

with the Commission's previous findings, there continues to be strong price competition in the air passenger service markets affected by the JSA.

### 5.3.1 Quality of service

In our view, trends in service quality and product development, including planned product developments, provide an indication of the extent of non-price competition and are therefore a component in evaluating the overall competitiveness of the relevant international air passenger service markets. In short, the evidence is consistent with a pattern of significant non-price competition. (Trends in quality of service over the period of the JSA also inform our expectations as to how costs of service provision may have changed, as noted in section 5.3.2).

Competition through service quality has taken place through the introduction of sleeper beds and improvements in other service aspects such as the phasing in and upgrading of in-seat entertainment systems. To illustrate the point, in 1996, British Airways introduced the first flat bed in First Class. Qantas followed in 1998, and by the end of 2000, most other premium carriers had followed, including Singapore Airlines and Cathay Pacific. In July 2001, British Airways introduced its new flat bed business class and also introduced World Traveller Plus, a premium economy product aimed at filling the gap between traditional economy and the new standard business class. World Traveller Plus features a traditional business class style seat and a 38" seat pitch.<sup>75</sup>

Equally, in 2001, new slimline economy class seats were introduced to the Qantas B747-400 fleet, which featured in-built lumbar support and manually adjustable headrest 'wings' for extra head and neck support. It is envisaged that the Qantas B747-300 fleet will also be fitted with slimline seats by the end of 2003. By that date, Qantas will have commenced the progressive introduction of the Qantas 'Silverchair' tilt bed business class seat on Hong Kong and London routes, followed by the rest of its B747-400 fleet. Silverchair involves an increase in seat pitch from 48" to 60". B747-400 fleet fitment is due for completion by mid 2004. Improvements in Qantas and British Airways seats have coincided with similar improvements by other airlines competing on JSA routes, including Singapore Airlines and Cathay Pacific. In June 2004, assuming the JSA is reauthorised, Qantas is to introduce Airbus

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Seat pitch is the distance from the front of one seat to the front of the next.

A330-300 aircraft on JSA routes. Aircraft will be in a two-class configuration, with tilt bed seats in business class and slimline seats in economy class.

With respect to in flight entertainment developments, British Airways aircraft fitted with personal IFE (in flight entertainment) in all cabins commenced operations on the Kangaroo Route in 2000. In 2001, Qantas commenced introduction of new IFE systems to the economy class cabin of B747-400 aircraft. System features include 16cm seat back screens, 7 movie channels, 5 TV channels, news sport and weather information, 10 video games, 16 audio channels, and an in-seat phone. All Qantas B747-400s will be fitted with this system by mid 2003. As part of the conversion of B747-400s from 3 class to 2 class, business class IFE systems will be upgraded. At the same time, cabins will be fitted with enhanced lighting and enlarged locker bins. As with seating and bedding, other airlines on JSA routes, including Singapore Airlines and Cathay Pacific, have introduced similar improvements. The Qantas Airbus A330-300s that will operate on JSA routes from June 2004 (subject to reauthorisation) will have audio and video on demand.

### 5.3.2 Costs

The costs of providing service on the routes covered by the JSA have been affected to some extent by the developments in service quality noted in the previous section. However, the most significant factors affecting costs are those that lie outside the parties' control. It is obviously relevant to consider trends in costs in assessing trends in prices and profitability (see below).

Thus, Table 30 sets out contribution of individual cost categories to Qantas' total JSA internal route costs (which are calculated on a fully allocated cost basis) for the year to September 2002. Qantas' most important cost component is fuel, which is largely beyond its control. Two other key cost components, cabin crew and landing fee costs, are also largely beyond the control of Qantas.

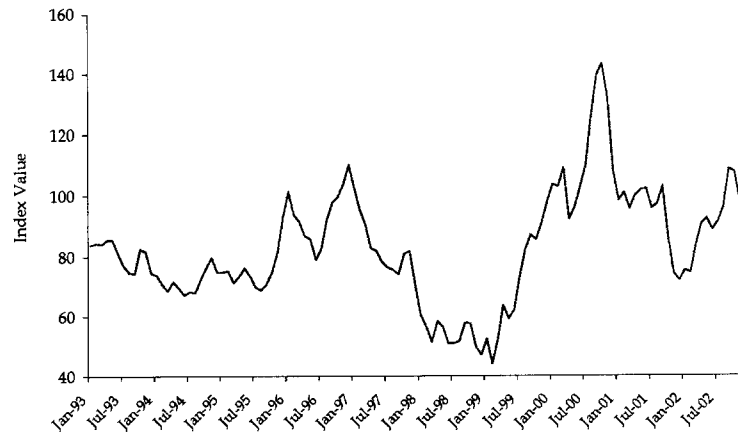
#### **Table 30: [Confidential Information Deleted]**

Movements in these three important costs categories are therefore of obvious relevance to the assessment.

Over the period of the JSA, there has been significant fluctuation in fuel prices, as shown in Figure 3. Figure 4 shows that wage costs have also consistently increased since 1993, while

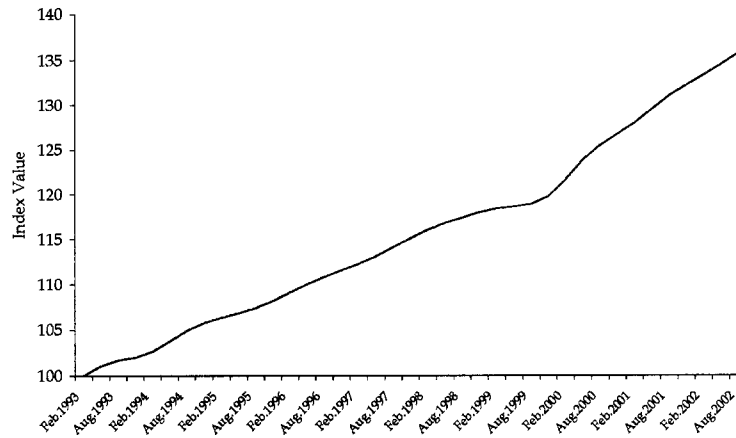
Figure 5 shows that though airport charges in Australia remained fairly constant during the period of price controls, they have recently experienced dramatic increases.

