the supply of IT services or engineering and maintenance services. If, however, the Commission considers that further consideration of these ancillary markets is required, the Applicants would be pleased to provide further information.

5.4 The Applicants consider that their approach to market definition is generally consistent with previous determinations of the Commission including, most relevantly, the 2000 Determination and the SQ/AN/NZ Determination. The Applicants believe that the conclusions reached by the Commission on market definition in those decisions remain equally applicable today.

5.5 The Applicants do note that, with respect to the product dimension of the definition of air passenger transport markets, in the 2000 Determination the Commission, while not concluding that there were separate markets, stated that it would:

> '*proceed with its examination of this application on the basis that a single air transport market for economy and premium class passengers can no longer be assumed*'.[19]

5.6 While it is unlikely to make any material difference to the analysis presented in this submission or the NECG Report, the Applicants remain of the view that, for the purposes of market definition, there is no relevant distinction between business and leisure passengers, the economy and business/first class cabins or between different fare classes. NECG supports this view for the reasons discussed in the NECG Report at section 4.1.1. Accordingly, this submission proceeds on the basis that there is a single product market for air passenger services and that different cabins in an aircraft or different passenger types (business/leisure) represent different segments of the passenger market rather than representing different markets.

5.7 The impact of the JSA on each relevant market is discussed briefly in this section and is considered in more detail in sections 5 to 9 of the NECG Report.

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15 Refer to Factual schedules, section 7.1 NECG Report, Tables 43 and 44.
16 Refer to 'Expected factual and counterfactual frequencies, section 7.2.3, NECG Report, Table 47.
17 Unless it were to do so through an Australian subsidiary.
18 SQ/AN/NZ Determination, pages 64 and 65.
19 2000 Determination, page 50.

Competition - Overview

5.8 Assessing whether competition would be substantially lessened in a market must usually be done on a purely hypothetical basis prior to implementation of a transaction. However, in this case, the Commission has the benefit of observing over seven years of the JSA's operation and its effect on competition. This experience demonstrates that, far from lessening competition, the JSA has in fact been pro-competitive and is likely to continue to be so. In particular:

(a) the effect of the JSA has been to increase rather than decrease capacity on JSA Routes. British Airways and Qantas have significantly increased capacity on JSA Routes over the period of the JSA;

(b) the aggregate market shares of mid-point carriers have increased substantially, whilst those of the Applicants and European carriers have fallen;

(c) barriers to entry and expansion, particularly for mid-point carriers, are low;

(d) price competition has remained intense (with benchmark passenger fares falling in real terms);

(e) the range and quality of passenger services provided by Qantas and British Airways and their competitors has continued to improve, indicating that product competition has also been strong on JSA Routes.

5.9 Overall, the JSA has enabled the Applicants to continue to provide effective competition in intensely challenging and competitive markets at a level that would not otherwise have been financially sustainable. The JSA has therefore been, and will continue to be, very much pro-competitive. This is consistent with the Commission's assessment in the 2000 Determination that there had '*been no lessening of competition over the period of the [Original] JSA*'.[20] This conclusion is also supported by NECG's analysis.

Competition in JSA Passenger Air Services Markets

<u>*Capacity*</u>

5.10 Generally speaking, competition regulators are concerned about mergers or coordination between firms because of the possibility that they may lead to the merged entity seeking to maximise profits by decreasing output and increasing prices.

5.11 Conversely, under the JSA, the benefits realised by Qantas and British Airways through engaging in the joint activities permitted by authorisation have not resulted in their decreasing capacity. Rather, Qantas and British Airways have substantially *increased* their capacity on JSA Routes over the term of the JSA. This capacity growth would not have been possible absent the JSA. Looking forward, Qantas and British Airways will continue to be able to deploy significantly greater capacity in the future with the JSA than would be the case without the JSA. Indeed, the Applicants' frequencies to Australia in the longer term are

[20] 2000 Determination, page 87.

estimated to be 60% and capacity to Australia at least 54% higher if the JSA is reauthorised than over the same period if it is not reauthorised.[21]

5.12 Thus, rather than leading to decreased output and higher prices, it is much more likely the JSA will result in a more competitive environment characterised by higher output and lower fares.

