

**Table 44: Factual schedule, long-term**

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	<b>A380</b>	LHR-SIN-MEL	7	747-400
SYD-SIN-FRA	7	747-400	LHR-BKK-SYD	7	747-400
SYD-SIN-MEL	7	<b>A330</b>			
BNE-SIN	7	747-300			
PER-SIN	7	<b>A330</b>			
PER-SIN-FCO	3	747-400			
PER-SIN-CDG	7	747-400			
ADL-DRW-SIN	7	767-300			
SYD-BKK-LHR	7	<b>A380</b>			

Source: Qantas and British Airways.

While the benefits that the JSA delivers, through feed and cost improvements, provide the JSA parties with the best opportunity to improve the profitability of poor performing JSA routes, the continued operation of these routes is not assured. The factual scenario described above is predicated on the changes being implemented by Qantas and British Airways delivering the expected improvement in profitability and there being no unexpected deterioration in the economic environment for air travel. However, were this not to be the case then a scaling back of capacity may still be necessary, even if the JSA is reauthorised. [Confidential Information Deleted]

Given the period over which the Asian and Middle Eastern airlines' capacity has now been in place on the JSA routes and the forward fleet plans of these other airlines, we expect that the capacity of non-JSA airlines in the factual scenario would grow in line with stated plans. Here too, a deterioration in international conditions could have a disruptive effect, but without necessarily altering the relativities between the JSA parties and their competitors.

## 7.2 Future without the JSA

In developing a scenario of the future without the JSA (the counterfactual) we have assumed, after discussion with the JSA parties, that they would not change their alliance membership nor would British Airways dispose of its equity stake in Qantas as a result of the JSA not being authorised.<sup>86</sup>

As discussed in section 2, marketing alliances, such as **oneworld**, do not provide the same efficiency and consumer benefits as more integrated alliances such as the JSA. Marketing alliances do not provide sufficient commonality of interest for economies of joint provision to be obtained. Although British Airways and Qantas would still both be **oneworld** members without the JSA, because the two airlines would compete on the same sectors, the cooperation between them would be greatly reduced.<sup>87</sup> We explore the incentives facing British Airways and Qantas absent the JSA further below and show that the incentives for British Airways and Qantas' to feed each other traffic would be significantly diminished if they were simply **oneworld** members.

In contrast to the factual scenario just elaborated, the future without the JSA would likely involve a substantial reduction in the services operated by Qantas and British Airways between Australia and Europe. A number of factors would lead to that outcome: reduced connectivity; reduced feed from one airline onto the other; and the flow-on effect to the network of removing weakened spokes.

### 7.2.1 Impacts on Qantas

Under the JSA, British Airways has an incentive to feed traffic on to Qantas' services from Europe: British Airways receives a share of all benefit generated by those Qantas services.

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<sup>86</sup> We assume in the counterfactual that Qantas and British Airways do not agree a JSA style agreement with another airline. There are very limited options for such agreements unless current alliance memberships, outlined in Section 2, are broken. In any event, any new alliance would face similar competition clearance requirements to the JSA.

<sup>87</sup> An example of this can be seen by the relationship between Qantas and fellow **oneworld** member Cathay Pacific. In Northern Summer 2002, Cathay Pacific had flights from London, Frankfurt, Paris, Rome and Amsterdam that arrive in Hong Kong three times per week at a convenient time to connect to Qantas flight QF188 to Sydney. Yet, from the five cities Cathay Pacific fed 198 passengers onto Qantas between April and September 2002, an average of less than 4 per flight.

The effect of this benefit sharing incentive is evidenced by the significant feed, detailed below, that the JSA parties provide each other.

Figure 17 illustrates the growth in passenger feed, that is, connections between British Airways flights and Qantas flights, as the JSA relationship has deepened. The graph illustrates that after the JSA was introduced to UK routes (December 1997) and continental European Routes (November 1998) the number of passengers connected grew significantly. There was also growth in feed after changes to the benefit sharing model in July 2000.

Without the JSA, and thus without benefit sharing, the only benefit that British Airways and Qantas would receive for short haul flights booked as part of JSA itineraries would be the amount that they would be entitled to receive for that flight under the oneworld [Confidential Information Deleted] prorate system, under which British Airways would have little incentive to feed passengers on to Qantas' services. [Confidential Information Deleted <sup>88</sup>] Table 45 below illustrates the impact of using the oneworld [Confidential Information Deleted] prorate formula on British Airways' revenues. It identifies the revenue British Airways receives for a London to Frankfurt sector on three different itineraries. Selling the London-Frankfurt sector as a single journey delivers much greater revenue to British Airways than selling the sector as part of a long haul itinerary with Qantas providing the long haul sector.

**Figure 17: [Confidential Information Deleted]**

**Table 45: [Confidential Information Deleted]**

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<sup>88</sup> [Confidential Information Deleted]

British Airways has also recently reduced intra-European capacity, and is unlikely to have spare capacity at peak times to allocate to Qantas passengers. Qantas' flights to and from Europe arrive in the morning and evening when there is a high business demand for intra-Europe seats. By making this limited capacity available to Qantas connecting customers, it receives far less in prorate payment than the yield it could obtain by reserving that capacity for intra-European business travellers. In the absence of the JSA, it is therefore highly unlikely that British Airways would continue to make its constrained capacity available to these Qantas passengers.

For airlines other than British Airways, the incentives of both oneworld and non oneworld airlines to feed Qantas traffic would be identical under the factual and counterfactual. All the airlines would operate under the same prorate agreements without the JSA as they did with the JSA and thus face identical incentives to feed traffic to Qantas. It is consequently unlikely that Qantas would be able to replace the lost British Airways feed from other sources in the counterfactual.

Having established that British Airways loses its incentive to feed traffic on to Qantas, it is important to identify the quantum of feed that could be lost. The sources of feed for Qantas' Frankfurt, Paris, Rome, and London services are presented in Figure 18 to Figure 22. As these figures demonstrate, British Airways feed is extremely important to Qantas's JSA services. For example, Qantas receives [Confidential Information Deleted]

**Figure 18: [Confidential Information Deleted]**

**Figure 19: [Confidential Information Deleted]**

**Figure 20: [Confidential Information Deleted]**

**Figure 21: [Confidential Information Deleted]**

Figure 22 sets out the share of Qantas passengers on key routes who are connected from a British Airways flight at Singapore or in Europe.

