Draft Determination

Applications for Authorisation A30226 and A30227

in respect of

The Restated Joint Services Agreement dated 3 April 2000 between Qantas Airways Limited and British Airways Plc and related and consequential coordination of schedules and pricing between the parties.

Date: 23 August 2004

Authorisation No:

A30226
A30227

Commissioners:

Samuel
Sylvan
King
Martin
McNeill
Willett

Public Register:

C2003/536

Executive Summary

On 6 May 2003 Qantas Airways Ltd (Qantas) and British Airways Plc (BA) lodged two applications for authorisation (A30226 and A30227) with the Australian Competition and Consumer Commission (the Commission).

The applications for authorisation were made under subsection 88(1) of the *Trade Practices Act 1974* (the Act) and sought authorisation for an indefinite period for an agreement between the Applicants entitled the Restated Joint Services Agreement (JSA). The JSA in this form was previously granted authorisation on 10 May 2000 for the period until 21 July 2003. On 11 June 2003 the Commission granted interim authorisation to the JSA from 21 July 2003 until the date of issue of this Draft Determination. An earlier form of the JSA was authorised from 12 May 1995 until 11 May 2000.

The JSA provides for the coordination of airline services between Qantas and BA primarily on services between Australia and Europe, including services between Australia/Europe and intermediate points such as Bangkok and Singapore. The coordination embraces scheduling, marketing, sales, freight, pricing and customer service activities. The JSA also provides for code sharing between the two airlines.

The Applicants sought authorisation for conduct which within the meaning of section 45 of the Act might be seen as involving an exclusionary provision or a substantial lessening of competition.

The JSA provides for Qantas and BA to agree on prices. The Commission regards price fixing between competitors as one of the most serious forms of anti-competitive behaviour which can be highly detrimental to economic efficiency and consumer welfare.

The Commission must, in considering whether to grant authorisation to the JSA, apply the statutory tests specified in subsections 90(6) and 90(8) of the Act. For authorisation to be granted under those tests:

(1) the JSA would need to be likely to result in a benefit to the public with that benefit outweighing the detriment to the public resulting from any lessening of competition attributable to the JSA; and

(2) the JSA would need to be likely to result in such a benefit to the public that it should be allowed to proceed.

The Applicants have submitted that the JSA satisfies the tests for authorisation. They stated in support of their claim that:

- markets covered by the JSA have seen an increase in competition with substantial reductions in fares, a decline in the market share of the Applicants, strong growth from mid-point Asian carriers such as Singapore Airlines and the entry of new carriers such as Emirates.
- the JSA has provided and will continue to provide a range of public benefits including:

- consumer product and service benefits such as more destinations, broader schedule choices, more flexible fare products and higher levels of consumer support;
- cost savings and efficiencies;
- lower fares;
- greater net exports;
- higher employment;
- higher levels of tourism; and
- international competitiveness for the Australian airline industry.

The Applicants submitted in support of their applications a Report from NECG which attempted to quantify the net benefits associated with the JSA.

The Commission received submissions from 13 parties with two of the parties, Virgin Atlantic and Virgin Blue, opposing authorisation. In opposing authorisation Virgin Atlantic made reference to separate markets for different passenger types.

The Commission has examined the claims made by Qantas and BA in relation to competition issues and public benefits associated with the JSA and is of the view that:

- there are separate markets for leisure and business travellers on long haul routes operated by Qantas and BA;
- while the JSA will lessen competition in all international passenger markets where both airlines have an operational presence, the United Kingdom business passenger market is the only market where the lessening of competition currently seems likely to be substantial;
- the JSA is likely to lead to significant cost savings for Qantas and BA; which are likely to be passed on to consumers in most passenger markets as a result of continuing competition from sixth freedom carriers;
- public benefits associated with JSA schedule options available to passengers have diminished as a result of the withdrawal of JSA services by Qantas and BA, increased passenger access to European destinations using other carries, and low cost carrier options available in Europe;
- there are no significant net exports, employment or tourism public benefits arising from the JSA.

The Commission does not believe that estimates of net benefit provided by NECG can be regarded as reliable. The estimates are dependent in particular on claims that Qantas and BA would substantially reduce capacity between Australia and Europe if the JSA was not approved. The Commission does not consider the schedules assumed to be operated by Qantas and BA in the absence of the JSA realistic or consistent with changes to schedules made since the authorisation application was lodged.

The Commission considers that overall there is a small net benefit associated with the JSA and on this basis proposes to grant authorisation. Given the fine balance between competitive detriment and public benefit and the volatility of the aviation industry authorisation is proposed to be limited to a period of five years.

Table of Contents

Glossary

ABTA	Australasian Business Travel Association
Act	*Trade Practices Act 1974* (Cth)
AFTA	Australian Federation of Travel Agents Limited
Applicants	Qantas Airways Limited and British Airways Limited
Applications	Applications for authorisation A30226 and A30227
Cathay	Cathay Pacific Airways Limited
Commission	Australian Competition and Consumer Commission
DITR	Department of Industry, Tourism and Resources (Commonwealth)
DTRS	Department of Transport and Regional Services.
fifth freedom	The right of an airline of one country to land in a foreign country and pick up and deliver traffic from that country to a second foreign country.
JSA	British Airways Plc and Qantas Airways Limited Restated Joint Services Agreement dated 3 April 2000 (as amended)
Kangaroo Route	The route between Australia and the United Kingdom.
NECG Report	A report by NECG (and commissioned by the Applicants) on economic issues relating to the application for authorisation of the Joint Services Agreement between Qantas and BA lodged by the Applicants as part of the submission in support of applications A30226 and A30227
oneworld	A marketing alliance formed in 1998. Its members are Qantas, BA, American Airlines Inc, Cathay, Aer Lingus, Finnair, Iberia and LanChile
Original JSA	Joint Services Agreement between Qantas and BA which was authorised by the Commission in 1995 for a period of five years
Proposed Arrangements	The conduct referred to in authorisation applications A30226 and A30227
RPKs	Revenue passenger kilometres
sixth freedom	The right of an airline to carry traffic between two foreign countries via its own country.
SSNIP	The test used to determine, for the purpose of market definition, the smallest area over which a profit maximising monopolist would impose a "small but significant and non-transitory increase in price".

Supporting Submission	Submission in support of applications for authorisation A30226 and A30227 lodged by the Applicants on 6 May 2003
UK	United Kingdom

1. Introduction

1.1. The Australian Competition and Consumer Commission (the Commission) is the Australian Government agency responsible for administering the *Trade Practices Act 1974* (the Act).

1.2. A key objective of the Act is to prevent anti-competitive arrangements or conduct, thereby encouraging competition and efficiency in business, resulting in greater choice for consumers in price, quality and service. The Act, however, allows the Commission to grant immunity from legal action for anti-competitive conduct in certain circumstances.

1.3. One way businesses may obtain immunity is to apply for what is known as an "authorisation" from the Commission. Broadly, the Commission may "authorise" businesses to engage in anti-competitive arrangements or conduct where it is satisfied that the public benefit from the arrangements or conduct outweighs any public detriment.

1.4. The Commission conducts a comprehensive public consultation process before making a decision to grant or deny authorisation.

1.5. Upon receiving an application for authorisation, the Commission invites interested parties to lodge submissions outlining whether they support the application or not, and the reasons for their views.

1.6. The Act requires that the Commission then issue a draft determination in writing proposing either to grant the application (in whole, in part or subject to conditions) or deny the application. In preparing a draft determination, the Commission will take into account any submissions received from interested parties.

1.7. This document is the Draft Determination in relation to applications for authorisation A30226 and A30227 lodged by Qantas Airways Limited (Qantas) and British Airways Plc (BA).