Market Concentration

5.13 There are two types of data that can be used to provide an indication of market shares - Australian Bureau of Statistics (**ABS**) data and MiDT data.[22] Each of these data sets has advantages and disadvantages. ABS data has been used by the Commission in previous determinations, while MiDT data has been widely used by European and United States competition regulators.

5.14 The differences between these two data sets are discussed in further detail in Appendix A of the NECG Report. As a general proposition, it is worth noting that ABS data will tend to overstate Qantas' market share on Australia to Europe routes for the reasons discussed in the NECG Report. On Australia to South East Asia routes, the figures tend to be more consistent. Also, the Applicants only hold records of MiDT data since 1998, so ABS data is useful for illustrating longer term trends. Key ABS and MiDT market data are set out in section 5.1 of the NECG Report.

5.15 Irrespective of which data set is used, two important trends are clear. First, the JSA Air Passenger Services Markets feature a large number of competitors, especially by international aviation standards. Because of the long haul nature of the Kangaroo Route and the requirement for a stopover, there are a large number of routings between Australia and Europe which are effective substitutes for each other. Accordingly, there are more than a dozen different airlines which provide competitive services from Australia to Europe[23]. This is notably higher than most country to country or country to region routes, where very high proportions of traffic are often shared between the two 'flag carriers' at either end of the route.

5.16 Secondly, over the term of the JSA, mid-point carriers have substantially increased their market shares, largely at the expense of European based carriers, while the combined British Airways and Qantas market share has declined. On ABS data, the current combined market share of Qantas and British Airways on routes between Europe and Australia is 43%. This represents a decline of 2% since 1995. On MiDT data, the combined market share is 33%, a 2% decline since 1998. Between Australia and South East Asia, Qantas and British Airways' combined market share is currently 33% on ABS data, a decline of over 11% since 1995. On MiDT data, the combined market share is currently 32%, a decline of 7% since 1998. In contrast, on ABS data, Singapore Airlines, Malaysia Airlines, Thai Airways, Cathay Pacific and Emirates' combined market share between Australia and Europe has almost doubled from 21% to 39% during the period that the JSA has been in operation.

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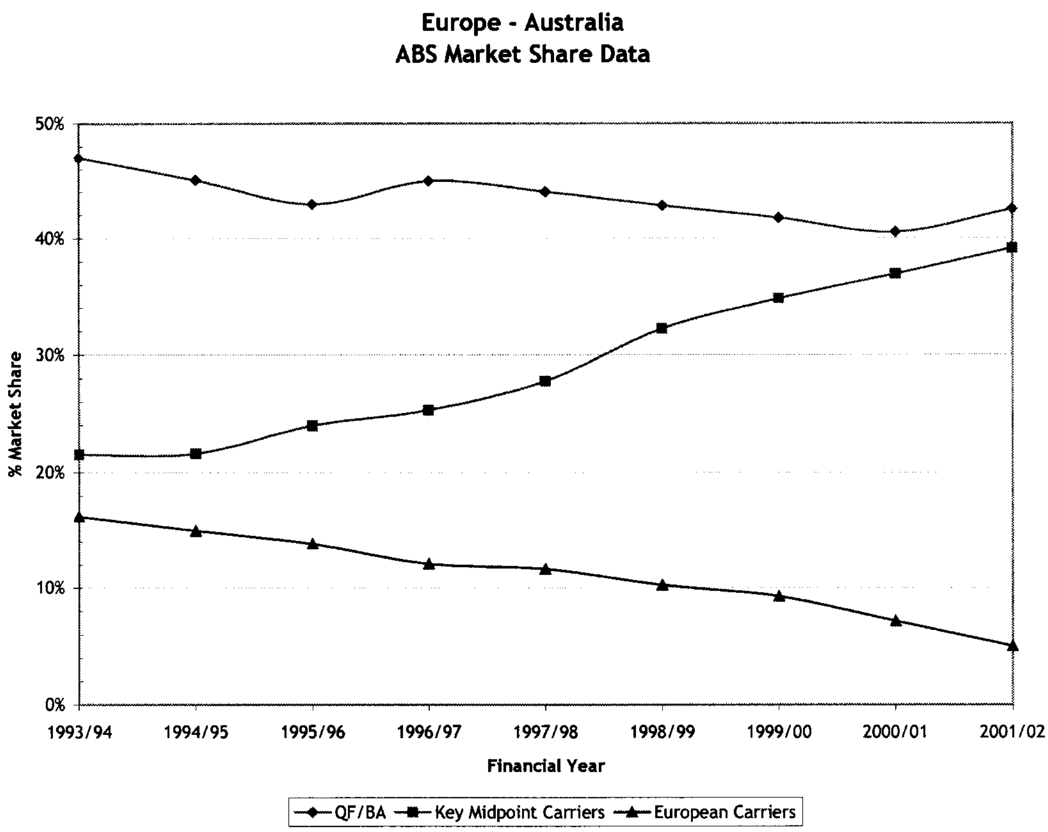
21 Refer to section 7, NECG Report, especially section 7.2.3.