**Figure 22: [Confidential Information Deleted]**

Absent the JSA, Qantas is likely to lose the majority of this feed from British Airways. As discussed above, British Airways will no longer have an incentive to feed passengers onto Qantas due to the loss of the benefit share agreement, the loss of which is not compensated for by the operation of the oneworld prorate agreement. In addition, British Airways is likely to become an active competitor, particularly for high yield customers. British Airways will have the incentive to target Frankfurt, Paris and Rome originating passengers that wish to fly to Singapore and Australia and hub them through London. However, there will be some offsetting effects as Qantas may retain some passengers previously connected to British Airways flights and may recover passengers previously spilled due to the high load factors currently on JSA services. In addition, in the counterfactual, any losses on Qantas flights would be fully borne by Qantas and not shared with British Airways. Qantas estimates, taking into account all factors described above, that the revenue loss on its European flights would be in the order of [between 9% and 13% (Confidential Information Deleted)].

Figure 23 shows the contribution margin for Qantas' JSA European flights. [Confidential Information Deleted]

**Figure 23: [Confidential Information Deleted]**

Although London services seem to out perform other routes, this performance is not consistent across all London flights. Figure 24 shows the financial performance of each of Qantas' three London services. [Confidential Information Deleted].

**Figure 24: [Confidential Information Deleted]**

Given the financial performance of the European flights and in particular the current marginal profitability, Qantas' schedule would be likely to be unsustainable in the face of the expected revenue loss [of between 9% and 13% (Confidential Information Deleted)] in the counterfactual.

[Confidential Information Deleted]

[Confidential Information Deleted] Qantas has determined that the reduction in revenue would necessitate [Confidential Information Deleted] contraction of its schedule. A sustainable schedule in the long term would be unlikely to comprise more than 24 weekly services to Europe, a reduction of at least 10 services from the current schedule and 14 services when compared to the factual schedule. There are a number of ways in which this sustainable service level could be delivered, and the financial performance of the routes at the time of the reduction would drive the decision on which services to continue and which to terminate. Given the current financial performance of the Rome, Paris, Frankfurt and [Confidential Information Deleted] London services, all would be candidates for capacity reduction.

The European services that Qantas operates, in turn, provide significant feed to Qantas and British Airways services between Singapore and Australia. The reduction in European services would therefore undermine the financial performance of the Sydney and Melbourne to Singapore services and even more severely impact the secondary Australian city services. Figure 21 shows that the services from Singapore to Perth, Brisbane and Darwin/Adelaide are dependent on feed for a significant proportion of their passengers. The chart shows the proportion of passengers that connect at Singapore from British Airways flights and from Qantas' London, Frankfurt, Paris and Rome services.

**Figure 25: [Confidential Information Deleted]**

Qantas estimates that the net loss of British Airways feed, increased British Airways competition and reduction of Qantas' Singapore to Europe flights would result in a significant reduction in revenue. Taking account of current profitability and contribution, set out in Figure 26, the viability of these services at their current level of frequency would be significantly undermined by these revenue impacts, even when the gains expected from other initiatives are considered.

**Figure 26: [Confidential Information Deleted]**

Thus, in the absence of the JSA, Qantas could not maintain the current number of services between Singapore and Australia. Qantas has estimated that a sustainable level of service would be likely to comprise 23 weekly services, a reduction of 5 services from the factual schedule. As with services to Europe, there are a number of ways in which the sustainable level of service might be reached. Qantas would consider the most up to date financial performance of each route at the time of the service reduction before determining the services that would be terminated. The current financial performance of all routes, particularly the services to the smaller capital cities, makes each of them candidates for rationalisation.

### **7.2.2 Impacts on British Airways**

In developing its counterfactual scenario British Airways, like Qantas, has identified the passengers that would be at risk absent the JSA. However, unlike Qantas, British Airways has split these passengers into three distinct groups for the purpose of this analysis.

#### *Passengers on Qantas code*

Currently, Qantas actively sells British Airways operated services as if they were Qantas services by placing Qantas code on the British Airways operated services. This is particularly evident on traffic from the mid-point to Australia where Qantas has a stronger presence than British Airways (driven by the fact that this traffic touches Qantas' home country). In the absence of the JSA, and thus without the benefit share, Qantas would have no incentive to continue to sell these services and would most likely direct this traffic onto Qantas operated services wherever possible.

#### *Passengers connecting to Qantas*

As we have already discussed in section 3, the mini-hub in Singapore allows the JSA parties to offer better connections and serve more cities by flowing traffic across both parties' networks. As illustrated in Table 45 above, in the absence of the JSA, both carriers would attempt to connect passengers onto their own services rather than handing revenue over to each other. Given the relative depth and breadth of the British Airways and Qantas networks into Australia and Europe from Singapore, Qantas would be able to serve more of this traffic directly without the need to connect to British Airways. For example, London-

Singapore-Perth on British Airways-Qantas could be served Qantas-Qantas but not British Airways-British Airways in the counterfactual world.

*Passengers ticketed by Qantas*

As a result of the JSA benefit share arrangements, Qantas has an incentive to sell British Airways operated JSA services, including through direct channel sales, such as Qantas telephone sales, stopover connections on a journey beginning on a Qantas service, or where Qantas has a sales presence and British Airways does not. In these situations, a passengers' journey could be issued on Qantas ticket stock without falling into either of the above categories. Without the JSA, these sales could be at risk.

Table 46 identifies British Airways' reliance on this traffic by route for October 2001 through to September 2002.<sup>89</sup> British Airways considers that [between 30-40% (Confidential Information Deleted)] of annual revenue is at risk absent the JSA.

**Table 46: [Confidential Information Deleted]**

Absent the JSA there is likely to be a redistribution of traffic between British Airways and Qantas and the their competitors on the JSA routes. British Airways will lose a proportion of its traffic at risk and likely recover a proportion of the Qantas traffic at risk as each carrier aims to direct traffic onto its own services. Utilising British Airways' methodology Qantas is estimated to have [Confidential Information Deleted] revenue at risk on their UK-Australia services.