1.8. Once a draft determination is released, the applicant or any interested party may request that the Commission hold a conference. A conference provides interested parties with the opportunity to put oral submissions to the Commission in response to a draft determination. The Commission will also invite interested parties to lodge written submissions on the draft.

1.9. The Commission then reconsiders the application taking into account the comments made at the conference (if one is requested) and any further submissions received and issues a written final determination.

2. The Applications

2.1. On 6 May 2003, the Commission received applications for authorisation (A30226 and A30227) from Qantas and BA (the Applicants).

2.2. The Applications were made pursuant to subsection 88(1) of the Act for an authorisation under that subsection to:

- make a contract or arrangement, or arrive at an understanding, where a provision of the proposed contract arrangement or understanding would be, or might be, an exclusionary provision within the meaning of section 45 of that Act;

- give effect to a provision of a contract, arrangement or understanding where the provision is, or may be, an exclusionary provision within the meaning of section 45 of the Act;

- make a contract or arrangement, or arrive at an understanding, a provision of which would have the purpose, or would have or might have the effect, of substantially lessening competition within the meaning of section 45 of the Act; and

- give effect to a provision of a contract, arrangement or understanding which provision has the purpose, or has or may have the effect, of substantially lessening competition within the meaning of section 45 of the Act.

2.3. Specifically, the Applications sought authorisation for the Restated Joint Services Agreement (JSA) dated 3 April 2000 (as amended) and related and consequential coordination of schedules and pricing between the Applicants. Pursuant to the JSA, the Applicants have sought authorisation to, from time to time, enter into and/or give effect to contracts, arrangements or understandings that may constitute or include exclusionary provisions, including, but not limited to, in connection with the joint supply or joint acquisition by the Applicants of air transportation services and other goods and services.

2.4. The Applicants have sought unconditional authorisation of unlimited duration.

2.5. The Applicants have suggested that if the Commission is not minded to grant authorisation for an unlimited period, authorisation should be granted for a period of not less than ten years.

Interim authorisation

2.6. In making the Applications, the Applicants requested that the Commission consider granting interim authorisation to the Proposed Arrangements. The Commission sought submissions from interested parties on the appropriateness of granting interim authorisation and on 11 June 2003 agreed to grant interim authorisation from 21 July 2003 (the date on which the previous JSA authorisation expired) until such time that the Commission issues a draft determination.

The Applicants

Qantas

2.7. Qantas was incorporated in Queensland in 1920 and is Australia's only international and largest domestic airline. Qantas operates a domestic and international fleet of 194 aircraft to 142 destinations in 32 countries. Qantas employs approximately 37 000 people worldwide and is the 12th largest airline (on the basis of revenue passenger kilometres (RPKs)).

2.8. Qantas is one of Australia's 30 largest listed companies. Qantas' main business is the transportation of passengers and air freight. In addition to the core airline, Qantas also operates Australian Airlines, Jetstar Airways Pty Ltd, Jetconnect, and a number of Qantas subsidiaries which operate regional airline services under the brands QantasLink, Eastern Australian Airlines Pty Limited, Southern Australia Airlines Pty Limited, Sunstate Airlines (Qld) Pty Limited, Airlink Pty Limited and Impulse Airlines Pty Limited.

2.9. Qantas Flight Catering Limited, Caterair Airport Services (Sydney) Pty Limited, Caterair Airport Services Pty Limited and Snap Fresh Pty Limited operate in-flight catering businesses within the Qantas group.

2.10. Qantas Holidays Limited operates holiday, tour and travel businesses.

2.11. Qantas also holds 46.32 per cent of the shares in Air Pacific Limited.

2.12. In March 1993, BA acquired a 25 per cent shareholding in Qantas from the Australian Government. In 1995, the Australian Government sold its remaining 75 per cent shareholding in Qantas through a public share offer and Qantas listed on the Australian Stock Exchange on 31 July 1995. BA's current shareholding in Qantas is 18.93 per cent following a further equity issue in which BA did not participate.

2.13. Qantas is a member of the **one**world marketing alliance. The alliance was formed in September 1998 and **one**world members commenced operating the alliance in February 1999. The members of the **one**world alliance are Qantas, BA, American Airlines Inc, Cathay Pacific Airways Limited (Cathay), Aer Lingus, Finnair, Iberia and LanChile.

BA

2.14. BA is incorporated in the United Kingdom (UK), was privatised in 1987 and is listed on the London Stock Exchange. BA operates domestic and international passenger and freight services from its principal bases at Heathrow and Gatwick Airports and other points in the UK.

2.15. BA operates a domestic and international fleet of 291 aircraft to 170 destinations in 75 countries. In 2003/04, the British Airways Group employed approximately 47 000 people worldwide. It had a turnover of £7 560 million, with a pre-tax profit of £230 million.

2.16. BA currently has two directors on the Qantas board.

2.17. As indicated above, BA is a member of the **one**world marketing alliance.

The JSA

2.18. The Original JSA was authorised by the Commission in 1995 for a period of five years, subject to certain conditions. Under the Original JSA, the Applicants agreed to coordinate business activities regarding their routings, fares, frequencies, aircraft types, product specifications, aircraft configurations, connection requirements and other aspects of their operation and marketing of JSA Routes.

2.19. In April 2000, the Applicants expanded the arrangements under the Original JSA. The Restated JSA provided that the Applicants could extend their coordination and benefit sharing to any part of their respective networks. The Restated JSA received an unconditional authorisation from the Commission in May 2000 for a period of three years. Since the expiry of that authorisation on 21 July 2003 the Restated JSA has been operated under an interim authorisation.

2.20. The Applicants have submitted that the only amendments to the JSA since the Commission authorised it in 2000 have been:

- the benefit sharing model was amended by agreement dated 27 September 2001; and

- changes in the JSA Routes operated by the Applicants have resulted in consequential changes to the sectors of which the benefit sharing model is applied.

2.21. The Applicants have submitted that the key provisions of the JSA include the following.

Condition Precedent (Clause 2)

2.22. The implementation of the JSA is conditional on the Commission's authorisation.

Term (Clauses 3 and 18)

2.23. The duration of the JSA is unlimited as to time. It may be terminated by either party on 12 months' notice or in the event of a breach or other terminating event.

Consumer Benefits (Clause 5)

2.24. Qantas and BA recognise and agree that their objectives in entering into the JSA are to continue to maximise consumer benefits and to operate cost effective and efficient networks.

2.25. Qantas and BA agree to continue to provide the consumer benefits that resulted from the Original JSA and to ensure that the JSA Routes are operated in a manner that will:

- enhance customer service and choice, including departure times, routings, fare and tariff types, fare availability and gateway choice;
- increase Australian, European and intermediate points inbound and outbound traffic and cargo flows; and
- improve the competitive position of each of Qantas and BA and thereby increase competition on the JSA Routes.

2.26. Qantas and BA also agree to:

- deliver significant operational efficiencies and improve the cost effectiveness and efficiency of the operation of the JSA Routes and all functions supporting such services;
- pursue additional opportunities where the parties can develop new services and products which, on a basis which is equitable for both parties, will enhance the consumer benefits and the effectiveness of the JSA Routes;
- pursue other aspects of the operations of the JSA Routes where specific activities and functions can be coordinated and carried out in such a manner that one party performs such activities and functions for the other, including where wider benefits can be derived from economies of scale and the combination of activities and functions;
- continue to encourage and facilitate movement of passengers on the JSA Routes and between those services and other airline services provided by the parties elsewhere;
- continue to promote a common culture of service standards and levels of customer service on JSA Routes including in relation to:
    - onboard products;
    - the handling of passengers and their baggage at all stages from the booking of tickets, checking in at the airport and transfer from one flight to another until disembarkation and retrieval of baggage;
    - the handling of cargo;
    - all other related services including frequent flyer offerings, holiday packages and marketing and distribution arrangements; and
    - joint offices at various points of the parties' networks;

- second staff to each other in order for the parties to benefit from each other's experience and expertise.