22 MiDT or 'Marketing Information Data Transfer' data is collected through the computerised information and reservation systems used by travel agents to book airline tickets.

23 Carriers operating flights between Australia and Europe include Singapore Airlines, Thai Airways International, Cathay Pacific, Emirates, Garuda, Japan Airlines, Malaysia Airlines, Austrian/Lauda Airlines, Royal Brunei Airlines, United Airlines, South African Airways, Air New Zealand and Korean Airlines. Many more airlines compete through the use of codeshare arrangements, including Lufthansa, Virgin Atlantic, Gulf Air, KLM, Air France, SAS (Scandinavian Airlines), Swiss International Airlines, Alitalia, Aeroflot, Finair, American Airlines, Air Mauritius and Turkish Airlines.

5.17 Meanwhile, European carriers, such as Air France, Alitalia, KLM, Lufthansa and Olympic have all ceased operating in the Australia – Europe market since 1995. Similarly, substantial increases in Asian carriers' market shares are evident in the Australia – South East Asia markets on both ABS and MiDT data.[24]

5.18 Overall, the market share data demonstrates that, consistent with their economic advantages, mid-point carriers' market shares have grown rapidly, and largely at the expense of the European carriers, most of which have been forced to exit. While Qantas and British Airways have increased their services in absolute terms, this has not been to the same extent as the mid-point carriers, with a resulting decline in market share for Qantas and British Airways over the term of the JSA.



Barriers to Entry and Expansion for Mid-Point Carriers

5.19 Potential barriers to entry and expansion on JSA Routes are an important factor in making an assessment of the likely future competitive environment. Among other things, factors such as network and density economies, regulatory barriers such as capacity under bilateral Air Services Agreements, slot constraints at airports and capital costs need to be considered.

5.20 NECG has considered these potential barriers to entry and expansion on JSA Routes in detail in its report. NECG's overall conclusion is that, while the economics of the Kangaroo Route may present a barrier to entry to end-point carriers, particularly on city pair routes where passenger traffic is relatively thin, there is

24 Refer to market share data in section 5.1, NECG Report.

unlikely to be any material constraint on further expansion by mid-point carriers as a result of regulatory barriers, lack of slots or any other factor. NECG also notes that a number of mid-point carriers are likely to have capital cost advantages over Qantas and British Airways due to public ownership.

5.21 However, the most compelling evidence of the lack of barriers to entry and expansion by mid-point carriers is the increase in market share of the mid-point carriers since 1995 described above, including the extremely successful entry and penetration of Emirates into the Australia - Europe market since 1996. Looking forward, Emirates has recently announced a capacity increase of 25% with the purchase of 11 new aircraft, including the new A340-500 which Emirates will use to fly one stop services from Sydney to Europe from 26 October this year. Emirates will also launch daily B777-300 services to Brisbane via Singapore, giving it its fourth Australian route after Sydney, Melbourne and Perth.[25] Gulf Air has also announced its intention to commence services in June 2003 between Australia and Europe via the Middle East.[26]

5.22 Virgin Atlantic has also indicated its intention to commence services between the UK and Australia with the support of Virgin Blue at the Australian end of the route.

5.23 Entry and expansion plans announced by the above airlines are described in more detail in Appendix 4.

Prices and Profit Margins

5.24 A comparison of fares on the Kangaroo Route over the course of the JSA clearly indicates that Qantas and British Airways have not been able to exercise any degree of market power or raise prices. Indeed, average fares have fallen substantially in both nominal and real terms since 1995.