In practice, due to the competitive nature of these routes, it is likely that British Airways would lose a higher proportion of the British Airways traffic at risk than would be recovered from the Qantas traffic at risk. This is because British Airways would be competing not just with Qantas but also with every other carrier on these routes to both retain the Qantas influenced traffic on British Airways' routes and capture the British Airways influenced

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<sup>89</sup> Double counting is avoided by focusing on the following categories: Qantas code on British Airways services regardless of whether point-point or connecting; BA-QF connections excluding those using the Qantas code; and British Airways uplift on Qantas ticket excluding those using Qantas code or connecting to Qantas within 1 calendar day.



traffic on the Qantas services. As discussed earlier, the Asian and Middle Eastern airlines have more attractive network propositions and it is purely the JSA (including the benefit share and Singapore mini-hub) which gives the JSA parties the ability to attract many of these passengers.

Recent improved market conditions, along with JSA initiatives, have led to an improvement in British Airways' profitability on JSA routes and for the 9 months to Dec-02, the combined JSA route delivered a ROS<sup>90</sup> of [Confidential Information Deleted] with a contribution of only [Confidential Information Deleted]. If we assume the same Quarter 4 versus full year relationship as 2001, then on a full year basis we would anticipate a ROS of [Confidential Information Deleted] with a contribution of [Confidential Information Deleted].<sup>91</sup>

Although it is difficult to estimate the impact precisely, [Confidential Information Deleted] Although reaction would not be immediate, in the medium term in the counterfactual, British Airways anticipates that potential losses would be unsustainable and capacity would need to be reduced.

British Airways believes the appropriate responses could include:

- reducing the number of Australian cities served; and/or
- changing to smaller aircraft; and/or
- redistributing Australian cities served [Confidential Information Deleted]

Under the counterfactual schedule, British Airways would propose sustaining levels of capacity to both Singapore and Bangkok where British Airways has a local selling force advantage at the UK end of the routes, whilst limiting exposure on the southern sector [Confidential Information Deleted] on services to both Sydney and Melbourne.

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<sup>90</sup> ROS is an abbreviation for return on sales, and is calculated as profit over total revenue

<sup>91</sup> Given the impact of SARS and the war in Iraq, this estimate is likely to be greater than British Airways' actual profitability for the year but should be representative of profitability under more stable conditions.

In the longer term, absent the JSA, the likelihood is that the losses would continue (or become more extreme) and this would necessitate further capacity reductions, detailed in Table 47. These changes sustain capacity on the northern sector while further minimising exposure on the southern sector, with the southern focus on Sydney, as the largest single route.

### 7.2.3 Counterfactual schedules

Table 47 presents the best estimate of the frequencies that Qantas and British Airways would operate in the medium term and long term absent the JSA. These estimates are subject to changes in circumstances, such as a sustained conflict in the Middle East. The counterfactual schedule represents a 38% decrease in flight frequency to Australia in the long term when compared with the factual schedule. Given the uncertainty surrounding the exact nature, in terms of routes and aircraft size, of the cancellations Qantas would have to make under the counterfactual, the anticipated reductions in frequencies could give rise to a range of capacity reductions. Analysing the range of possible scenarios, Qantas' capacity reduction in the counterfactual (measured in terms of total seats to and from Australia) would range from 23% to 32%. Although British Airways' counterfactual also contains uncertainty as to the exact routes likely to be withdrawn, because of the similar distances in alternative routes and the similarity of the likely aircraft operated, this uncertainty does not affect the likely level of overall capacity reduction. Thus British Airways' long term likely counterfactual schedule represents a reduction of capacity of up to 67%. Overall, the counterfactual represents a reduction in capacity to Australia of between -35% and -42%.

**Table 47: Expected factual and counterfactual frequencies per week**

		Medium Term		Long Term	
		Factual	Counterfactual	Factual	Counterfactual
Australia to Singapore/Bangkok Sectors	Qantas	60	51	66	47
	British Airways	21	14	21	7
Singapore / Bangkok to Europe Sectors	Qantas	36	28	38	24
	British Airways	21	21	21	21
Australia to Europe through Flights	Qantas	36	28	38	24
	British Airways	21	14	21	7

Source: Qantas and British Airways.

### 7.3 Conclusion

In our factual scenario, an improvement in profitability means that Qantas and British Airways are likely to maintain and, over time, expand services on the Kangaroo Route. In contrast, in the counterfactual, the loss of the JSA results in a loss of feed between the JSA parties. This leads to the cancellation of flights, which has flow-on effects for the Singapore mini-hub, to the point where that mini-hub may eventually disintegrate.

In the following sections we use the factual and counterfactual scenarios to analyse the competitive effects and public benefits associated with the JSA.

## 8 Competitive effects

This section analyses the likely competitive effects of the JSA by comparing the most likely prices and output in the future with and without the JSA. Section 8.1 outlines the strong competitive disciplines operating in the relevant market. Section 8.2 examines the likely competitor responses to the Qantas and British Airways factual and counterfactual schedules. Given that predicting competitor response is extremely difficult, we put forward two scenarios where in the counterfactual all and none of the capacity removed by the JSA parties is replaced. Reality will inevitably be somewhere between these two scenarios. Given the competitive nature of the relevant markets and likely competitor reaction we assess the likely outcome under the two scenarios for prices and output in section 8.3. Section 8.4 concludes.

### 8.1 Competitive disciplines

The most relevant market for evaluating the JSA is the air passenger services market between Australia and Europe. In section 5, we demonstrate by analysing a range of indicators, that competitive disciplines are effective in this market and have been at all times since the initial JSA was authorised. In particular, section 5 shows:

- The Asian airlines and Emirates have been extremely successful at winning passenger and market share over the last seven years;
- Several airlines have reported their intentions to commence or expand services on the Kangaroo Route; and
- JSA parties' profitability has fallen.

There is no reason to believe that the structural features that underpin competition on the Kangaroo Route will change in the near future. Indeed competitive pressure can be expected to increase as expansion and entry by Asian and Middle Eastern airlines occurs.

In the market for the transport of air freight, which was discussed in section 6, market shares and competitive pressures have closely paralleled those in the passenger market, and we would expect this close link to persist.