Operation of JSA Routes (Clause 6)

2.27. In entering into the JSA, Qantas and BA agree to operate JSA Routes to deliver defined consumer benefits and objectives. This may include code sharing on each other's services.

Cooperation between the parties (Clause 7)

2.28. Qantas and BA may coordinate the following:

- service parameters (routings, frequencies, aircraft types, products specifications, aircraft configuration, connection requirements and times for services offered);
- scheduling;
- sales and marketing;
- cargo;
- pricing (which may include fares and new fare products as well as consumer rebates, incentives and discounts);
- holiday products;
- distribution and agency arrangements;
- frequent flyer programs;
- in-flight products;
- information technology; and
- purchasing activities

to the extent that such service parameters and activities relate wholly or partly to services between Australia and Europe (via any intermediate point), Australia and any intermediate points to Europe, and Europe and intermediate points to Australia, or such other routes as the Applicants may agree from time to time.

2.29. Qantas and BA may also coordinate sales and marketing activities and may:

- operate co-branded joint offices, joint retail sales outlets and joint call centres in agreed locations;
- collocate certain facilities and staff in agreed locations;
- conduct joint promotions;
- coordinate frequent flyer activities and offerings; and

- coordinate agency commissions, rebates, incentives and discounts.

2.30. Qantas and BA will also coordinate their acquisition of goods and services to achieve the most efficient purchasing practices and obtain the best available rates for goods and services. This includes coordinating purchasing in the areas of information technology, fleet acquisitions and engineering and maintenance.

The Committee (Clause 8)

2.31. Qantas and BA also agree to establish a committee with representatives of each of the parties. The Committee will:

- establish schedules for JSA services to maximise the utilisation of each airline's resources committed to the JSA Routes and to best manage capacity demand;
- establish formal and informal pricing parameters for each IATA scheduling season;
- take responsibility for the coordination and integration of all marketing and sales for JSA services;
- take responsibility for coordination of yield and capacity management on JSA services; and
- coordinate on-ground service (for example, check in, baggage delivery, catering, lounge facilities and freight delivery).

Financial arrangements (Clauses 9-13, 15 and 17)

2.32. Qantas and BA agree to make transfer payments to each other in respect of both passengers and cargo carried on JSA services. A detailed model was established for calculating the transfer payments which is designed to ensure that both airlines receive a fair and proportionate transfer of profits derived from JSA services. The model was amended by agreement between the parties on 27 September 2001. The JSA also contemplates that changes to the financial arrangements between Qantas and BA may have to be made over time. This is to take account of changes which Qantas and BA introduce to their services as well as external events affecting the yield each party derives from the air services.

Information exchange (Clause 14)

2.33. Qantas and BA agree to exchange information relating to their air services on JSA services.

3. Chronology

3.1. The Commission conducts inquiries in accordance with the requirements of the Act.

3.2. A chronology of the main stages of the Commission's inquiry follows.

Date	Description
7 May 2003	Applications A30226 and A30227 lodged with the Commission
12 May 2003	Letter to interested parties seeking submissions on Applicants' request for interim authorisation and on A30226 and A30227.
20 May 2003	Deadline for submissions from interested parties on request for interim authorisation.
6 June 2003	Deadline for submissions from interested parties on A30226 and A30227.
6 June 2003	Deadline for interested parties' submissions extended until 20 June 2003
11 June 2003	Commission grants interim authorisation for period until draft determination issued.
20 June 2003	Submissions from interested parties close
30 June 2003	Commission requests cross-submissions and further information from the Applicants by 14 July 2003.
3 July 2003	The Commission agrees to request to extend deadline to 31 July 2003 for response to letter of 30 June 2003.
7 August 2003	Applicants provide cross-submissions and partial response to information requests in Commission letter of 30 June 2003
5 September 2003	Applicants provide outstanding information sought in Commission letter of 30 June 2003.
25 September 2003	Commission requests further information from Applicants by 10 October 2003.
29 September 2003	Meeting with Virgin Atlantic
13 October 2003	Applicants provide partial response to Commission letter of 25 September 2003.

31 October 2003	Commission requests elaboration of information provided in Applicants' letter of 13 October 2003.
3 November 2003	Virgin Atlantic provides supplementary submission to the Commission.
14 November 2003	Applicants provide further information requested in Commission letters of 25 September and 31 October 2003
27 November 2003	Meeting with the Applicants
8 December 2003	Commission requests further information from Applicants
9 December 2003	Applicants' response to Commission letter of 14 November 2003
12 December 2003	Applicants' response to Virgin Atlantic submission of 3 November 2003.
24 December 2003	Commission requests further information from Applicants
6 January 2004	Submission from Applicants on matters raised at meeting of 27 November 2003
16 January 2004	Meeting with Applicants
22 January 2004	Submission from Applicants on matters raised at meeting of 27 November 2003
3 February 2004	Meeting with Applicants
26 February 2004	Submission from Applicants on matters raised at meetings of 16 January and 3 February 2004.
12 March 2004	Submissions (2) from Applicants on matters raised at meeting of 3 February 2004.
10 June 2004	Meeting with Virgin Atlantic
29 June 2004	Applicants' response to Commission letter of 24 December 2003
23 August 2004	Draft Determination issued

4. Background to the Applications

Domestic and international aviation policy

4.1. Over the last decade, there have been significant reforms within the aviation industry. An appreciation of these changes assists in understanding the environment in which the Applications have been lodged.

- Up until the late 1980s Government policy saw the Australian domestic trunk market divided almost equally between Ansett and Australian Airlines under a two airline policy with Qantas as the sole Australian international carrier;

- In 1987 deregulation of the domestic aviation market commenced with the Government withdrawing from the regulation of areas such as fare setting, aircraft imports, capacity controls and route entry.

- In the early 1990s, international aviation reform saw a policy of multiple designation of international carriers introduced which was actively pursued in negotiations on air services agreements with other countries.

- A new authority, the International Air Services Commission (the IASC), was created whose primary role was to allocate, in the public interest, capacity negotiated in air services agreements amongst Australian designated carriers. Pre-existing international capacity was grandfathered under legislation, effectively to Qantas.

- Around the same time the Government merged Qantas (the Government-owned national international carrier) with Australian Airlines (the national domestic carrier). Following the merger, the Government sold 25 per cent of the shares in Qantas to BA in 1993, with a public float of the balance of the shareholding occurring in 1995-96.

More recent policy developments

4.2. The Australian Government has for some time been actively encouraging the expansion of airline capacity within the framework of international bilateral aviation agreements with the objective of ensuring that the ability to meet demand for air travel on routes involving Australia is not constrained by bilateral capacity limitations.

4.3. In June 1999, the Australian Government announced a range of measures aimed at liberalising air travel between Australia and the rest of the world. This announcement followed a report by the Productivity Commission into international air services.[1] Included in the Government's response to the report were the following initiatives:

- Australia would seek to negotiate reciprocal "open skies agreements" with like-minded countries where this was in the national interest;

- Australia would propose that international aviation be liberalised on a multilateral basis through the General Agreement on Trade in Services round beginning in 2000;

- foreign international airlines would be offered unrestricted access to all of Australia's international airports except Sydney, Melbourne, Brisbane and Perth (unrestricted access included unlimited capacity, code share and own stopover rights);

- Australia would reform foreign ownership rules for Australian airlines, to ensure Australia has the resources to compete effectively in a world of airline alliances:

    - foreign persons (including foreign airlines) would be allowed to acquire up to 49 per cent of the equity of an Australian international airline and up to 100 per cent of the equity in an Australian domestic airline, unless that was contrary to the national interest; and

    - existing ownership restrictions on Qantas, which limit foreign ownership to 49 per cent, ownership by foreign airlines in aggregate to 35 per cent and ownership by an individual (including a carrier) to 25 per cent, would be retained.