**Figure 3: Index of average monthly Singapore kerosene spot based jet fuel prices (Base Dec 2002 = 100)**



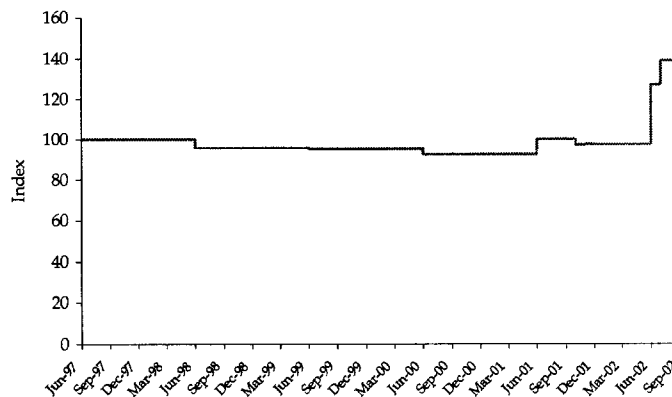
Source: U.S. Department of Energy, Energy Information Administration. We have presented the Singapore spot price index, since this index mirrors that for other geographies.

**Figure 4: Index of Australian total average weekly earnings (Base Feb 1993 = 100)**



Source: ABS. We have used an Australian economy wide general labour cost index excluding bonuses.

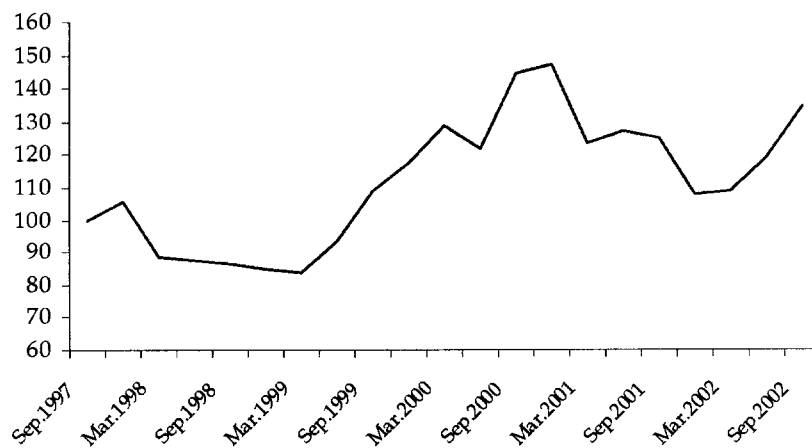
**Figure 5: Index of airport charges, 1997 to 2002**



Source: ACCC.

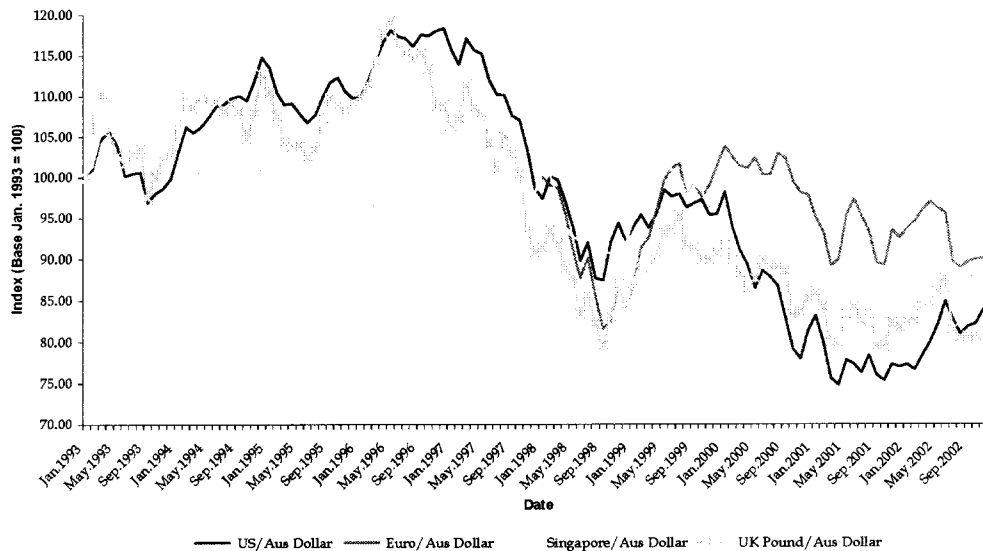
In order to determine how important these changes in costs have been for the JSA parties, we have constructed a single cost index that weights the price changes in fuel, wages and airport charges by their relative importance in Qantas' costs. Although the cost index does not capture all of Qantas' costs, it does highlight the increase in Qantas' key costs since 1997.

**Figure 6 Airline Cost Index (fuel, wages and landing fees)**



In addition to the specific cost categories described, an important driver of Qantas' costs is exchange rates, given the significant proportion of costs Qantas incurs overseas in delivering its services. Figure 7 illustrates the movements in the Australian dollar exchange rate with the US dollar, the UK pound, the Euro and the Singapore dollar. While displaying significant volatility, there is a discernable downward trend over the period, with the Australian dollar depreciating against all four currencies. To the extent that costs are incurred overseas to a greater extent than revenues, the depreciation of the Australian dollar will have accentuated the pressures on margins.

**Figure 7: Exchange Rate Index US\$, Euro, Sin\$, UK£ vs. Aus \$**



Source: ABS.

Finally, a potentially relevant trend relates to the impact of September 11. Most obviously, since then, additional resources have had to be devoted to security. However, the effects of September 11 go further.

More specifically, it is likely that the threats to global security, and to airline safety in particular, have affected both the systematic and the non-systematic risk bearing on airlines and hence increased their cost of capital. While the extent of this effect is still difficult to determine, its impacts need to be seen in the light of the fact that international airline operations have generally had difficulty in covering their cost of capital in competitive markets. An increase in the return investors require to provide equity funding to international airline operations can only accentuate the difficulties airlines face in retaining and renewing their asset base.

### 5.3.3 Yields

Overall, given the material set out above, there are strong reasons to believe that costs have tended to rise over the most recent period. It is with this in mind that trends in yields need to be considered.

Qantas and British Airways do not have access to price data that would enable us to calculate market prices, that is, a measure of average yields for all airlines operating in the relevant markets. However, Figure 8 shows the trend in combined British Airways and Qantas average yields on the JSA services, measured in Australian cents per revenue passenger kilometre (RPKs). It illustrates that despite fluctuations over the period, nominal yields are at a similar level in 2002 as they were in 1994. When general inflation in Australian prices is taken into account, it can be seen that real average yields fell by nearly 20% over this period, equivalent to a 2.6% average annual rate of decline.