## 8.2 Competitor response

Given the lack of information that the parties have on their competitors' costs structures and strategies, it is difficult to accurately gauge the reaction by other airlines to the removal of British Airways and Qantas capacity in the counterfactual. At the highest level, there are two main options: maintain current capacity, which would see a decline in total capacity for the market and likely increase in prices; or increase capacity to replace that left vacant by Qantas and British Airways.<sup>92</sup>

There are a number of ways in which airlines can increase capacity on the Kangaroo Route. First, capacity devoted by a hub carrier to any particular route can be changed without introducing additional flights. Currently, airlines flying on the Kangaroo Route do not dedicate all their capacity to those passengers who are flying from Australia to Europe. For example, Singapore Airlines does not allocate 100% of the capacity it operates between Australia and Singapore to passengers travelling to and from Europe. Rather, many of the passengers travelling between Australia and Singapore are likely to be travelling to and from a point in Asia. Hence, capacity left vacant by Qantas and/or British Airways may be replaced, at least in part, by the reallocation of capacity by other airlines to these sectors. The extent to which such reallocation actually occurs depends on airline performance on the Kangaroo Route relative to other routes and ultimately on the profitability of reallocating capacity.

Second, competitors may increase capacity by adding larger planes on existing flights. The use of larger planes would require either additions to the airlines' fleet or a reallocation of aircraft within the carrier's existing network.

Third, competitors may increase the number of flights operating on the Kangaroo Route. Again in order to achieve this either fleet additions or a reallocation of aircraft usage within the airline's network would be required.

Despite the range of options available, the impact of Qantas and British Airways' capacity reduction on individual airlines may not initially be significant enough to warrant

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<sup>92</sup> The JSA parties understand that on some airlines' existing flights there is currently spare capacity and, as a result, part of the British Airways and Qantas passengers lost in the counterfactual may be able to be absorbed without the need for extra operating capacity to be added.

competitor capacity reaction. Experience and analysis suggests that passengers formerly carried by Qantas and British Airways, to the extent that they are able to be absorbed by other airlines, would likely be absorbed across all the airlines competing in the market place rather than captured by a single airline and hence the additional passengers carried by any one airline may be insufficient to warrant a large capacity reaction.

Taking Frankfurt as an example, in addition to Qantas, there are seven other airlines that operate one-stop services to Australia (six airlines apart from Qantas operate Paris and Rome). Passengers historically carried by Qantas from Frankfurt would most likely be spread over the remaining seven airlines operating a one-stop service on the city pair, plus the numerous airlines operating a two-stop or multi-stop service. Additionally, many of the European passengers carried by Qantas and British Airways do not originate in Frankfurt, Paris or Rome but are connected to these flights. In making their journey to Australia, these passengers would have a range of other airports at which to make their connection to Australia. As a result, passengers who historically flew with Qantas from Frankfurt would not only be spread among the other operators flying from Frankfurt, but also among many other airports and the operators flying from them.

Given this dispersion of the existing passenger base, the increase in passenger numbers on each other airline may be too small to prompt any other airline to increase capacity immediately, particularly when the additional capacity currently planned on the Kangaroo Route (see section 5.2.6) is taken into account. The withdrawal of capacity by British Airways and Qantas would, however, bring forward the date of profitable capacity increases.

In the discussion so far we have treated all competitors as one. However, individual competitor responses will vary. The response by an individual competitor will be dependent on a number of company specific factors, some of which affect profitability and some of which are relevant to the companies' wider objectives. These include:

- current aircraft utilisation;
- profitability across routes on the network;
- impact on network connectivity of additional flights;
- available capital – are there any capital constraints to investing;
- political constraints – eg the requirement to serve non profit making politically sensitive routes; and

- other non profit maximising objectives – for example supporting “Singapore inc”.

In reality, competitors will likely react in different ways to the withdrawal of British Airways and Qantas capacity; even where competitors increase capacity, different airlines will use a differing mix of the options outlined above.

The nature of competitors’ reaction is extremely complex and, given the limited information available to the JSA parties, almost impossible to predict accurately. Given this uncertainty surrounding competitors’ response to the reduction in Qantas and British Airways capacity, we proceed by considering the two extreme scenarios:

- competitors add no capacity; and
- competitors replace all the capacity left vacant by British Airways and Qantas.

The reality, of course, is likely to be somewhere between these two scenarios.<sup>93</sup> In the next section we analyse the likely effect on prices under the two competitor reaction scenarios.

## 8.3 Prices and output

### 8.3.1 No capacity replacement

Intuitively, a reduction in capacity of the size envisaged under the counterfactual will create upward pressure on prices. Theoretically, there may be some offsetting effect because absent the JSA there would be an additional competitor operating on the Kangaroo Route. That is, British Airways and Qantas would operate on the Kangaroo Route as two distinct and competing airlines rather than one. However, given the competitive nature of the

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<sup>93</sup> This discussion predominantly focuses on air passenger markets. Based on historical experience, we suspect that freight competitive effects will be similar to those in the air passenger services market. That said, freight is more likely to be closer to the full capacity replacement scenario than air passenger services given that expansion and entry barriers for these markets are relatively lower, and the operation of dedicated freighters.

Kangaroo Route and, in particular, the number of existing competitors,<sup>94</sup> the impact of this additional competitor is unlikely to be substantial.<sup>95</sup>

Under the no capacity replacement scenario, despite competitors operating at below efficient maximum load factors and consistent with its extreme nature, it is assumed that no passengers lost from the JSA parties' services are able to travel on competitors' services. As a result output will decline in the counterfactual.

As discussed above, the effect of an additional competitor in the counterfactual would be small. Thus, it is our view that in the scenario where no capacity is replaced, prices would be higher and output lower in the counterfactual when compared with the factual. Thus the JSA delivers competitive benefits in terms of increased output and lower prices.

### 8.3.2 Full capacity replacement

Assuming full capacity replacement and strong competition, prices would likely be the same with and without the JSA. Prices could theoretically be higher in the factual when compared with the counterfactual due to an addition of a competitor under the counterfactual, but for the same reasons described in the previous section, the impact of this additional competitor would likely be small.