- Australia would offer unrestricted access to all international airports for dedicated freighters;

- Australia would aim to achieve a more liberal regime for designating international carriers;

- the Government would establish a formal consultation process to help develop its position in air services negotiations; and

- the Government would reform the roles and responsibilities of the IASC to simplify the processes for allocating capacity to Australia airlines.

4.4. In its submission to the Commission in relation to this matter (see Appendix A of this Draft Determination), the Department of Transport and Regional Services (DTRS) submitted that Australia's current international aviation policy aims to:

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[1] Productivity Commission (1998), *International Air Services: Inquiry Report,* Commonwealth of Australia: Canberra.

> *"[I]ncrease competitive pressure on international routes in order to provide reasonably priced access to major trading partners and to avoid potential monopolies exploiting dominant positions on critical international routes. A key element of the policy has been the trading of 'fifth freedom' intermediate and beyond rights, which allow foreign carriers access to markets between and beyond Australia to stimulate competition on routes from key tourism sources for Australia.*
>
> *This policy is primarily being implemented through liberalisation of the bilateral system and where possible pursuing a liberalised agenda in multilateral fora such as APEC, ICAO, OECD and GATS. In the bilateral context, Australia's policy seeks liberalised outcomes where bilateral partners through open skies agreements. Where this is not possible or not in the national interest, Australia negotiates the most liberal outcome available.*

4.5. Currently, New Zealand is the only country with which Australia has an open skies policy. However, DTRS submitted that the Australian Government is actively seeking agreements with additional partners.

Developments in aviation markets

International aviation – passengers and freight

4.6. This section examines passenger and freight movements between Australia and other countries. Table 4.1 below shows that demand for international passenger services to and from Australia increased steadily through the 1990s but fell away in 2002 and 2003 as a result of the impact of terrorism events, the war in Iraq and SARS.

Table 4.1 Passengers carried on scheduled air services to and from Australia, 1994 to 2003

Year ended 31 December	Number of flights	Number of passengers ('000)	Number of seats available ('000)	Seat Utilisation (%)
1994	57,199	11,108 (+9.1%)	16,394	67.8
1995	64,542	12,285 (+10.6%)	18,536	66.3
1996	71,943	13,582 (+10.5%)	20,448	66.4
1997	76,372	14,419 (+6.2%)	21,232	67.9
1998	79,013	14,577 (+1.1%)	21,620	67.4
1999	80,476	14,987 (+2.8%)	21,936	69.6
2000	91,188	16,488 (+10.0%)	23,932	70.2
2001	92,045	16,799 (+1.9%)	24,144	70.9
2002	87,422	16,682 (-0.7%)	22,759	75.6
2003	92,168	16,439(-1.5%)	23,748	70.8

Source: DTRS

4.7. However a recovery in demand appears to have commenced at the end of 2003 and continued into 2004. The Director General of IATA stated[2] on 27 May 2004 that industry efforts to rebuild passenger confidence had seen traffic largely recovered. At the same time the number of passengers carried in total into and out of Australia in each of the four months November 2003, December 2003, January 2004 and February 2004 were records for those months.[3]

4.8. In 2003 there were 50 airlines operating scheduled services to and from Australia with 6 operating freight only services and 44 operating passenger flights.

Table 4.2 Passengers on scheduled air services by selected region/country of origin destination, year ended 31 December 1994, 1998 and 2003

Region/country	1994 ('000)	1998 ('000)	2003 ('000)
Europe	2,479.3	3,226.1	3,902.1
- United Kingdom	1,226.8	1,632.8	2,080.2
South East Asia	2,128.4	2,860.7	2,751.5
- Singapore	569.0	767.5	804.4
- Thailand	283.4	377.8	416.3

Source: ABS

4.9. Table 4.2 above shows changes in the carriage of passengers on routes served by both Qantas and British Airways over the period of the JSA to date. While there has been growth of the order of 70% on the United Kingdom route, on the Singapore and Thailand routes growth has been around 40% and 47%.

Table 4.3. Airline share (%) of passengers on scheduled air services to and from Australia, year ended 31 December 1994, 1998 and 2003

Airline	1994	1998	2003
Qantas*	41.6	36.4	35.5
Air New Zealand**	10.8	9.5	11.8
Singapore Airlines	6.4	8.1	10.7
Japan Airlines	4.6	4.1	4.2
United Airlines	4.5	4.1	2.3
Cathay Pacific	4.3	3.7	3.7
British Airways	3.6	4.6	3.3
Malaysia Airlines	3.4	4.6	5.4
Garuda	3.2	2.8	1.5
Thai Airways	1.8	2.7	4.1
Ansett International	1.2	4.1	..
Emirates	..	..	3.3
Other	14.6	15.3	16.8
Total	100.0	100.0	100.0

**Includes Australian Airlines. ** Includes Freedom Air. Source: DTRS.*

[2] "*Traffic Up but Oil Price Threatens Profitability*", IATA Press Release No 13, 27 May 2004.
[3] DTRS Monthly Air Transport Statistics for International Airlines.

4.10. Table 4.3 above shows the movement in passenger shares for the major carriers into and out of Australia over the period of the JSA. Although the share of Qantas has decreased over the nine years it still retains by far the largest share. Airlines which have notably increased share include Singapore Airlines, Malaysia Airlines, Thai Airways and Emirates. The share of United Airlines has decreased significantly.

Freight

4.11. The volume of international freight carried on scheduled airline services between Australia and other countries grew by 17% between 1994 and 2003. The majority of the freight is carried on passenger flights. However there is a significant number of dedicated freighter services. At the start of the 2004 Northern summer scheduling period there were 15 airlines operating dedicated freighter services in the Australian market, of which five also offered passenger services.

4.12. Table 4.4 below shows that Qantas was the leading carrier in the freight market but experienced a decline between 1994 and 2003 with its share of freight carried falling from 34.2% to 22.8%. Over the same period Singapore Airlines and Malaysia Airlines increased their freight shares significantly, while Air New Zealand experienced a substantial decline in share.

Table 4.4: Freight traffic to and from Australia by Airline, years ended 31 December 1994, 1998 and 2003.

	1994		1998		2003	
Airline	**Tonnes**	**(%)**	**Tonnes**	**(%)**	**Tonnes**	**(%)**
Qantas Airways	174,849	34.2	182,561	28.9	139,248	22.8
Singapore Airlines	56,727	10.9	81,963	13.0	100,941	16.5
Air New Zealand	49,476	9.5	69,200	11.0	35,645	5.8
Cathay Pacific	44,023	8.5	49,201	7.8	53,703	8.8
British Airways	18,028	3.5	22,080	3.5	16,337	2.7
Japan Airlines	17,483	3.4	22,334	3.5	16,541	2.7
Malaysia Airlines	15,191	2.9	30,739	4.9	46,390	7.6
United Airlines	14,749	2.8	16,976	2.7	7,818	1.3
Garuda	13,321	2.6	7,144	1.1	8,983	1.5
Thai Airways	12,653	2.4	14,708	2.3	29,784	4.9
Emirates	..	..	..	..	28,001	4.6
Other	90,851	16.9	124,912	19.8	127,777	*20.9*
Total	*520,599*	*100.0*	*631,908*	*100.0*	*611,168*	*100.0*

Source: DTRS

4.13. Table 4.5 below shows cargo statistics for individual airlines for the Singapore, Thailand and Europe areas of uplift/discharge.

Table 4.5: Freight traffic to and from Australia by Airline and selected region, years ended 31 December 1994, 1998 and 2003 (tonnes).