#### Figure 8: [Confidential Information Deleted]

However, there have been a number of exchange rate movements that influence this picture - principally, the sharp fall in the value of the Australian dollar against many of the world's major currencies (see Figure 7), most relevantly, the pound. This depreciation of the Australian dollar is significant because, on the JSA services, about one third of revenues are received in pounds sterling, and another third in other currencies, mainly euros and US dollars, but also some Asian currencies. The remaining third arises from tickets paid for in Australian dollars. With two thirds of revenues on the JSA operations coming from tickets purchased in currencies other than the Australian dollar, these revenues will be worth more in AUD terms in 2002 than they were in the mid-1990s merely because of the loss in value of the Australian currency.

Figure 9 shows that average yields on Australian dollar sales only have remained reasonably constant over the last two years, illustrating that the recent upward trend in yields captured in Figure 8 is likely being driven by exchange rate movements.<sup>76</sup>

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A longer time series of this data was not available.

**Figure 9: [Confidential Information Deleted]**

When Sterling is used as the reference currency instead of Australian dollars there is a downward trend in average yields, as shown in Figure 10, with average yields falling by 25% over the period 1994-2002, an average annual rate of decline of over 3.5%.

**Figure 10: [Confidential Information Deleted]**

The actual yield performance on JSA services could be characterised as being between the differing trends illustrated with Australian dollars and Sterling as the reference currency. In any event, the evidence clearly demonstrates that real average yields have declined over the past seven years.

#### **5.3.4 Profitability**

Overall, the data suggest that route profitability has been low for the most recent period of authorisation. This is to be expected given the observed trends in costs and yields presented above. For instance, Figure 12 shows that for the UK 2001/02 financial year, profitability for British Airways on JSA routes, as measured by return on sales, was [Confidential Information Deleted]. For the Australian 2001/02 financial year, profitability for Qantas on JSA routes, as measured by profit before tax expressed as a percentage of air passenger revenues, was [Confidential Information Deleted]. We understand that JSA profitability has improved over the early quarters of the most recent financial year. This improved profitability has arisen, amongst other things, due to further development of the Singapore hub and improved market conditions. However, more recent market conditions including war in Iraq and SARS have dramatically affected the JSA routes, and as such this trend has been arrested.



**Figure 11: [Confidential Information Deleted]**

**Figure 12: [Confidential Information Deleted]**

### **5.3.5 Conclusions**

Overall, the evidence indicates that over the past decade key costs have increased. Average yields have also fallen over the period of the JSA. The decline in profitability suggests that price increases have been insufficient to offset the worsening cost position. The inability to pass through the changes in costs is consistent with the routes being subject to effective price competition. Indeed, it is difficult to see why margins would remain so low were competitive disciplines on the routes at issue weak. Rather, the logical inference to be drawn from the material set out above is that competitive constraints on the markets affected by the JSA have been and remain strong and effective.

## 6 International air freight service markets

In Determination A30202, the Commission was not able to form a conclusive view about whether competition in international air freight markets had been lessened, since it was not able to view trends in air freight rates.

In our view, there is no evidence to suggest that the JSA parties have been able to act free from effective competitive constraint in affected international air freight service markets over the most recent period of authorisation. As with our assessment of the relevant international air passenger service markets, our evaluation is based on a similar analysis of the structural features of the relevant international air freight service markets and, to the extent that data permits, an evaluation of market performance.

Our analysis of market structure again focuses on trends in market shares as well as entry and expansion barriers. We present BTRE data in section 6.1 which, despite its limitations, suggests market share trends in air freight services that are similar to those observed in air passenger service markets, in particular, growth in the freight shares of Asian airlines.

Most important in our assessment of competition in the relevant international air freight service markets is the extent to which entry and expansion barriers exist. As outlined in section 6.2, we believe entry and expansion barriers for these markets are low for freight operators, regardless of their home base. For reasons discussed in this section, we believe that many of the factors that give rise to entry and expansion barriers for air passenger service markets are not relevant when considering air freight service markets. That said, as noted in section 4.1.2, the Productivity Commission has previously observed that 90% of air freight between Australia and the rest of the world is carried in the bellyholds of air passenger aircraft. This estimate suggests that trends in air freight shares, particularly the increased shares of Asian airlines, have been driven by market share trends in air passenger service markets.

In light of the Commission's previously expressed views, we note that our analysis of market performance contained in section 6.3 focuses on trends in air freight yields. Bearing in mind the changes in costs and exchange rates that have occurred recently, declining air freight yields for Qantas suggest that it has been significantly constrained by competing freight service providers.

## 6.1 Market shares

We have two sources of data available to indicate air freight market shares. Cargo Accounts Settlement System (CASS) data is O/D data produced by IATA.<sup>77</sup> However, we only have very recent CASS data relevant to assessing the Australia-Europe freight shares. Even then, this data does not allow us to construct an aggregate market share for the JSA, since the data we have available for Qantas and British Airways covers different time periods. Hence, we also present market shares using data from the Bureau of Transport and Regional Economics (BTRE).

Unlike the ABS and MiDT data used for calculating passenger traffic shares, which are O/D data sets, the BTRE freight data we have is uplift discharge ('U/D') data. There are serious limitations associated with U/D data sets, which the Commission recognised in Determination A30202. The main difference between O/D and U/D data is that U/D traffic is measured within flight numbers. For any given carrier, flight numbers typically change at a carrier's home port or hub. To illustrate how U/D might lead to misleading market share results, consider freight that is being carried on a Singapore Airlines flight from Australia to Europe with a change of flight number in Singapore. An O/D data set would record the freight as traffic between Australia and Europe. However, U/D data would record the freight as Australia-Singapore traffic, due to the change in flight number at Singapore. The same example is equally applicable to all other Asian airlines, as well as to airlines such as Emirates, which fly between Australia and Europe via their home ports. It is also applicable to all flights operated by the JSA parties that are not through flights. The practical effect of using U/D data to measure air freight market shares is that it will overstate the share of Asian airlines and Emirates between Australia and their home ports, and underestimate their share between Australia and Europe. For the same reason, British Airways' and Qantas' share for Australia-Europe will be overstated.

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<sup>77</sup> CASS, which is run by IATA, is a 'Cargo Clearing House', which settles transactions between airlines and authorised freight forwarders. Specifically, it is through this system that freight consolidators remit the proceeds of their sales (less commissions) to airlines. British Airways and Qantas currently participate in this system. The majority of the world's major airlines, including all of British Airways' and Qantas' principal competitors on the Kangaroo Route, also participate in this clearing system. IATA uses CASS to estimate shares of freight traffic accounted for by its member airlines.