With full capacity replacement, given the range of active competitors, it would seem reasonable to assume that output is likely to be the same in the factual and counterfactual. Although if there is a small price increase, due to the addition of an extra competitor, then there may be a corresponding minor fall in output.

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<sup>94</sup> Table 16 gives the market shares of JSA parties' 12 largest competitors.

<sup>95</sup> Kwoka found that the number of firms, when it is sufficiently high, does not influence the relationship between market structure and the market performance. Empirical evidence shows the threshold is as low as 3. See Kwoka J E, 1979, "The Effect of Market Share Distribution on Industry Performance", *Review of Economics and Statistics*, 61-1:101-09; and Kwoka J E, 1981, "Does the Choice of Concentration Measure Really Matter?" *Journal of Industrial Economics*, 445-453.



Thus, in the scenario in which all capacity is replaced, prices and output are likely to be unchanged in the counterfactual when compared with the factual. It is theoretically possible, given the addition of a competitor, that there would be a price fall associated with the removal of the JSA. However, given the nature of competition in the relevant market this price fall is unlikely, and even if it did eventuate, the effect would be very small.

## 8.4 Conclusion

The competitive constraints operating on the Kangaroo Route, in both the air passenger services market and freight markets, are expected to continue with or without the JSA. Determining competitor response to the counterfactual is complex and as a result two extreme scenarios, full capacity replacement and no capacity replacement, are analysed. Under the full capacity replacement scenario, although there is in theory a possibility of a small competitive detriment associated with the JSA, in practice, in such a competitive market it is most likely that there will be no competitive impact with prices and output unchanged. Under the no capacity replacement scenario, it is likely that prices will be higher and output lower in the counterfactual and thus the reauthorisation of the JSA would be clearly pro competitive.

The reality of competitor response is likely be between to the two extreme scenarios and as such there is most likely to be a competitive benefit, through lower prices and higher output, associated with a reauthorised JSA. As described in Section 3, the JSA makes Qantas and British Airways more effective competitors to the Asian and Middle Eastern airlines than they otherwise would be. This, in turn, ensures stronger competition than could otherwise prevail, in all segments of the relevant markets. It is for these reasons that we believe the JSA is far more likely to promote competition than to lessen it.

## 9 Effects relating to domestic air services in Australia

There are two reasons for taking account of domestic air passenger services in Australia when considering the reauthorisation of the JSA.

### ***Impact of domestic competition on international competition***

First, it could be argued that domestic air passenger services provide the JSA parties with significant feed advantages, which limit the ability for other airlines to compete in the relevant international air service markets. That is, the nature of competition for domestic air services in Australia - specifically Qantas' strong presence - could be said to impact on competition in the relevant international air passenger service markets.

However, the market share trends set out in section 5.1 demonstrate that airlines competing with the JSA parties have increased their presence in the Australia-Europe and Australia-South East Asian air passenger service markets in recent years. This suggests that, despite any advantages that the JSA parties may have from Qantas providing Australian domestic services, as a matter of commercial reality, this has not prevented effective expansion by its competitors in these markets.

A possible explanation for this lies in Australia's population geography. Australia is highly urbanised, with 1% of the landmass being home to 84% of the population. Moreover, a few population centres account for the bulk of the urbanised population. As a result, by flying to a small number of major centres, Asian and Middle Eastern carriers are able to service a large proportion of customers directly. The concentration of customers in these major centres also makes international carriers less reliant on domestic feeds than is the case elsewhere in the world; the majority of Australian customers for international flights do not require domestic connections to meet international services.

Table 48 below shows that 61% of the Australian population live in a major city which is an O/D port for JSA services and is served directly by at least two carriers other than Qantas and British Airways. The figures represented in the table are conservative: the population figures for each O/D port do not capture nearby population centres, whose residents are unlikely to use domestic air services to meet international flights.

**Table 48: Population served by direct flights on JSA routes**

	Non JSA carriers on routes	Population 000s	Cumulative % of Australian population
Sydney	Singapore Airlines, Cathay Pacific, Japan Airlines, Lauda Air	4,085	21%
Melbourne	Singapore Airlines, Cathay Pacific, Japan Airlines, Lauda Air	3,466	39%
Perth	Singapore Airlines, Emirates	1,381	47%
Brisbane	Singapore Airlines, Cathay Pacific, Japan Airlines,	1,627	55%
Adelaide	Singapore Airlines, Cathay Pacific	1,096	61%
Cairns	Cathay Pacific, Japan Airlines,	116	61%

Source: Australian Bureau of Statistics.

An airline such as Qantas operating on domestic routes might be better placed to compete on JSA routes for inbound passengers intending to undertake significant domestic travel within Australia. However, Qantas, in particular, would not be able to act unconstrained in the provision of services to such customers (assuming that it were able to price discriminate against this particular customer segment), since airlines operating on JSA routes would be able to feed traffic to Virgin Blue, whose migration to the Sabre booking system enables overseas travel agents to access its tickets.<sup>96</sup>

Regardless, and reflecting its commercial interests,<sup>97</sup> Qantas widely agrees Special Prorate Agreements (SPAs) with international competitors in respect of Australian domestic travel.<sup>98</sup>

<sup>96</sup> Additionally, even if Qantas were unconstrained, given the ability to price discriminate it would presumably take the rents from domestic services. There would, in other words, be no reason for that ability to be used to affect conditions in the international markets.

<sup>97</sup> For the reasons set out in the footnote immediately above, it would likely be irrational for Qantas to seek to use its domestic position to alter international outcomes. This is all the more the case as the attempt to do so might simply provoke the expansion of competing domestic services.

Qantas has over 45 SPAs with other carriers for Australian domestic flights. For JSA routes, Qantas has SPAs covering Australian domestic travel with airlines including Emirates, Japan Airlines, Malaysia, Scandinavian, and Singapore.

### ***Impact of competition in international markets on domestic competition***

It might also be argued that a reauthorised JSA could affect competition in domestic air services in Australia. That is, competition in the relevant international air passenger service markets could impact on domestic competition.