Airline	Singapore	Thailand	Europe	Total
1994				
- Qantas	33,844	3,031	15,891	52,766
- BA	5,220	1,539	9,671	16,430
- Thai Airways		10,916		10,916
- Singapore Airlines	56,727			56,727
- Other	1,012	1,572	9,588	12,172
Total	96,803	17,058	35,150	149,011
1998				
- Qantas	26,334	4,140	12,290	42,764
- BA	11,695	1,649	8,496	21,840
- Thai Airways		11,395		11,395
- Singapore Airlines	79,846			79,846
- Other	3,563	647	13,994	18,204
Total	121,438	17,831	34,780	174,049
2003				
- Qantas	35,377	1,577	8,555	45,509
- BA	7,544	2,776	6,017	16,337
- Thai Airways		23,213		23,213
- Singapore Airlines	97,877			97,877
- Other	7,900	181	15,613	23,694
- Total	148,698	27,747	30,185	206,630

Source: DTRS

4.14. While for the reasons described below the figures in Table 4.5 do not provide an accurate measure of market shares in the individual areas covered, they do provide some guide to relative movements in market share for the aggregate markets covered by the JSA.

4.15. The primary source of international aviation statistics, DTRS, does not compile statistics of international air freight on the basis of the origin and destination of the cargo but on the basis of the port of uplift and discharge. For this reason it is difficult to accurately measure an individual airline's shares of particular geographic or regional freight markets.

4.16. Where cargo is offloaded at an intermediate port en route to its ultimate destination the cargo is attributed to that port. Cargo destined for the UK, for example, on Singapore Airlines flights, would appear in statistics for Singapore.

4.17. Based on the figures in Table 4.5 the Qantas/BA share of the freight market covered by the JSA declined from 46% in 1994 to 30% in 2003. It is likely that these figures overstate the Qantas/BA market share as they do not include cargo carried by sixth freedom operators to Europe via intermediate points such as Malaysia, Indonesia, and Hong Kong.

Domestic aviation

4.18. The Australian domestic market has undergone substantial change in the past few years. Historically an industry with two carriers, Qantas and Ansett, the entry of Virgin Blue and Impulse in 2000 sparked a period of intense competition. Impulse ceased to operate in May 2001 and Ansett followed shortly thereafter, entering a period of voluntary administration in September 2001 and ceasing to operate entirely in March 2002. Qantas' share of the domestic market increased from around 50 per cent to almost 90 per cent following the failure of Ansett. However, vigorous growth by Virgin Blue has subsequently seen Qantas' market share fall to an estimated 70 per cent.

4.19. In May 2004 Qantas introduced a low cost carrier subsidiary, Jetstar Airlines Pty Ltd (Jetstar) into the domestic Australia market. Currently, Qantas, Virgin Blue, Jetstar and Regional Express (Rex) are Australia's principal domestic airlines.

4.20. Qantas receives on-carriage benefits, that is feed from its international services onto its domestic services and vice versa, from its relationships with BA, **one**world alliance carriers and other carriers with whom it has code share relationships such as Asiana, Japan Airlines, EVA, South African Airways, China Eastern and Vietnam Airlines. Qantas has indicated that around 15% of its domestic traffic is accounted for by on-carriage.[4]

4.21. Airlines, such as those in the Star Alliance, that once relied on Ansett for providing domestic on-carriage would be disadvantaged in competing internationally if they are unable to obtain well priced access to domestic feeder services. The style of operations of low cost carriers such as Virgin Blue is not normally suitable for interlining with long haul carriers.

4.22. According to DTRS, major Australian domestic airline passenger activity grew by 5.2 per cent to 28.55 million in the year ended 30 June 2003 compared with 2001/02.[5] However, industry passenger numbers were still 3.6 per cent below those in 2000/01. Revenue passenger load factors increased 0.7 per cent on 2001/02 to 78.2 per cent.

4.23. The figures in Table 4.6 below reflect the recent developments affecting the domestic aviation industry in Australia with a significant rise in traffic in 2000/01 as a result of increased competition following the entry of Impulse and Virgin Blue into the market, and a substantial fall in traffic in 2002/03 as a result of terrorism incidents and the failure of Ansett and Impulse.

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[4] Qantas 2003 Annual Report, page 5.

[5] DTRS (2003), *Air Transport Statistics: Australian domestic airline activity annual summary 2002/03,* Issue 74, Commonwealth of Australia: Canberra.

Table 4.6. Domestic passenger movements, 1993/94 to 1998/99

Year	Passengers	
	('000)	Change (%)
1993/94	19,997	+7.6%
1994/95	22,114	+10.6
1995/96	23,406	+5.8%
1996/97	23,463	+2.4%
1997/98	24,545	+4.6%
1998/99	24,809	+1.1%
1999/00	24,922	+0.5%
2000/01	29,625	+18.9%
2001/02	27,142	-8.4%
2002/03	28,551	+5.2%

Source: DTRS

Airline industry performance

Global performance

4.24. *Airline Business* magazine conducts an annual assessment of the financial performance of the world airline industry. An outline of the performance of the aviation industry over the past five years is at Table 4.7 below.

4.25. *Airline Business* noted that while the industry's collective loss of US$8.8 billion in 2002 is the second worst in history and revenues remained virtually unchanged between 2001 and 2002, the underlying result was less bleak, with the industry more or less at break even level (-0.1 per cent).

Table 4.7 Performance of top 150 airline groups: 1998-2002[6]

Year	1998	1999	2000	2001	2002
Revenue (US$bn)	299.1	320.0	346.4	320.7	318.8
Operating result(US$bn)	19.3	1.6	13.7	(5.7)	(0.4)
Operating margin	6.7%	5.3%	4.2%	(2.0%)	(0.1%)
Net result(US$bn)	9.0	8.7	3.5	(12.6)	(8.8)
Net margin	3.1%	3.0%	1.1%	(5.2%)	(2.8%)

4.26. *Airline Business* also noted that the real damage to the industry-wide performance of airlines came from North American carriers, with North America posting an operating loss of US$6 billion and a net operating loss of US$11 billion. *Airline Business* suggested that the performance of North American carriers entirely cancelled out profits in other regions.

4.27. *Airline Business* ranked BA eighth in terms of revenue and Qantas seventeenth. Qantas was ranked tenth in terms of net profitability and

[6] Baker, Colin (2003), "Elusive recovery", *Airline Business,* September 2003, p 52.

operating profit and BA was ranked thirteenth in terms of net profitability and sixth in terms of operating profit.

Qantas' performance

4.28. Table 4.8 below outlines Qantas' financial performance over the period since entering the JSA. Qantas has continually traded profitably over that period and has generally outperformed the industry globally.

4.29. Qantas' performance in recent years has been particularly noticeable. Despite a series of exogenous shocks and volatility in both international and domestic markets Qantas has continued to achieve profitability at a time when the industry globally has been sustaining substantial losses.

Table 4.8. Qantas financial performance, 1993/4 to 2002/03

Financial year ended	Revenue ($m)	EBIT ($m)	Net profit ($m)	Operating margin	Net margin
1993/94	6,531.4	480.0	155.9	7.3%	2.4%
1994/95	7,162.9	471.4	180.1	6.6%	2.5%
1995/96	7,600.4	504.4	246.2	6.6%	3.2%
1996/97	7,834.4	517.2	252.7	6.6%	3.2%
1997/98	8,131.5	581.7	304.8	7.2%	3.7%
1998/99	8,448.7	701.8	421.6	8.3%	5.0%
1999/00	9,106.8	874.0	517.9	9.6%	5.7%
2000/01	10,188.2	695.8	419.7	6.8%	4.1%
2000/02	10,968.8	679.3	429.3	6.2%	3.9%
2002/03	11,374.9	567.0	346.6	5.0%	3.0%

Source: Qantas annual reports.