5.25 When the Original Joint Services Agreement was authorised, the then Trade Practices Commission made it a condition of authorisation that a representative economy benchmark fare (the **benchmark fare**) must not rise faster than the Consumer Price Index (**CPI**) over the course of the authorisation. In the Applicants' last application for authorisation, it was noted that, far from rising faster than the CPI, the actual benchmark fare had in fact fallen. While it was not a condition of the 2000 Determination, the Applicants have nevertheless calculated movements in the benchmark fare since the 2000 Determination. This analysis indicates that even in nominal terms, the benchmark fare is still lower than it was in May 1995 when the JSA commenced - $1,988 in 1995 compared to $1,762 today. When adjusted for CPI changes, the reduction in the benchmark fare has been over 25% since 1995.

5.26 NECG has also undertaken an extensive analysis of costs, yields and profitability on JSA Routes. This is detailed in section 5.3 of the NECG Report. NECG's conclusion is that increases in costs have not been offset by increases in yields, and that as a result, route profitability has declined.

5.27 The overall picture is clearly one of intense and sustained price competition with clear evidence that Qantas and British Airways have neither been able to raise prices above competitive levels, nor achieve supra competitive profits as a result of the JSA. There is every reason to believe that this will remain the case for the foreseeable future and that the JSA will actually result in more discount fares being available to consumers.

Product Competition

5.28 Competition on JSA Routes has not been limited to the realm of price. At the same time as fares and yields have been falling, carriers on the JSA Routes have been engaging, and continue to engage, in vigorous competition to continually upgrade the quality of their services.

5.29 For example, when the JSA was first authorised in 1995, the standard in-flight entertainment offered by carriers on JSA Routes was a single movie channel shown on central screens in aircraft cabins. During the period of the JSA, however, nearly all major carriers on the JSA Routes (including the Applicants) have moved to provide passengers with individual screens. Singapore Airlines and Cathay Pacific have taken these improvements a step further by installing video and audio 'on demand' systems that not only provide passengers with their own screen, but allow passengers to start or stop the movies or music of their choice whenever they wish. Other carriers, including Qantas and British Airways, now also offer passengers in-seat video games and satellite telephones and some carriers are trialing in-flight SMS and e-mail systems.

5.30 This strong product rivalry has extended to seating standards. In 1996, British Airways was the first airline to introduce a flat bed in First Class. As a result of the JSA, this design was licensed to Qantas and introduced on Qantas services in 1998. Other carriers, such as Singapore Airlines and Cathay Pacific, now also offer beds in first class and Emirates has announced that it intends to introduce beds in first class shortly. At the same time as introducing beds in first class, Qantas introduced improved, motorised business class seating with more space between seats and commenced installation of upgraded economy cabin seats with features such as adjustable lumbar support and headrest 'wings' for head and neck support.

5.31 In 2001, British Airways introduced flat beds in business class. Cathay Pacific responded almost immediately by offering tilt beds. In 2002, Singapore Airlines and Japan Airlines responded by introducing their own tilt bed in business class. Qantas will introduce what will be the world's longest business class bed later this year and Emirates is expected to introduce a rival product shortly. Other improvements offered by the Applicants have included greater business amenities, new baggage allowances and improved catering.

5.32 This product rivalry show no signs of abating. Emirates and Singapore Airlines will be among the first airlines to receive the Airbus A380 for use on the Kangaroo Route. Qantas, too, plans to use this aircraft on JSA Routes.

5.33 Fare reductions have therefore not been at the expense of quality of service. Rather, the period of the JSA has coincided with increases in quality of service at the same time as fares have fallen, so customers are demonstrably better off on both fronts.

5.34 Overall, price and product competition in JSA Passenger Air Services Markets has been characterised by sustained and intense competition that will continue. Despite the concerns expressed by the Commission

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[25] Emirates Press Release, 23 January 2003.

[26] 'Gulf Stream set for Sydney daily', *Australian,* 13 December 2002, page 26.

in the 2000 Determination that competition from mid-point carriers might be transitory, this has been shown not to be the case. Rather, due to their underlying economic advantages, mid-point carriers appear likely to continue to grow and ensure that competition on JSA Routes remains intense.