In Determination A30202, the Commission expressed concerns over the impact the JSA might have on Australian domestic air passenger services, noting the traffic share of Qantas on international routes relative to Ansett.<sup>99</sup> However, it was prepared to accept that the JSA would not lessen domestic competition. In our view, the JSA does not appear to have impacted significantly on Virgin Blue's ability to compete in Australia, Virgin Blue having now captured around 30 percent of domestic Australian traffic.<sup>100</sup>

This is possibly due to the fact that the fraction of international traffic that flows onto domestic routes would appear to be low. Information provided by Qantas certainly suggests this. For the period February 2002 to January 2003, [Confidential Information Deleted] passengers connected from an overseas point onto a Qantas domestic flight, at any Australian gateway. For the same period, Qantas had a total of [Confidential Information Deleted] commercial passengers flying within Australia. Hence, overall, only [Confidential Information Deleted] of passengers that flew on Qantas within Australia in the last 12 months joined from an international flight.

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<sup>98</sup> Special Prorate Agreements are variations from the standard IATA fare and range.

<sup>99</sup> Determination A30202, p. 64 to 65.

<sup>100</sup> Estimate by Qantas management. Virgin estimated in January 2003 that they had obtained 26% of domestic Australian traffic. See *The Age*, 2003, Virgin Blue boosts fleet, eyes market, Steve Creedy, January 17, [http://www.theaustralian.news.com.au/common/story\\_page/0,5744,5850004%255E23349,00.html](http://www.theaustralian.news.com.au/common/story_page/0,5744,5850004%255E23349,00.html) (accessed 4 February, 2003).

Of these [Confidential Information Deleted] connecting passengers, [Confidential Information Deleted] came from a Qantas flight number, only [Confidential Information Deleted] came off British Airways, while [Confidential Information Deleted] were provided by other oneworld carriers. Hence, less than [Confidential Information Deleted] percent of passengers that flew on Qantas domestically or regionally within Australia in the last 12 months joined from an international flight provided by British Airways. This would suggest that the advantages that Qantas might have domestically as a result of securing feed from international flights as a result of the JSA are indeed very limited. More importantly, it suggests that it is highly unlikely that, as the result of the JSA, entry or expansion in Australian domestic air services could be materially affected, much less foreclosed.

Even if international feed onto domestic routes were significant, it is understandable why this might not affect an airline operating under a VBA model. For VBAs, the typical strategy is to provide short haul point to point services on high density domestic routes. In contrast to full service airlines, VBAs have tended to avoid the complications, slower turnaround times and resulting higher costs associated with interlining. By avoiding reliance on feeder traffic, VBAs have been able to retain a substantial cost advantage relative to their full service rivals.

Moreover, if a VBA or an FSA operating domestically in Australia wished to interline, there is no reason to believe that it would not be able to secure a substantial share of international feed from JSA routes, particularly from a Star Alliance airline. The codesharing agreement signed between Virgin Blue and United Airlines in June 2002 is testament to this.<sup>101</sup> More specific to the matter at hand, there is no reason why Virgin Blue, or any airline entering Australia (whether it be an FSA or VBA), could not form a similar agreement with an airline operating on the Kangaroo Route, particularly given that a significant proportion of the Australia-Europe and Australia-South East Asia markets remain served by airlines other than the JSA parties (see section 5.1).

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<sup>101</sup> See <http://www.virginblue.com.au/news/jun2002.html#050602>.

## 10 Effects arising from proposed Qantas and Air New Zealand alliance

As the Commission is aware, Qantas and Air New Zealand are proposing to enter into a strategic alliance. The proposed alliance would involve Qantas acquiring up to 22.5% shareholding in Air New Zealand and the creation of a Joint Airline Operation (JAO) involving price and schedule coordination for all Air New Zealand flights and all Qantas flights to, from and within New Zealand. If the proposed alliance between Qantas and Air New Zealand were authorised, competition in the international air passenger markets relevant to the JSA could be affected. In our view, any competitive effects will be minimal and, in any event, most likely be pro-competitive.

As the relevant tables contained in section 5.1 show, Air New Zealand has effectively 0% market share in the Australia-South East Asia market and, for the Australia-Europe market, a share of 2% based on the most recent ABS data and a share of less than 1% based on MiDT data. Air New Zealand has also recently announced that it is going to withdraw its direct Sydney to Los Angeles service. In short, Air New Zealand's presence in these two markets is minimal.

It could be argued that if the JSA were reauthorised and the proposed alliance between Qantas and Air New Zealand were approved, it is possible that there might be some European bound traffic that is currently fed by Air New Zealand to Singapore Airlines at Singapore, which would instead be fed to the JSA parties.<sup>102</sup> Our view is that the effects of this, if any, would be pro-competitive in the sense of decreasing the competitive disadvantages that face Qantas and British Airways vis-à-vis Asian hub operators. More specifically, we would expect some, though slight, potential gains in terms of the viability of Qantas' services to continental Europe; this would help ensure that the competitive pressures these services place on mid-point carriers remained in place.

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<sup>102</sup> In this respect, we note that the bulk of all traffic that is at present carried by Air New Zealand to Singapore is New Zealand-Singapore O/D traffic with only a small amount currently passed on to Singapore Airlines to carry beyond Singapore.

## 11 Public benefits

The JSA provides significant benefits for Australian consumers and for the Australian economy. The overall benefits from the JSA are estimated at between \$402m and \$561m; the component parts that make up this benefit are set out in Table 49.

**Table 49: Estimation of Australian benefits \$m 2003-2007**

Benefit	Lost JSA capacity replaced	Lost JSA capacity not replaced
Cost savings (Qantas only)	\$43	\$43
Enhanced schedule options	>0	>0
Tourism	\$58	\$353
Net Exports	\$301	\$165
Yield Management	>0	>0
International competitiveness	>0	>0
<b>Total</b>	<b>&gt;\$402</b>	<b>&gt;\$561</b>

The following sections provide the detailed empirical estimates of each of the benefits, in particular:

- Section 11.1 sets out the cost savings that the JSA allows British Airways and Qantas to achieve. The JSA helps reduce the overall costs of operating the JSA routes. So as to illustrate this effect, we have examined in some detail the significant cost saving the JSA allows in two major areas: IT systems and joint facilities.
- Section 11.2 discusses the additional consumer benefits provided by the improved scheduling and availability of flights that the JSA facilitates.
- Section 11.3 describes and estimates the inbound tourism effect that the JSA delivers for Australia.