4.30. In 2002/03, Qantas delivered a profit (before tax) of $631 million and a net profit of $428 million. In its 2002/03 annual report, Qantas noted its record first half profit (before tax) of $513.1 million and stated that *"the war in Iraq and SARS combined to decimate [Qantas'] profitability in the second half of the year".*[7]

[7] Qantas 2003 Annual Report, page 3.

Table 4.9 Qantas earnings before interest and tax: 2001/02 and 2002/03

Segment	2001/02		2002/03	
	EBIT ($m)	(%)	EBIT ($m)	(%)
International operations	202.8	29.9	221.6	39.1
Domestic operations	298.2	43.9	165.7	29.2
Qantas Holidays Group	42.4	6.2	43.6	7.7
QantasLink Group	42.5	6.3	57.3	10.1
Qantas Flight Catering	69.6	10.2	73.3	12.9
Australian Airlines	-	-	(14.7)	(2.6)
Other subsidiaries	23.8	3.5	20.2	3.6
Total	*679.3*	*100.0*	*567.0*	*100.0*

Source: Qantas annual reports.

4.31. Qantas results for the first six months of 2003/04 were described by its Chairperson as "*excellent given the circumstances existing in the aviation industry*".[8] The net profit after tax of $357.8 million achieved was described as a product of a strong performance in the domestic market, recovery in the international market and cost reduction initiatives.

4.32. While also contributing to Qantas' results through its domestic on-carriage support the main contribution of the JSA is to Qantas international operations. Table 4.9 above shows the contribution of international operations in recent years.

Table 4.10. Qantas revenue by region, 1993/94, 1998/99 and 2002/03[(1)]

	1993/94		1998/99		2002/03	
Region	**Revenue ($m)**	**%**	**Revenue ($m)**	**%**	**Revenue ($m)**	**%**
UK and Europe	710.6	24.5	816.1	26.6	904.6	26.6
Japan	756.6	26.0	561.2	18.3	574.0	16.9
SE Asia/NE Asia	627.8	21.6	649.6	21.2	481.4	14.2
Americas/Pacific	458.2	15.8	688.5	22.4	813.2	23.9
New Zealand	**(2)**	**(2)**	**(2)**	**(2)**	404.0	11.9
Other regions	352.3	12.1	351.8	11.5	221.4	6.5
All international regions	2,905.5	100.0	3,067.2	100.0	3,398.6	100.0
Australia [(3)]	*2,823.5*		*4,221.8*		6,449.0	

Source: Qantas annual reports
(1) Derived from the country from which revenue was sourced. (2) Included in (3) "Australia" includes revenue from domestic and international operations.

4.33. Table 4.10 above shows that over the period of the JSA to date there have been some significant changes in where Qantas obtains its revenue. In 1993/94 revenue received from Australia was 3% less than that received from overseas. By 1998/99 Australian revenue was 38% more than international revenue and in 2002/03 it was 90% more.

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[8] *Qantas Results for Half Year ended 31 December 2003,* media release, Qantas, 19 February 2004.

4.34. The revenue received from UK and Europe has remained relatively steady as a share of international revenue but has declined as a share of overall revenue from around 12% to 9% over the period of the JSA.

BA's performance

4.35. As table 4.11 below shows, like many network carriers, BA has struggled to achieve profitability in recent years in a difficulty operating environment. In February 2002 BA announced a Future Size and Shape programme designed to reduce costs, restructure shorthaul operations and remove complexity from the business.

Table 4.11. BA financial performance, 1994/95 to 2003/04

Financial year ended	Revenue (£m)	EBIT (£m)	Net profit (£m)	Operating margin (%)	Net margin (%)
1994/95	7,177	618	250	8.6	3.5
1995/96	7,760	728	473	9.4	6.1
1996/97	8,359	546	553	6.5	6.6
1997/98	8,642	504	460	5.8	5.3
1998/99	8,915	442	206	5.0	2.3
1999/00	8,940	84	(51)	0.1	(0.1)
2000/01	9,278	380	81	4.1	0.1
2001/02	8,340	(110)	(129)	(1.3)	(1.5)
2002/03	7,688	295	85	3.8	1.1
2003/04	7,560	405	145	5.4	1.9

Source: BA annual reports.

4.36. In announcing the 2003/04 results the Chief Executive of BA stated that the company had exceeded its two year Future Size and Shape targets, achieving £869 million cost savings (against a target of £650 million) and reducing manpower by 13,082 against a target of 13,000.[9] This progress was described as being reflected in the improved 2003/04 results.

4.37. Figure 4.12 below shows BA's revenue by region. The Far East and Australasian routes account for 12 per cent of BA's revenue. The Far East and Australian routes are providing better outcomes than European routes but are generating lower returns than other long haul routes.

[9] *Good results in a difficult year*, BA News Release, 17 May 2004.

Table 4.12. BA revenue and EBIT by region, 1994/95, 1998/99 and 2002/03

	1994/95	1998/99	2002/03
Revenue (£m)			
Europe	3,015	3,412	2,838
The Americas	2,185	3,281	2,763
Africa/Mid East/India	9,53	1,137	1,201
Far East/Australasia	1,024	1,085	886
Total	*7,177*	*8,915*	*7,688*
EBIT (£m)			
Europe	2	(166)	(117)
The Americas	245	451	223
Africa/Mid East/India	226	124	168
Far East/Australasia	145	33	21
Total	*618*	*442*	*295*
Operating margin			
Europe	0.0%	(4.9%)	(4.1%)
The Americas	11.2%	13.7%	8.1%
Africa/Mid East/India	23.7%	10.9%	14.0%
Far East/Australasia	14.2%	3.0%	2.4%
Total	*8.6%*	*5.0%*	*3.8%*

4.38. As at January 1995 BA was operating 50 B747 services per week to the Far East/Australasia region, of which 14 services (28%) were operated under the Current JSA. As at the end of October 1999, BA was operating 60 services per week to this region of which 24 (40%) were Current JSA services. As at the end of March 2004 BA was operating 57 services per week to this region of which 21 (37%) were JSA services

Airline alliances

4.39. The proliferation of airline alliances has been a feature of the development of the international aviation industry over the last decade. The alliance was an industry response to strong competition, low yields and low profitability and enabled airlines to expand networks and services while controlling costs and increasing productivity.

4.40. There are effectively two styles of alliance: marketing alliances and integrated alliances.

4.41. Integrated alliances (such as the JSA) typically involve a high degree of integration of the airlines concerned, including coordination of fares, schedules, service levels and yield and capacity management.

4.42. Marketing alliances offer the consumer the benefits of broader networks, more seamless travel and expanded loyalty programs. However, alliance airlines generally continue to offer their fares, schedules and services independently and airlines within the same marketing alliance may compete with each other if on the same route. Examples of marketing alliances include **one**world and the Star Alliance.

4.43. Another form of alliance behaviour which can occur within both integrated alliances and marketing alliances, as well as outside of such alliances, is code sharing. Code sharing involves one airline purchasing and marketing under its own brand name seats on another airline's flights.

4.44. The impact of code sharing on a market will depend upon the nature of both the code share payment arrangements and the market in which it occurs. It is fair to say that competition benefits generally will only arise where the code share involves a blocked seat arrangement whereby the purchasing airline effectively commits to purchase a fixed number of seats and therefore has an incentive to market them. When code shares involve "free sale" arrangements (where the marketing carrier effectively only pays for the seats it sells), there is normally no increase in competitive pressure.

4.45. Code sharing may add competition, albeit at the margin, on routes where multiple airline operation is not economically feasible. The Productivity Commission has noted that where carriers are already operating on the same route and have relatively high market shares, code sharing is likely to reduce competition.[10]

4.46. Generally, where code sharing is used to extend routes by offering seats on other carriers' flights, there is little competitive impact. In such circumstances, there is little apparent difference for the passenger over interlining. Against this is the possibility that the consumer may not be aware of the actual carrier operating the flight.