Ideally, we would prefer to use an extended O/D data series for both JSA parties for the purpose of analysing air freight market shares, as we have done with respect to air passenger market shares. Given that this is not possible, we rely on the limited CASS O/D data that is available to gauge current *absolute* freight share levels for the JSA parties. While the limitations of U/D data render BTRE data unhelpful in gauging absolute levels of market shares, absent an extended time series of CASS data, BTRE data provides an insight as to *trends* in freight shares over time.

Turning to the CASS data, data on competitors' market shares is commercially sensitive and not available to other IATA CASS members. However, it is clear from the tables below that the JSA parties' share of air freight in the Australia-Europe market is low. Table 31 presents the volume and share of air freight carried by Qantas from Australia to Europe for the twelve months to December 2002. As the data shows, Qantas' share of total freight carried from Australia to Europe for this period was only [Confidential Information Deleted].

**Table 31: [Confidential Information Deleted]**

Table 32 presents the volume and share of air freight carried by British Airways from Australia to Europe for the eleven months to November 2002 based on CASS data. As the data shows, British Airways' share of total freight carried from Australia to Europe for this period was only [Confidential Information Deleted].

**Table 32: [Confidential Information Deleted]**

Qantas' share of total freight carried from Europe to Australia for the twelve months to December 2002 was only [Confidential Information Deleted] as shown in Table 33.

**Table 33: [Confidential Information Deleted]**

We do not have British Airways' CASS data for services from Europe to Australia alone. However, Table 34 presents the volume and share of air freight carried by British Airways from Europe to Australasia for the eleven months to November 2002. As the data shows, British Airways' share of total freight carried from Europe to Australasia for this period was only [Confidential Information Deleted].

**Table 34: [Confidential Information Deleted]**

Turning to the BTRE data, as noted above, these are unhelpful in evaluating absolute freight share levels, though are helpful in analysing trends. The JSA parties' shares in both the Australia-South East Asia and Australia-Europe markets have declined over the period of the JSA, as shown in Table 35, Table 36 and Table 37.<sup>78</sup> As these tables show, declines in JSA shares for services between Australia and South East Asian countries have generally been offset by increases in shares for South East Asian airlines. For instance, Malaysia Airlines, Thai Airways and Garuda have all increased their shares to their home ports. Bearing in mind the limitations of U/D data, it is likely that at least some of these market share increases for South East Asian airlines reflect increases in shares for air freight services between Australia and Europe. The same is also likely to be the case with respect to the apparent increase in shares for North Asian flag carriers between Australia and their home ports. The tables do not fully highlight the extent of Emirates' freight operations. Based on BTRE data, aside from carrying 6155 tonnes of freight between Australia and Singapore for the 2001 calendar year, it also carried 9340 tonnes between Australia and the UAE. In all likelihood, a significant portion of this freight would be relevant to the Australia-Europe air freight market.

It is also relevant to note the growth of dedicated freighters both generally, and in the freight markets relevant to the JSA. The BTRE data shows that Asiana's share for Australia-Korea grew substantially between the 1994/95 Australian financial year to the 2001 calendar year. It may also be relevant to note that Polar Air Cargo and Federal Express both have a significant worldwide presence. For instance, BTRE data indicates that they have a significant Australia-United States presence for the 2001 calendar year. Given that there is greater flexibility associated with air freight services compared with air passengers services,

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<sup>78</sup> Data sourced from the Bureau of Transport and Regional Economics. For the three years of data presented in these tables, we have only been able to obtain underlying quantity data for the 2001 calendar year period. For the 1994/95 and 1997/98 financial years presented we only have market share data. For these two years, BTRE has only presented market share data for the UK and a figure capturing shares for the rest of Europe. As noted above, we believe that the relevant market is the Australia-Europe market. For this reason, for the 1994/95 and 1997/98 financial years, we estimate Australia-Europe market shares by taking the shares for the UK and the rest of Europe, and weighting these by calendar year 2001 quantities for the UK and rest of Europe.

delivery of air freight from Australia to Europe via the United States is likely to be an effective alternative to delivery via Asia. In this respect, these dedicated freighters serving the United States may well competitively constrain airlines delivering freight to Europe via Asia.

In summary, CASS data indicates that the JSA parties' freight share in the Australia-Europe market is low in absolute terms. Given these low absolute freight shares, the JSA would appear to raise few competition concerns in this air freight market. In addition, one can infer from the BTRE market share data that trends in international air freight services are similar to those in international air passenger services: airlines operating mid-point hubs between Australia and Europe are likely to have increased their Australia-Europe market shares significantly, while the share of the JSA parties is likely to have fallen significantly.



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**Table 35: Market shares (%) for combined inbound and outbound air freight, Australian FY1994/95**

	Europe	NZ	USA	Singapore	Malaysia	Thailand	Vietnam	Indonesia	Hong Kong	China	Korea	Japan	All Others	Total
Qantas	45.2%	34.8%	45.0%	33.4%	10.7%	20.6%	22.7%	24.7%	24.4%	0.5%	24.4%	40.3%	24.6%	32.4%
British Airways	17.7%			5.2%		9.7%								3.1%
Singapore Airlines		1.6%		59.0%										10.9%
Air New Zealand		44.0%	2.3%			1.8%						0.3%	1.9%	9.5%
Ansett International							1.9%	5.0%				4.7%		1.2%
Cathay Pacific								70.3%						9.4%
Malaysia Airlines					89.0%									3.0%
Japan Airlines												38.8%		3.6%
United		9.2%	7.5%											2.8%
Polar Air Cargo			22.4%	0.5%										3.0%
Thai International		1.3%				58.3%								2.0%
Garuda							71.0%							2.3%
Korean Air											71.9%			1.5%
All Nippon												15.4%		1.4%
Evergreen														0.0%
Federal Express			12.4%											1.6%
Asian Express														0.0%
Air Canada			6.3%											0.8%
Connie Kalitta			3.8%	0.6%										0.6%
Asiana														0.0%
Lauda Air	1.1%												0.4%	0.1%
KLM Royal Dutch	7.4%												2.7%	0.4%
Martinair Holland										99.5%				0.0%
Air China														0.0%
Emirates														0.0%
All Other	28.6%	8.9%	0.4%	1.3%	0.3%	9.7%	4.4%					0.5%	70.4%	10.6%
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

Source: BTRE.