- Section 11.4 estimates the benefit that the JSA secures in increased net exports
- Section 11.5 details the impact on employment.
- Section 11.6 estimates the benefit associated with joint yield management.
- Finally, section 11.7 describes the improvement in Qantas' international competitiveness with the JSA.

It has not been possible to derive an estimate for all the public benefits identified, nor have we sought to quantify public benefits related to the freight market. Thus while our estimate of public benefits is substantial, it should be viewed as a conservative estimate of the true public benefits associated with a reauthorised JSA.

## 11.1 Cost synergies

In Determination A30202, the ACCC accepted that the JSA had and would continue to deliver cost savings and that these costs savings were public benefits due to the more efficient use of resources. The ACCC noted:<sup>103</sup>

It would be surprising to the Commission if two substantial businesses such as Qantas and BA were not able to achieve substantial cost savings through a joint rationalisation of aircraft operations and support services.

The JSA continues to deliver significant cost savings and the termination of the JSA would have two significant impacts on costs. First, fixed costs would have to be recovered over fewer flights and a smaller revenue base, thereby harming Qantas' cost competitiveness. Second, variable costs would rise due to the loss of economies of scale and scope that the JSA provides.

Since the inception of the JSA, the JSA parties have been able to achieve significant cost synergies. However, many of these cost synergies will be lost if the JSA is not reauthorised because differences in the commercial interests between the JSA parties, the lack of a

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<sup>103</sup> Determination A30202, p 78.



framework that can help align these interests, and the constraints of the TPA will inhibit collaboration between the JSA parties.

To highlight the issues involved, and the magnitudes of the impacts, the following sections detail synergies in IT, joint facilities and aircraft utilisation that would be lost under the counterfactual. We would expect that given the extremely competitive nature of the Kangaroo Route, as detailed in section 5, a significant proportion of the benefits are passed on to consumers in the form of lower prices and or improved quality.

### 11.1.1 IT systems

To date, Qantas and British Airways have invested in the joint development of a number of systems that provide both parties with the capability to deliver effective customer service to passengers booked on either carrier.<sup>104</sup> Since both carriers are now on a common reservations platform—the Amadeus System User— customer service staff can manage passengers’ itineraries, and changes to them, much more effectively.

Another area where joint IT investment has yielded passenger benefits is the common management of inventory on the JSA routes, which opens out the number of seats available for passengers on these routes.

It is assumed that in the absence of the JSA, Qantas and British Airways will be competitors on the Kangaroo Route and will therefore not wish to share proprietary information or commercially sensitive data. This would have two impacts:

- joint development of commercial IT systems would become impracticable due to the risk of information leakage and the unwillingness of two competitors to signal emerging business opportunities; and
- modifications would need to be made to existing shared systems to allow each party to protect competitively sensitive information.

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<sup>104</sup> Several years ago, Qantas concluded that it could no longer afford to fund the ongoing investment in large commercial systems such as Yield Management as a single airline, and instead, must partner with other large airlines (such as British Airways) or service providers (such as Amadeus).

Given these impacts, in the absence of the JSA, British Airways and Qantas would no longer benefit from the shared maintenance or development of common IT systems. This is likely to result in significantly increased costs, incurred because each company would need to establish separate teams to perform functions that are presently conducted jointly. Although these costs are difficult to quantify precisely, an idea of their magnitude can be gained by considering the different strategies that the parties might pursue were they to lose the benefits currently enjoyed by the two airlines through the JSA.<sup>105</sup>

The primary areas where scope economies are currently achieved in IT are:

- yield management systems;
- the Triton New Gen program (to develop and use Amadeus services); and
- shared facilities and related IT infrastructure.

We consider these areas, and the implications for them of termination of the JSA, in greater detail below. For the purposes of this analysis, we have used five-years as a reasonable time-frame in which costs can be estimated.

### ***Yield management systems***

The Origin and Destination Yield Management (O&D) system has been developed as a means of optimally managing supply and demand – by balancing customers’ needs to travel and their desire for greater flexibility. Some customers will need to travel at short notice, or via a particular route, or to fit in with a tight time schedule. These customers effectively desire greater flexibility in order to obtain more convenient travel times and routes. Customers who do not require this extra flexibility can be given discounted fares. As a result of the JSA, Qantas and British Airways have collectively invested over [Confidential Information Deleted] million over 7 years in jointly developing and implementing an

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<sup>105</sup> The size and complexity of commercial airline systems mean that changes to strategies cannot be implemented rapidly. The Qantas/British Airways new Origination and Destination Yield Management system has taken over seven years from the date the strategy was approved to implementation this year, and the New Generation Departure Control (NGD) system will have taken more than five years to develop.

industry leading O&D yield management system. The JSA is key to the level of investment and degree of integration the parties are committed to. British Airways and Qantas have not jointly developed and invested in similar systems with other oneworld members.

As part of the development of the O&D system, both parties have worked together to develop sophisticated algorithms, which they believe provide major advantages in optimally managing supply and demand.<sup>106</sup> If the JSA is reauthorised, Qantas and British Airways intend to maintain their investment and expect to spend [Confidential Information Deleted] million over the next five years (Qantas [Confidential Information Deleted] million and British Airways [Confidential Information Deleted] million).<sup>107</sup> It is expected that this will permit further substantial improvements in system quality.

For effective system enhancements to be secured, Qantas and British Airways development staff need to work with real pricing and inventory data, reflecting each airline's business strategy. Without the JSA, the airlines could not share the same level of information and would need to change their yield management system strategies accordingly. There are a number of strategies that each airline could adopt in this respect, but due to the complexity of these systems, and the fact that the existing O&D system is integrated with other IT applications, none of these options could be implemented rapidly or inexpensively. The most likely strategies are considered below, and the costs associated with these are shown in Table 50.