Competition in JSA Freight Markets

5.35 Generally speaking, the level of competition in freight markets will depend on many of the same factors as the passenger market. This is because the majority of freight is carried in the bellyholds of passenger aircraft. However, there are a number of factors specific to freight markets which suggest that freight markets will typically be even more competitive than air passenger services markets. The two most important factors are the additional discipline imposed by competition from dedicated air freight aircraft and the possibilities for indirect routings and inter-modal substitution (ie sea, road, rail) for many classes of freight. The importance of these factors was noted by the Commission in the SQ/AN/NZ Determination, in which it concluded that the level of competition in air freight markets was relatively high.[27]

5.36 For these reasons, and given the conclusions with respect to the competitiveness of the JSA Passenger Air Services Markets, the Applicants submit that competition in JSA Freight Markets will continue to be intense and will not be adversely affected by the JSA.

5.37 Further detailed analysis supporting this conclusion is set out in section 6 of the NECG Report.

Competition in the Market for Travel Distribution Services

5.38 In the 2000 Determination, the Commission stated that it did '*not consider that the Restated JSA would lead to a lessening of competition in the airline ticket sales market*'.[28] The Applicants agree with this view and submit that it continues to apply to the JSA under current market conditions. The analysis at section 4.3 of the NECG Report also supports this conclusion.

5.39 To put this issue in context, on ABS data, British Airways accounts for just 2.5% of all international traffic to and from Australia in 2001-2002.[29] Consequently the impact, if any, of the JSA on the market for ticket sales in Australia is likely to be negligible.

Competition in the Provision of Domestic Air Services

5.40 In the 2000 Determination, the Commission accepted that the JSA would not lessen competition in the domestic market in Australia.[30] The Applicants submit that this is still the case and that competition in the provision of domestic Australian air services has not, and will not be, affected by the JSA.

5.41 The period since the implementation of the JSA has been a dynamic and highly competitive period in Australian domestic aviation. Significant changes include the demise of Ansett Australia and the entry and

27 SQ/AN/NZ Determination, pages 51, 57.
28 2000 Determination, page 67.
29 ABS Worldnet.
30 2000 Determination, page 65. It is Qantas' view that domestic air services in Australia form part of a broader Australasian market for air services. For the purposes of this submission, however, the Applicants have adopted the approach taken by the Commission in the 2000 Determination and the SQ/AN/NZ Determination of considering the potential interaction between conduct in relevant markets for

aggressive expansion of Virgin Blue. However, it cannot be suggested that the failure of Ansett Australia was in any way contributed to by the JSA. The JSA can equally not be regarded as raising any barriers to Virgin Blue's expansion in or the entry of another carrier to the domestic market in Australia.

5.42 Qantas' domestic services do benefit from some international feed from British Airways, however the level of this feed is too low to have any real effect on domestic competition. Passengers connecting to or from domestic flights from international carriers other than Qantas account for less than [*CONFIDENTIAL INFORMATION DELETED*]% of Qantas' domestic traffic and passengers connecting to or from British Airways flights account for less than [*CONFIDENTIAL INFORMATION DELETED*]% of Qantas' domestic traffic.

5.43 Perhaps the most compelling evidence, however, that the JSA does not lessen competition in domestic air services, is Virgin Blue's extremely rapid and successful penetration of this market since the last authorisation of the JSA. Virgin Blue's Australian network now operates to all major Australian cities and nearly all major Australian tourist destinations and Virgin Blue plans to commence international services in the near future.

5.44 In documents lodged with the Australian Securities and Investment Commission in February this year, Virgin Blue recorded a net profit of $35.3 million in its second year of operation to 31 March 2002. Virgin Blue has targeted a profit of at least $100 million for the year to 31 March 2003.[31]

5.45 Virgin Blue also recently announced plans to acquire at least ten 737-800 aircraft (with options for another 40) over eight years, potentially more than doubling its fleet size.[32] Half-owner Patrick Corporation's chief executive, Chris Corrigan, told Patrick's annual meeting in February that Virgin Blue planned to lift its domestic market share from 24% to 30% this year as it expands its fleet and Richard Branson recently stated after Virgin Blue gained access to the former Ansett domestic terminal in Sydney that '*our dream of reaching 50% of the [domestic] market one day I think now is a realistic one*'.[33]