4.47. Code sharing may give rise to competitive benefits if it allows an airline to develop a market to a stage where own aircraft operation is feasible. It may also allow an airline to maintain a presence following withdrawal from an unsustainable market pending possible re-entry at a later stage. There may also be other circumstances where code sharing is competition neutral.

4.48. Both Applicants are involved in integrated alliances, in a marketing alliance and in separate code shares. Qantas and BA are both members of the **one**world alliance. **One**world alliance partners include Aer Lingus, American Airlines, Cathay, Finnair, Iberia and LanChile in addition to 23 regional affiliates.

4.49. Aside from its bilateral alliance with BA, Qantas has alliances with American Airlines, Japan Airlines and Air Pacific and has code share arrangements with airlines including Air Calin, Air Nuigini, Air Tahiti Nui, Air Vanuatu, Alaska Airlines, Alitalia, Asiana, China Eastern, EVA Air, Gulf Air, Origin Pacific, Polynesian Airlines, South African Airways and Vietnam Airlines. In 2002/03, new code share arrangements were made between BA and Finnair, Iberia and Cathay.

[10] Productivity Commission (1998), *International Air Services: Inquiry Report,* Commonwealth of Australia: Canberra.

4.50. Other global alliances include the Star Alliance, the SkyTeam alliance and Wings. Members of the Star Alliance are Air New Zealand (Air NZ), Air Canada, All Nippon Airways, Asiana Airlines, Austrian Airlines, British Midland, Lauda Air, Lufthansa, Mexicana, Scandinavian Airlines, Singapore Airlines, Thai Airways, Tyrolean Airways, United Airlines and Varig.

4.51. According to Credit Suisse First Boston, aligned airlines had a 45.4 per cent share of the total number of seats offered worldwide in 2001 (see Table 4.11 below).

Table 4.11 Estimated alliance share of worldwide capacity 2000 and-2001

Alliance	**Share (%)**		**Growth (%)**
	2000	**2001**	**2000-01**
Star			
oneworld	13.0	12.9	-0.5
SkyTeam	11.6	11.1	-3.6
Wings	1.2	4.1	-1.9
Total	*46.0*	*45.4*	*-0.6*

Previous commission decisions

4.52. The Commission has previously considered a number of authorisation applications relating to alliance or equity proposals between airlines. An outline of some of the more recent Commission decisions follows.

Qantas/BA JSA

4.53. In 1995, the Commission granted authorisation for Qantas and BA to operate a JSA which provided for the coordination of various key aspects of their Australia-Europe, Australia-South East Asia and South East Asia-Europe services. The agreement involved:

- fixing prices on all routes between Australia and Europe (including through the US) and Australia and South East Asia;
- jointly managing capacity and yields on selected routes between Australia and Europe and Australia and South East Asia;
- coordinating scheduling of flights and relevant sales and marketing operations on selected routes between Australia and Europe and Australia and South East Asia; and
- amending the routes which will be subject to all aspects of the agreement at any time in the future.

4.54. In making its determination, the Commission concluded that the agreement would result, or would be likely to result, in a lessening of competition. However, it acknowledged that a number of public benefits would result from the agreement.

4.55. Overall, the Commission considered that the weighing of anti-competitive detriment against public benefit was finely balanced. The Commission decided to grant authorisation for five years from May 1995, subject to certain conditions relating to fare revenue, and freight capacity.

4.56. In May 2000, the Commission considered a Restated JSA lodged by Qantas and BA. The agreement provided for the coordination of airline services between Qantas and BA on nominated routes. The coordination arrangements included coordination on freight, scheduling, marketing, sales, pricing and customer service initiatives. The agreement extended to the full networks of both airlines.

4.57. The Commission granted authorisation of the agreement for a period of three years. The authorisation expired on 21 July 2003.

Air New Zealand acquisition of Ansett Holdings Limited

4.58. In May 1996, the Commission was advised that Air NZ proposed to acquire TNT Limited's 50 per cent interest in Ansett Holdings Limited.

4.59. The Commission concluded that the acquisition would not substantially lessen competition in an Australian market. It was also satisfied that there would not be a substantial lessening of competition in relation to international travel into and out of Australia or travel distribution in Australia.

Alliance agreement between Ansett Australia, Ansett International, Air NZ and Singapore Airlines

4.60. On 22 July 1998, the Commission granted authorisation for Ansett Australia, Ansett International, Air NZ and Singapore Airlines to enter into an alliance agreement which provided for the coordination of various aspects of their airline services including capacity, frequency and prices. The agreement applied to services operated between Singapore and New Zealand, between Australia and South East Asia, on trans-Tasman, on Australian domestic routes and on routes between Australia, New Zealand and Singapore.

4.61. The Commission concluded that while the alliance agreement would lessen competition, the agreement would be likely to result in benefits to the public which would outweigh that detriment. The Commission formed the view that the alliance agreement was likely to have public benefits in the areas of:

- increasing competition, particularly with the Qantas/BA group;
- more efficient use of resources and elimination of duplication;
- assisting in the development of Ansett International and the consequent benefits of a strong, second Australian international airline; and
- improved customer service through the integration of computer systems, seamless service, wider lounge access and the ability to earn frequent flyer points on economy class travel with Singapore Airlines.

4.62. This authorisation expired on 21 July 2003.

Star Alliance corporate and conventions programs

4.63. On 4 September 2003, the Commission issued a final determination responding to an application for authorisation lodged by Air NZ on behalf of other members of the Star Alliance. The determination authorised the:

- Star Joint Corporate Agreement which would enable Star Alliance members to offer fares and incentives jointly to corporate customers for their air travel business; and

- Star Alliance Conventions Plus Program which would enable Star Alliance members to offer fares and incentives jointly to convention organisers and convention delegates.

4.64. The authorisation is subject to an Air NZ undertaking not to participate in the Corporate Agreement and Conventions Programs at the same time as participating in an alliance with Qantas.

4.65. Authorisation was granted for a period of four years.

Qantas and Air NZ strategic alliance and equity proposal

4.66. On 9 September 2003, the Commission denied authorisation to Qantas and Air NZ in respect of a strategic alliance agreement and an equity proposal.

4.67. Specifically, the applications sought authorisation for:

- arrangements for the coordination of activities, such as scheduling and pricing, for all passenger and freight services on all Air NZ flights and all Qantas flights into, within and departing from New Zealand; and

- the acquisition by Qantas of ordinary shares comprising up to a 22.5 per cent voting equity interest in Air NZ.

4.68. The Commission formed the view that the alliance between Qantas and Air NZ would be highly anti-competitive and would lead to increases in fares and decreases in capacity and quality of service on routes which involve Australia and where both airlines have a presence, particularly in relation to the trans-Tasman passenger and freight markets and the Australian domestic air transport passenger market.

4.69. The Commission also expressed substantial reservations about the extent of public benefit claimed to arise from the arrangements, particularly in relation to cost efficiency savings, new direct services and tourism benefits.

4.70. The Commission ultimately considered that the highly anti-competitive effects of the alliance would substantially outweigh the low public benefits accepted by the Commission as flowing from the alliance.

4.71. The Commission also carefully considered undertakings offered by the Qantas and Air NZ, however, it formed the view that the gap between anti-competitive detriment and public benefits likely to flow from the alliance was substantial and would not be significantly reduced by the undertakings offered by Qantas and Air NZ.

4.72. The New Zealand Commerce Commission also denied authorisation to the proposal.

4.73. Qantas and Air NZ have lodged an appeal on the Commission's decision with the Australian Competition Tribunal and on the NZCC's decision with the New Zealand High Court.