***Strategy 1: Enter into contracts to use a third party product***

This strategy assumes that either or both of Qantas and British Airways conclude that owning and investing in their own Yield Management system is not feasible over the long

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<sup>106</sup> Qantas and British Airways have developed a bid price system. This enables Australian passengers on JSA services to gain access to connections to BA's short haul network in Europe, even when their fare class is no longer available on those connecting flights. The bid price system is part of both the yield management (O&D) system, and the New Gen systems (under the Triton New Gen program). IT issues related to the bid price system are therefore incorporated into issues relevant to the O&D system and Triton New Gen program and are not considered separately in this analysis.

<sup>107</sup> These totals and all subsequent totals are presented as five-year totals discounted at 6 percent.

term. There are a number of products available on the market, and the cost of implementing this strategy will vary according to which products are chosen. The relevant costs include licence fees, maintenance costs and operating costs. For the purpose of this analysis, we have used the cost of implementing a product called the PROS Revenue Management System (PROS). Although PROS is one of the most popular third party products available, it would not deliver the same benefit as the joint system operated under the JSA, as it would not be as tailored to each of the parties' specific needs.

*Strategy 2: Continued, but independent, investment in O&D*

Under this strategy, either or both parties would continue to operate their separate versions of the O&D system and independently fund their version's enhancement. In order to do this, both Qantas and British Airways would have to recruit and train additional highly skilled mathematicians and other yield management specialists, thereby individually bearing costs they currently pool or avoid. Since such specialised staff cannot be hired easily in the market and have to be trained over a long period, without the JSA and access to British Airways' and Qantas' pooled resources, both airlines would, in practice, be unable to advance their IT capabilities in the short to medium term. The effect of this is difficult to quantify, and as a result, estimates of the cost associated with this strategy are conservative.

*Strategy 3: Attempt to sell the O&D system to a third party*

The third option is to sell the existing O&D system to an entity such as Amadeus,<sup>108</sup> and enter into a contract with the purchaser to use it as a managed service. This option is likely to involve long and complex negotiations, both commercially and technically, and there is no guarantee that an acceptable buyer would be found. The problems associated with such a sale might be reduced if the system were sold to Amadeus, since Amadeus has already undertaken a significant amount of work for the two parties as part of the Triton program. However, as Amadeus does not currently offer a yield management product, this option would require it to diversify its business, which may result in time delays or reductions in

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<sup>108</sup> Global Travel Distribution S.A. (Amadeus) is a publicly listed company, which provides electronic services to travel services around the world. Its founder shareholders, Air France, Iberia and Lufthansa currently own 60% of the company. Its products include reservation systems, sales management and agency network management tools.

quality while Amadeus builds up expertise in this area. The costs of this strategy have been calculated assuming that the O&D system is sold to Amadeus, which already has knowledge of both airlines' businesses and currently hosts both airlines' reservation systems. As a result, the costs associated with selling the O&D system to Amadeus are likely to be lower than those that both airlines are likely to face if they need to sell the O&D system to a different third party that is starting from a much lower knowledge base with respect to their business.

**Table 50: [Confidential Information Deleted]**

The analysis in Table 50 shows that the costs associated with the loss of the benefits of the JSA conservatively range from [Confidential Information Deleted]. Comparing the total costs incurred under each strategy in the absence of the JSA, both airlines would be better placed to implement Strategy 2, at an additional cost of \$[Confidential Information Deleted] million to Qantas, and an additional cost of \$[Confidential Information Deleted] million to British Airways. As discussed previously, this does not incorporate the additional costs of being unable to fully replicate the current staff capability over the short to medium term and thus extend development time. This underestimate is inherent in the costing of each of the options. If the JSA were not reauthorised, the aggregate additional cost to both parties (or the implied saving associated with the JSA), with respect to the yield management system, is likely to be upwards of \$27 million.

***Triton New Gen program***

During the period in which the JSA has operated, Qantas and British Airways have completed several phases of the migration of their core passenger service IT systems to Amadeus systems. The first part of this migration was the move of each carrier to the Amadeus Reservations platform. This enables the parties, with regulatory approval, to offer customer service benefits by servicing each other's passenger bookings on the JSA routes.

This program, known as the Triton New Gen program, has resulted from strategic collaboration between Qantas, British Airways and Amadeus in order to build on the carriers' common reservations platform by developing new common departure control and inventory systems. Both Qantas and British Airways have signed 10-year agreements with Amadeus under which Amadeus will operate and develop these core passenger service systems. Considerable input on the part of both airlines has been involved, including information on future business capabilities and system requirements, consideration of feasibility studies, and the assessment of designs. Consequently, the carriers have shared detailed business plans, algorithms, and data related to yield management and data warehousing systems. This collaboration between the three parties has been, and continues to be, fundamental to the development of the New Gen systems—New Gen Inventory Management (NGI) and New Gen Departure Control (NGD). Both the NGI and NGD systems are being developed to be integrated and tested with the existing joint O&D yield management system.

If the JSA is not reauthorised, and continued collaboration is prevented due to commercial confidentiality and the constraints of the TPA the full integration, testing and implementation of the NGI and NGD systems would need to be re-evaluated. The NGI and NGD project plans are dependent on the availability to the parties of a combined pool of highly skilled and experienced Qantas and British Airways specialists. Any revisions to the plan would need to accommodate delays and increased costs, while Qantas and British Airways sought to find and train the extra specialists needed to work independently with Amadeus. This may, in turn, reduce the feasibility of the projects, individually and jointly.

The projects at issue are expected to be beneficial to the airlines' customers, since they are intended to result in smoother airport processing and reduced airline costs. More specifically, the systems are expected to significantly reduce the effort required to pre-allocate seats at check-in, thereby reducing customer queuing times; to reduce training time for staff; and to improve customer relationship management. If the implementation of these systems is delayed or cancelled, benefits that would otherwise be achieved will be foregone.

Using current estimates, the aggregate ongoing cost of jointly developing these systems over the next five-year period is expected to be approximately [Confidential Information Deleted] million (Qantas [Confidential Information Deleted] million; British Airways [Confidential Information Deleted] million). In the absence of the JSA, these costs are likely to increase. For the purpose of this analysis, it has been assumed that in the absence of the JSA, the New Gen projects will suffer a 12-month delay. In addition, it is assumed that both airlines will have increased staff costs, and both airlines will incur increased costs due to the added complexity of working separately. Table 51 summarises these costs. A twelve-month delay