**Table 36: Market shares (%) for combined inbound and outbound air freight, Australian FY1997/98**

	Europe	NZ	USA	Singapore	Malaysia	Thailand	Vietnam	Indonesia	Hong Kong	China	Korea	Japan	All Others	Total
Qantas	33.7%	34.6%	37.8%	24.7%	7.4%	25.4%	27.8%	28.0%	26.8%	34.9%	12.7%	39.1%	27.2%	29.3%
British Airways	18.7%			8.4%		9.4%								2.9%
Singapore Airlines		2.0%		63.0%										12.0%
Air New Zealand		48.3%	6.3%			1.2%					2.2%	0.4%	1.2%	10.9%
Ansett International		0.3%			2.6%			23.6%	7.7%	19.4%	4.1%	12.0%	3.1%	3.6%
Cathay Pacific									65.4%					7.9%
Malaysia Airlines					86.0%									4.5%
Japan Airlines												33.9%		3.2%
United		5.5%	15.1%											2.6%
Polar Air Cargo			22.3%	0.3%										2.3%
Thai International		1.7%				60.1%		1.0%						1.9%
Garuda		0.3%						44.4%						1.3%
Korean Air											68.1%			2.1%
All Nippon												14.6%		1.4%
Evergreen														0.0%
Federal Express			9.1%											0.9%
Asian Express		5.3%												1.1%
Canadian Airlines			7.1%											0.7%
Connie Kalitta			2.0%	1.0%										0.4%
Asiana														0.4%
Lauda Air	1.9%			0.3%							12.8%		0.7%	0.3%
KLM Royal Dutch	12.5%				3.5%									0.6%
Martinair Holland	25.1%			0.1%										1.2%
Air China										14.4%				0.1%
Emirates				1.0%										0.7%
All Other	8.1%	2.0%	0.3%	1.2%	0.5%	3.9%	72.2%	3.0%	0.1%	31.3%	0.1%		5.7%	0.7%
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

Source: BTRE.



**Table 37: Market shares (%) for combined inbound and outbound air freight, CY2001**

	Europe	New Zealand	USA	Singapore	Malaysia	Thailand	Vietnam	Indonesia	Hong Kong	China	Korea	Japan	All Others	Grand total
Qantas	38.8%	32.7%	21.5%	26.7%	0.0%	17.0%	0.0%	20.1%	22.8%	5.8%	0.0%	36.7%	11.5%	23.7%
British Airways	15.9%			4.7%		6.1%								2.3%
Singapore Airlines		1.6%		63.3%	0.6%									15.5%
Air New Zealand		38.7%	6.9%											7.7%
Ansett International								3.1%	9.2%			10.7%	0.7%	1.8%
Cathay Pacific									68.0%					7.5%
Malaysia Airlines					95.5%									5.2%
Japan Airlines											52.6%			3.3%
United		2.4%	15.0%											2.0%
Polar Air Cargo			10.3%											1.1%
Thai International		6.9%				75.2%								3.9%
Garuda		0.5%						76.7%						1.6%
Korean Air											79.7%			2.3%
All Nippon														0.0%
Evergreen		0.5%	12.9%										0.1%	1.5%
Federal Express			19.4%										16.6%	3.6%
Asian Express		6.6%												1.2%
Canadian Airlines														0.0%
Connie Kalitta														0.0%
Asiana											20.3%			0.6%
Lauda Air	0.8%													0.0%
KLM Royal Dutch	2.1%													0.0%
Martinair Holland	27.4%													0.1%
Air China		0.1%								27.9%				1.6%
Emirates				4.0%									15.3%	0.3%
Cargolux	11.3%	5.6%			0.9%									2.4%
Lufthansa	2.4%	1.9%	4.2%		3.0%								0.1%	1.7%
Olympic Airways	1.3%					0.8%								1.1%
All Other		2.3%	9.8%	1.3%			10			66.4%			55.7%	0.1%
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

## 6.2 Entry and expansion barriers

Barriers to entry and expansion would appear to be low in the relevant international air freight service markets for freight operators compared with air passenger service markets.

As shown in Table 38, under Australian bilateral agreements, capacity entitlements for specialist freighters are unlimited for designated airlines of many countries.<sup>79</sup> For instance, under the relevant bilateral agreements between Australia and Asian countries, capacity is unlimited for freighters designated under Australia-Singapore and Australia-Malaysia bilateral agreements. For Thailand, almost all freight entitlements remain unused. Only Hong Kong airlines have exercised their full capacity entitlements, though as noted in section 5.2.2, the Australian and Hong Kong Governments are considering a significant increase in bilateral entitlements.

With respect to bilateral agreements between Australia and the European countries most relevant to evaluating a reauthorised JSA, again, there appear to be few constraints, except in the case of France. There remains capacity available for freight operators designated under the Australia-UK bilateral agreement to provide freight services between Australia and the UK. There is unlimited capacity available for freight operators designated under the Australia-Germany bilateral agreement to provide freight services between Australia and Germany. Given the existing Australia-Italy bilateral agreement, there remains capacity available for freight operators to provide freight services between Australia and Italy. Indeed, since no designated Italian airlines currently use entitlements to provide air passenger services, the entire capacity allocated to designated Italian airlines could be used to provide air freight services.

Under the Australia-France bilateral agreement, there are no specific entitlements for freighters. However, consistent with the discussion contained in section 5.2.2, there would be nothing to prevent a designated German airline wishing to provide air freight services between Australia and France from delivering air freight using a combination of an Australia-Germany service and a Germany-France service or road connection.

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<sup>79</sup> This is consistent with the Commission's observation in Determination A30202 that regulatory barriers were decreasing. See Determination A30202, p. 64.

**Table 38: Air freight capacity entitlements between Australia and foreign countries, as of December 2002**

Air Services Agreement	Capacity Entitled		Utilised Capacity		Unused Capacity	
	Freq pw each way		Freq pw each way		Freq pw each way	
Between Australia and:	Australian Carriers	Foreign Carriers	Australian Carriers	Foreign Carriers	Australian Carriers December '02	Foreign Carriers December '02
United Kingdom	3	3	-	-	3	3
Austria	Unlimited	Unlimited	-	-	Unlimited	Unlimited
France (Paris)	Nil	Nil	-	-	-	-
Germany	Freighters Unlimited	Freighters Unlimited	-	3 x MD11F	Unlimited	Unlimited
Italy (Note 3)	Variable	Variable	4 B747 pax	-	3	7
Netherlands	2	2	-	3 x B747F	2	-
Greece	250 tonnes	250 tonnes	-	-	250 tonnes	250 tonnes
Norway/ Denmark/Sweden	Unlimited	Unlimited	-	-	Unlimited	Unlimited
Finland	Unlimited	Unlimited	-	-	Unlimited	Unlimited
Switzerland	7	7	-	-	7	7
Luxembourg	Unlimited	Unlimited	-	2 x B747F	Unlimited	Unlimited
Ireland	Unlimited	Unlimited	-	-	Unlimited	Unlimited
Malta	Nil	Nil	-	-	-	-
Russia (Note 3)	Freighters Variable	Freighters Variable	-	-	3	2
Singapore	Unlimited	Unlimited	2 x MD11F	4 x B747F	Unlimited	Unlimited
Thailand	7	7	2 x MD11F	-	5	7
Malaysia	Unlimited	Unlimited	-	3 x B747F	Unlimited	Unlimited
Hong Kong (Note 3)	Variable	Variable	(See Note 4) 33 pax serv.	2 x B747F 35 pax ser.	Variable - currently 4 freq any a/c	Nil
Indonesia	3	3	-	-	3	3
Brunei	Unlimited	Unlimited	-	-	Unlimited	Unlimited
Philippines	300 tonnes	300 tonnes	-	-	300 tonnes	300 tonnes
Vietnam	Nil	Nil	-	-	-	-
Burma(Myanmar)	Freighters Variable	Freighters Variable	-	-	2 B747	2 B707/DC8
China	Nil	Nil	-	-	-	-
Taiwan	Freighters Unlimited	Freighters Unlimited	-	-	Unlimited	Unlimited
Japan (Note 3)	Variable	Variable	-	-	7.9 B747 Equiv	18.5 B747 Equiv