5.46 Virgin Blue is also able to pursue its own sources of international feed, for example, by forming ties with the Star alliance or by entering into individual bilateral alliances with Star member airlines. Virgin Blue has also recently completed agreements with Sabre for participation in the Sabre global distribution system. This will allow Virgin Blue's reservation system to be accessed by Star members and other airlines and will enable overseas travel agents to sell Virgin Blue tickets. As a result, Virgin Blue will be in an even better position to enter into agreements with international airlines to obtain international feed onto its domestic network. Virgin Blue's ability to pursue this strategy has already been demonstrated by its entry into a codeshare agreement with United Airlines announced on 5 June 2002. There has also been media speculation that Singapore Airlines will sign a codeshare agreement with Virgin Blue.

Impact of the Strategic Alliance between Qantas and Air New Zealand

5.47 On 25 November 2002 Qantas and Air New Zealand agreed to enter into a wide-ranging strategic alliance. This Air NZ Alliance is separate to the arrangements between Qantas and British Airways under the JSA.

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international air services and the provision of domestic air services in Australia. In doing so, the Applicants have not sought to define the geographic boundaries of the market within which domestic services are provided in Australia.

31 'Virgin looks to treble its profits', *Australian Financial Review*, 5 February 2003, page 45.

5.48 If approved, the Air NZ Alliance will involve Qantas taking up to a 22.5% shareholding in Air New Zealand. Under the agreement, Qantas and Air New Zealand will also form a 'Joint Airline Operation' which will involve the coordination of pricing, capacity and schedules for Air New Zealand and Qantas flights to, from, and within, New Zealand.

5.49 The New Zealand Government, as the majority shareholder in Air New Zealand, granted approval in principle on 18 December for Qantas to proceed with its proposal to buy up to 22.5% of Air New Zealand. The alliance is still, however, subject to approval from the New Zealand Commerce Commission, the Commission and Air New Zealand shareholders.

5.50 The proposed Air NZ Alliance primarily affects trans-Tasman and domestic New Zealand routes. The JSA has little or no practical application to such routes since British Airways does not operate on them. Its only presence on such routes is through a codesharing arrangement with Qantas for passengers travelling to Europe.

5.51 Air New Zealand does provide some services between Australia and Europe via Los Angeles. However, even if Air New Zealand's market share were to be considered in combination with the Qantas and British Airways, this would not have any material impact on competition in JSA Air Passenger Markets or any other markets. Air New Zealand is a very small operator between Europe and Australia. According to MiDT market share data, in 2002 Air New Zealand accounted for only 0.4% of passengers between Europe and Australia.[34] ABS data suggests that Air New Zealand accounted for a slightly higher figure of approximately 2% on Australia - Europe routes.[35]

5.52 Even 2% would not represent a material accretion to the Applicants' market share between Australia and Europe. However, most of the traffic that Air New Zealand currently carries between Australia and Europe depends on Air New Zealand's direct services between Sydney and Los Angeles. On 10 February 2003, Air New Zealand announced that it would suspend these services with effect from 27 April 2003, irrespective of whether or not the Air NZ Alliance proceeds. With the termination of Air New Zealand's Sydney - Los Angeles flights, the potential for impact of the Air NZ Alliance on JSA Passenger Air Services Markets will be even less than may be suggested by the historic market share data referred to above.

5.53 Qantas and British Airways note, however, that though Air New Zealand's presence in the market for travel between Australia and Europe is small, some overlap may exist. A consequence of giving effect to both authorisations (if both the JSA and Air NZ Alliance are authorised) is likely to be a degree of price and schedule coordination arising between Qantas, British Airways and Air New Zealand due to Qantas' simultaneous participation in the two alliances and the fact that the Air NZ Alliance may feed passengers to JSA services via Air New Zealand's services between Auckland and Singapore. However, any consequential price and schedule coordination is unlikely to have any material impact on competition due to the extremely limited overlap between the services affected by the two alliances and the high level of competition provided by the many other carriers on affected routes.

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32 'Virgin buys 10 new jets, looks offshore', *Sydney Morning Herald,* 17 January 2003 page 23.
33 'Virgin moves in after $25m deal', Sydney Morning Herald , *7* November 2002, page 3.
34 Refer to section 5.1.2 NECG Report, Table 16.
35 Refer to section 5.1.1 NECG Report, Table 10.