Air Services Agreement	Capacity Entitled		Utilised Capacity		Unused Capacity	
	Freq pw each way		Freq pw each way		Freq pw each way	
Between Australia and:	Australian Carriers	Foreign Carriers	Australian Carriers	Foreign Carriers	Australian Carriers December '02	Foreign Carriers December '02
Korea	Unlimited	Unlimited	-	-	Unlimited	Unlimited
Macau	Nil	Nil	-	-	-	-
United Arab Emirates	Unlimited	Unlimited	-	-	Unlimited	Unlimited
Bahrain	1	1	-	-	1	1
Lebanon/Egypt/	KUW -1	KUW -1	-	-	KUW -1	KUW -1
Kuwait/Jordan	LEB - Var	LEB - Var	-	-	LEB -3	LEB -2
(Note 3)	JOR - Var	JOR - Var	-	-	JOR - 3	JOR - 2
	EGY - Var	EGY - Var	-	-	EGY - 3	EGY - 3
India/Pakistan/	PAK - 1	PAK - 1	-	-	PAK - 1	PAK - 1
Sri Lanka	SRI -	SRI -	-	-	SRI -	SRI -
	Unlimited	Unlimited			Unlimited	Unlimited
	IND - Nil	IND - Nil				
USA	Unlimited	Unlimited	2 x MD11F	10	Unlimited	Unlimited
Argentina	7	7	-	-	7	7
Chile	Unlimited	Unlimited	-	-	Unlimited	Unlimited
Canada (Note 3)	Variable	Variable	-	7 B747 pax	750 tonnes	10 tonnes
New Zealand	Unlimited	Unlimited	5 x B727F	-	Unlimited	Unlimited
PNG	100 tonnes	100 tonnes	-	-	100 tonnes	100 tonnes
Fiji	70 tonnes	70 tonnes	1 x MD11F (50 tonnes)	-	20 tonnes	70 tonnes
South Africa/	SA - 1	SA - 1	-	-	SA - 1	SA - 1
Zimbabwe	ZIM - 1	ZIM - 1	-	-	ZIM - 1	ZIM -1
New Caledonia	1 B737F	1 B737F	1 B737F (Tr.Pac. service not commenced)	-	Nil	1 B737F
Tahiti	Nil	Nil	-	-	-	-
	freighters	freighters				
Vanuatu	100 tonnes	100 tonnes	25 tonnes (Tr.Pac. service not commenced)	100 tonnes	75 tonnes	100 tonnes
Mauritius	Nil	Nil	-	-	-	-
	Freighters	Freighters				
Cook Islands	Unlimited	Unlimited	-	-	Unlimited	Unlimited
Nauru (Note 3)	Variable	Variable	-	2 B737 pax	3 B737	1 B737
Solomon Islands	100 tonnes	100 tonnes	-	-	100 tonnes	100 tonnes
Tonga	Unlimited	Unlimited	-	-	Unlimited	Unlimited

Air Services Agreement	Capacity Entitled		Utilised Capacity		Unused Capacity	
	Freq pw each way		Freq pw each way		Freq pw each way	
Between Australia and:	Australian Carriers	Foreign Carriers	Australian Carriers	Foreign Carriers	Australian Carriers December '02	Foreign Carriers December '02
Niue	Unlimited	Unlimited	-	-	Unlimited	Unlimited
Western Samoa	Unlimited	Unlimited	-	-	Unlimited	Unlimited

Notes: (1) Codesharing occurs on some freighter services currently operated. In all cases, operated services only are shown in the above table. (2) Except as otherwise shown, all services can be operated with any aircraft type. In some cases (shown) cargo capacity entitlements in air agreements have been expressed in tonnes rather than weekly frequencies. In these cases the capacity may be exercised with any aircraft/ frequency up to the weekly tonnes capacity limit. (3) Variable capacity: In these cases all entitlements under the bilateral allow services to be operated, at the option of the carrier, with freighter aircraft as well as passenger aircraft. Accordingly, entitlements not used for passenger services can be exercised with freighter flights. In most cases, capacity entitlement remains unused to permit multiple freighter services to be operated by the airlines of each country. In the case of Japan, in addition to rights for independent freighter services, there is provision for a weekly B747F service to be operated jointly between a Japanese and Australian carrier. This service is not included in the unused capacity shown. (4) Qantas' weekly Australia-Hong Kong MD11F services was temporarily suspended in late September 2002.

Another structural factor that might give rise to entry and expansion barriers in air passenger markets, namely access to landing slots, is unlikely to be relevant in evaluating air freight markets. There is even greater scope for indirect routing between O/Ds for air freight services relative to air passenger services. Hence, to the extent that landing slots might constrain expansion and entry for air passenger services, the greater flexibility associated with freight delivery would make landing slot constraints much less an issue for specialist freight operators.

As a result, we believe that entry and expansion barriers in the relevant international air freight service markets for freight operators are low. Nonetheless, given the practical interdependence between the carriage of passengers and that of freight, the growth in freight shares for Asian airlines has undoubtedly been primarily driven by competition in air passenger service markets, with competition for freight itself playing an essentially supporting role in inducing changes in market outcomes.

### 6.3 Market performance

As noted above, in Determination A30202, the Commission was not able to form a conclusive view as to whether competition in international air freight markets had been affected by the JSA, since it was not able to examine trends in air freight rates. The data we have obtained shows that freight yields have declined over the most recent period of authorisation. It is important to bear in mind, in relation to these figures on yield, the findings in section 5.3 above that key costs have increased over the past five years.

There are two types of published rates that are relevant in measuring the performance of freight markets:<sup>80</sup>

- The General Commodity Rate (GCR) is the air freight rate applicable to all commodities except those for which specific rates have been filed. Rates are based on weight and distance and are published for each pair of cities an airline serves.
- Specific Commodity Rates (SCR) are applicable to certain classes of commodities, typically high volume commodities. Because of these higher volumes, specific commodity rates are usually lower than GCRs.

SCR freight may be either shipped 'loose' or in a Unit Load Device (ULD). A ULD is a generic term used when referring to containers and pallets. The ULD enables individual pieces of cargo to be assembled into standardised units to facilitate rapid loading and unloading of aircraft, as well as to facilitate the transfer of cargo between aircraft. There are many types of ULD.

Based on the available data, there has only been one increase in published freight rates over the most recent period of authorisation.<sup>81</sup> All rates, except ULD rates, from the UK to all destinations were increased by 10% effective 10 October 2001. The changes in General Commodity Rates (GCR) for London-Sydney freight services are presented in Table 39.

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<sup>80</sup> See <http://www.outlook-freight.com/air.htm>.

<sup>81</sup> In this section, we again present yields in nominal prices rather than deflating them by a general price indicator given that we have already considered changes in key cost categories and exchange rate fluctuations above in section 5.3.

**Table 39: GCR rates for London-Sydney air freight services (in AUD), as of June 1999 and June 2002**

Weight	June 1999	June 2002	Increase
Min Charge	50.00	55.00	10.00%
N	10.52	11.57	9.98%
100	5.14	5.65	9.92%
300	4.36	4.80	10.09%
500	3.92	4.31	9.95%
1000	3.79	4.17	10.03%

Source: Qantas.

There have also been changes in published charges for Sydney-London freight services. Rates from Australia to Europe, except minimum charges and the "N" rate, were increased by 3% in October 1999. SCR rates for food from Australia to all destinations were cancelled, effective 1 February 2002, and replaced by ULD rates for "Freight All Kind" at the levels resulting from the October 1999 increase. Minimum charges from Australia to all destinations were increased to \$100, effective February 2002.<sup>82</sup> Changes in GCR rates are presented in Table 40. Changes in loose and ULD GCR rates are presented in Table 41.

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<sup>82</sup> We understand that since most freight goes through consolidators, the minimum charge imposed by the airlines will have almost no effect as nearly all shipments will be above both the new and the old minimum level.

**Table 40: GCR rates for Sydney-London air freight services (in AUD), as of June 1999 and June 2002**

Weight	June '99	June '02	Increase
Min Charge	85.00	100.00	17.65%
N	15.35	15.35	0.00%
45	11.50	11.85	3.04%
100	7.50	7.75	3.33%
250	4.85	5.00	3.09%
500	3.75	3.85	2.67%
1000	3.40	3.50	2.94%

Source: Qantas.

**Table 41: SCR rates for Sydney-London air freight services, as of June 1999 and June 2002**

SCR Item	ULD type	Weight	June '99	June '02	Increase	
SCR/LOOSE	Foodstuffs	N/A	100.00	4.00	4.10	2.50%
SCR/LOOSE	Foodstuffs	N/A	500.00	3.70	3.80	2.70%
SCR/LOOSE	Flowers	N/A	100.00	4.90	5.05	3.06%
SCR/ULD	Foodstuffs	5.00	Flat Charge	12330.00	Cancelled	
SCR/ULD	Foodstuffs	8.00	Flat Charge	4140.00	Cancelled	
ULD/FAK		5.00	Flat Charge		12700.00	3.00%
ULD/FAK		8.00	Flat Charge		4260.00	2.90%

Source: Qantas.

However, most freight is purchased at spot rates, which are lower than published rates. To capture this, we present measures of combined Qantas/British Airways yields per revenue tonne kilometre (RTK) and per kilogram prices in Figure 13 and Figure 14, respectively. Using both these measures, it can be seen that freight yields have declined over the most recent period of authorisation.



**Figure 13: [Confidential Information Deleted]**

**Figure 14: [Confidential Information Deleted]**

In summary, the data we have obtained shows that freight yields for the JSA parties have declined over the most recent period of authorisation despite the fact that key costs have increased over the past five years. These results are consistent with our analysis of market shares and entry barriers, which suggest that the JSA parties are competitively constrained in the relevant freight markets.

## 7 Future with and without the JSA

Based on the material set out above, our view is that the markets affected by the JSA are and will remain strongly competitive. This in and of itself suggests that reauthorisation of the JSA could not result in a net detriment to the public; market forces would preclude any harm from being done to the travelling public, while the JSA parties (and ultimately, the Australian economy as a whole) would gain from the efficiencies the JSA allows.

That said, we accept that a more detailed assessment of the consequences of the JSA can be helpful in gauging the desirability of its reauthorisation. So as to carry out this more detailed assessment, we present a scenario of the relevant airline markets in a future in which the JSA does not apply; and we compare that future scenario with another in which the JSA operates. We adopt this approach for consistency with the Commission's authorisation test. The Commission is concerned to test whether the future with the JSA would be preferable to the future without authorisation. This test, in other words, does not compare the future with the past; it compares two futures, one in which an authorised agreement operates and another in which it does not.

While a comparison of two futures involves a degree of uncertainty, it is most unlikely that the relevant markets would remain the same without the JSA. It is obviously important to try to characterise as precisely as possible and then assess the differences its absence would make. After elaborating in this section on these two alternative futures—with and without the JSA—we use these scenarios, in the remainder of the report, as the framework for assessing the competitive effects and public benefits of the JSA.

### 7.1 Future with the JSA

The JSA has provided a means for Qantas and British Airways to coordinate schedules and pricing and share benefits. For Qantas and British Airways, the JSA has provided the scale necessary to operate flights between Australia and Europe via Singapore and Bangkok, where neither Qantas nor British Airways has a natural hub or home country advantage.

Through its local presence in the UK and resulting passenger feed, British Airways improves the viability of Qantas' services between Bangkok and London and between Singapore and London, Frankfurt, Paris and Rome. The scale of Qantas' and British Airways' operations from Europe to Singapore generates sufficient connecting demand to justify direct flights from Singapore to Perth, Brisbane, and Darwin. Table 42 details Qantas and British Airways' current schedule on the Kangaroo Route.

The JSA is also vitally important to British Airways' Australia–Europe operations. The agreement improves the viability of British Airways' 21 flights per week to Australia, 14 of

which hub through Singapore. Qantas provides sales support to British Airways' Australia-Europe operations in Australia and feeds passengers to them at Sydney, Melbourne, Singapore and Bangkok.

**Table 42: Current schedule (Northern Summer 2003, effective March 2003)<sup>83</sup>**

Qantas			British Airways		
Route	Frequency (roundtrips per week)	Aircraft	Route	Frequency (roundtrips per week)	Aircraft
SYD-SIN-LHR	7	747-400	LHR-SIN-SYD	7	747-400
MEL-SIN-LHR	7	747-400	LHR-SIN-MEL	7	747-400
SYD-SIN-FRA	7	747-400	LHR-BKK-SYD	7	747-400
SYD-SIN-MEL	4	767-300			
BNE-SIN	7	747-300			
PER-SIN	7	767-300			
PER-SIN-FCO	3	747-400			
PER-SIN-CDG	3	747-400			
PER-SIN	1	747-400			
ADL-DRW-SIN	3	767-300			
SYD-BKK-LHR	7	747-400			

Source: Qantas and British Airways. Airport Codes used are: SYD=Sydney; SIN=Singapore; LHR=London Heathrow; MEL=Melbourne; BNE=Brisbane; PER=Perth; FCO=Rome; CDG=Charles de Gaulle, Paris; ADL=Adelaide; DRW=Darwin; BKK=Bangkok; HKG=Hong Kong.

<sup>83</sup> This table summarises the Applicants' official schedules for Northern Summer 2003. However, the combined effects of the war in Iraq and the outbreak of SARS have required the JSA Parties to implement temporary capacity and frequency reductions on some JSA Routes. As a result, not all of the frequencies shown in this table were being flown as at the date of this report.

Figure 15 and Figure 16 show return on sales and contribution margin<sup>84</sup> for Qantas' and British Airways' Europe to Australia services. There has been a downward trend in both profitability and contribution since 1999/00, although Qantas has shown some profitability improvement in the most recent six month period. Qantas' profits have been small [Confidential Information Deleted].

**Figure 15: [Confidential Information Deleted]**

**Figure 16: [Confidential Information Deleted]**

Putting aside the current unsettled international conditions, profitability is likely to improve if general air travel trading conditions ease and the longer term trend of growth in international air travel continues.

In addition, the JSA parties are making a number of changes to improve the profitability of the JSA routes, specifically:

- In November 2002, Qantas changed its departure times from Paris and Rome to midday to reduce aircraft standing time in those ports and thereby increase aircraft utilisation.
- Also in November, Qantas upgraded its Brisbane-Singapore flights from 11 Boeing 767-300s per week to a daily Boeing 747-300. Because the cost per seat to operate the larger 747 aircraft is lower than operating two trips with the 767s, this change allows Qantas to achieve a unit cost reduction of around 10%.
- British Airways has increased its London-Singapore-Melbourne services from 5 to 7 per week in the Northern Summer 2003 schedule.<sup>85</sup>
- Qantas is also currently converting 10 Boeing 747-400 aircraft from a three class to a two class configuration, replacing first class seats with economy seats, thereby

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<sup>84</sup> Contribution margin is profit, after flight costs but before an allocation of overheads is made, as a proportion of revenue.

<sup>85</sup> As at the date of this report the introduction of these extra frequencies had been temporarily delayed as a result of the current unsettled international conditions.

increasing total seats on the aircraft from 394 to 432. This will enable Qantas to carry more passengers on the Frankfurt, Rome and Paris routes with only a small cost increase, lowering unit costs.

- Assuming the JSA is reauthorised, in 2004, Qantas also plans to introduce Airbus A330-300 aircraft into its international fleet for use on the JSA routes which will allow further unit cost improvements. The Airbus A330 aircraft will have approximately 299 seats and will replace Boeing 767-300 aircraft with 229 seats. Qantas estimates that the new aircraft will provide a 10% unit cost saving.
- Qantas plans to introduce the Airbus A380 aircraft on London services in 2006. These aircraft will have approximately 514 seats and will be the largest passenger aircraft in operation in the world. The Airbus A380s are conservatively forecast to provide a 7% unit cost advantage in comparison to a new Boeing 747-400. The unit cost improvement compared to the aircraft currently operating is even greater.

These actions taken by the JSA parties, together with improved market conditions, should improve the profitability of these routes. Thus, in a scenario where the JSA continues, the two airlines aim to continue developing their European services and maintain, and eventually augment, the current schedule.

Set against the backdrop of these developments, Qantas and British Airways plan to continue building on the mini-hub in Singapore to strengthen the quality of service they provide between Australia and Europe.

Table 43 below sets out the frequency of flights Qantas and British Airways plan to operate in the short to medium-term (1-3 years) future if the JSA continues. Frequencies are presented by major route and by aircraft type. The table shows that services will be the same as the current schedule with the exception of additional Sydney-Singapore-Melbourne and Perth-Singapore-Paris services.

Table 44 outlines the longer-term (years 4 and 5) schedule, predicated on continued growth in international air travel. Qantas plans to replace the Boeing 747-400 aircraft operating the Melbourne-Singapore-London and Sydney-Bangkok-London routes with Airbus A380 aircraft and the Boeing 767-300 aircraft operating Sydney-Singapore-Melbourne and Perth-Singapore-Hong Kong with Airbus A330 aircraft. Additional flights are planned on the Perth-Singapore-Paris and Adelaide-Darwin-Singapore routes. [Confidential Information Deleted.] Compared with the current schedule set out in Table 42, the factual longer-term schedule reflects a 13% increase in frequencies and a 19% increase in capacity.

**Table 43: Factual schedule, short to medium-term**

Qantas			British Airways		
<i>Route</i>	<i>Frequency (roundtrips per week)</i>	<i>Aircraft</i>	<i>Route</i>	<i>Frequency (roundtrips per week)</i>	<i>Aircraft</i>
SYD-SIN-LHR	7	747-400	LHR-SIN-SYD	7	747-400
MEL-SIN-LHR	7	747-400	LHR-SIN-MEL	7	747-400
SYD-SIN-FRA	7	747-400	LHR-BKK-SYD	7	747-400
SYD-SIN-MEL	7	767-300			
BNE-SIN	7	747-300			
PER-SIN	7	767-300			
PER-SIN-FCO	3	747-400			
PER-SIN-CDG	5	747-400			
ADL-DRW-SIN	3	767-300			
SYD-BKK-LHR	7	747-400			

Source: Qantas and British Airways.