5. The Applicants' submissions

The supporting submission

5.1. The Applicants made a submission to the Commission in support of their Applications on 7 May 2003 (the Supporting Submission). The Applicants also submitted a "[d]etailed independent economic analysis" prepared by Network Economics Consulting Group (NECG) in support of their Applications. This report is hereafter referred to as the "NECG Report".

5.2. An outline of the issues raised in the supporting submission follows. Issues are examined in more detail in areas of the Draft Determination where the Commission undertakes an assessment of claims made by the Applicants.

5.3. A full copy of the Applicants' submission (subject to any claims for confidentiality) is on the Commission's public register.

Market performance since the commencement of the JSA

5.4. The Applicants submitted that, during the JSA's operation to date:

- despite substantial increases in costs, fares have reduced and over the last seven years, the representative benchmark fare for travel between Australia and Europe monitored by the Commission during the first authorisation of the JSA has decreased (in real terms) by 25 per cent;

- carriers have competed vigorously to provide higher product standards;

- the market has grown significantly with ABS data showing that the number of passengers flying between Australia and Europe has increased by over 40 per cent since 1995;

- despite this growth, the market shares of the Applicants have declined whilst the combined market share of Singapore Airlines, Malaysia Airlines, Thai Airways, Cathay and Emirates between Australia and Europe has doubled; and

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

5.5. The Applicants submitted that the JSA has created cost savings and efficiencies that have been passed on to consumers through lower fares and has delivered a range of other benefits including access for consumers to broader schedules, more flexible fare products and higher levels of customer support.

The future with and without the JSA

The future with the JSA

5.6. The Applicants submitted that the JSA will continue to allow Qantas and BA to compete more effectively and to sustain a wider range of services than either carrier could sustain on its own.

5.7. The Applicants submitted that the length of the Kangaroo Route precludes non-stop operation and that any carrier based at one or the other end of the route must operate long services with a minimum of two separate sectors. For Qantas, the first sector is between Australia and a "suitable" mid-point. The second sector is from the mid-point to Europe. The Applicants submitted that this second sector is intrinsically difficult to operate profitably because over half of Qantas' passengers disembark at the mid-point. The Applicants submitted that Qantas must either operate the second sector with a half full plane, or attempt to refill the plane at a mid-point where it has only a limited sales presence and competition from dominant local carriers. The Applicants submitted that many of these carriers enjoy government protection and support.

5.8. The Applicants submitted that BA faces the same problem as Qantas, but from the other direction. That is, the sector from the mid-point to Australia is isolated from BA's home airline sales presence and any source of feed which makes it difficult to operate profitably. The Applicants submitted that this problem faces any carrier attempting to operate services between Australia and Europe from either end point and that, as a result, Air France, Alitalia, KLM, Lufthansa and Olympic have been forced to withdraw from the Kangaroo Route over the past seven years.

5.9. The Applicants submitted that a carrier whose hub is located at a suitable mid-point does not need to operate the Kangaroo Route as one long two sector operation. Instead, it carries passengers between Australia and Europe by combining any of the single sector flights between its hub and Australia with any of the flights it operates between its hub and Europe. Each of these flights can be supported with traffic feed from the mid-point carrier's hub. The Applicants submitted that the Kangaroo Route strongly favours carriers that have a hub located at a suitable mid-point on the route such as Singapore Airlines, Cathay, Malaysia Airlines, Emirates, JAL and Thai Airways.

5.10. The Applicants submitted that the JSA helps counteract Qantas and BA's structural disadvantages by allowing them to coordinate passenger flows and support services from both ends of the Kangaroo Route.

5.11. The Applicants submitted that, due to BA's presence in Europe, it is able to contribute passengers to Qantas services on sectors between Europe and its mid-points which allows Qantas to sustain a wider range of services than would otherwise be viable. The Applicants also submitted that Qantas' greater traffic between its mid-points and Australia can be used to address BA's weakness that would otherwise make it difficult for BA to continue to operate these sectors.

5.12. The Applicants submitted that combining traffic flows in this manner enables them sufficient scale to support a mini-hub in Singapore that neither carrier could create on its own.

5.13. The Applicants submitted that the JSA also enables them to:

- justify greater investments in aircraft;

- make significant cost savings in overheads such as information technology (IT) investments; and

- create a joint selling presence in Asia and establish joint facilities that neither could justify on its own.

5.14. The Applicants submitted that the JSA enables Qantas and BA to maintain and expand services on JSA Routes while other endpoint carriers have been forced to withdraw. Further, the Applicants submitted that the JSA results in greater capacity and a wider range of services being made available to consumers which creates higher levels of product and price competition than would exist without the JSA.

5.15. The Applicants submitted that, if the JSA is reauthorised, Qantas and BA would be able to maintain and expand their range of frequencies and capacities.

The future without the JSA

5.16. The Applicants submitted that, without the Proposed Arrangements, it would be unlikely that Qantas and BA could sustain their current flight schedules. The Applicants submitted that Qantas would be forced to reduce services to Europe and rationalise services between Singapore and cities other than Sydney and Melbourne.

5.17. The Applicants submitted that BA would most likely reduce the number of its daily services from the UK to Australia.

Anti-competitive detriment

JSA passenger air services markets

5.18. The Applicants submitted that the operation of the JSA over the last seven years has enhanced competition and is likely to continue to do so. In particular, the Applicants submitted that:

- the effect of the JSA has been to increase rather than decrease capacity on JSA Routes. Qantas and BA have significantly increased capacity on JSA Routes over the period of the JSA to date;

- the aggregate market shares of mid-point carriers have increased substantially, while those of the Applicants and European carriers have fallen;

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

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

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

JSA freight markets

5.19. The Applicants submitted that the level of competition in freight markets depends on many of the same factors as the passenger market with additional competition from dedicated air freight aircraft and inter-modal substitution. The Applicants submitted that competition in JSA freight markets will continue to be intense and will not be adversely affected by the JSA.

Market for travel distribution services

5.20. The Applicants stated that the JSA will not lead to a lessening of competition in the airline ticket sales market under current market conditions.

Domestic passenger air services markets

5.21. The Applicants submitted that the low level of feed from British Airways to Qantas domestic services and the rapid growth of Virgin Blue following the failure of Ansett Australia point to the JSA not lessening competition in domestic air services.

Public benefits

5.22. The Applicants submitted that the JSA would provide the public benefits identified below.

Product and service benefits

5.23. The JSA will provide product and service benefits including more destinations, broader schedule choices, more flexible fare products and higher levels of consumer support.

Cost savings and efficiencies

5.24. The Applicants submitted that the JSA will produce cost savings and efficiencies particularly in relation to IT and shared facilities. NECG has calculated that the JSA will provide cost savings in fixed overheads to Qantas over the next five years of the order of $43 million.

Lower fares

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

Greater net exports

5.26. The Applicants submitted that the JSA results in greater net exports from Australia. Absent the JSA Qantas would reduce its capacity on JSA routes resulting in less passengers being carried and leading to lost export earnings amounting from NECG estimates to around \$418 million over the next five years. The Applicants also claimed that there would be likely to be an increase in the importation of services (as Australian travellers move from Qantas to foreign airlines) which NECG estimated to amount to as much as \$285 million over the next five years. NECG estimated that the overall increase in national income attributable to the JSA is between \$165 million and \$301 million in real terms over the next five years.

5.27. The figures quoted in the above paragraph have subsequently been revised as a result of errors made by NECG and the suspension of Qantas' services to Rome. The revised figures do not take into account the suspension of Qantas' Paris services.

Higher employment

5.28. The Applicants submitted that the additional flights permitted by the JSA support over 950 Australian jobs.

Higher levels of tourism

5.29. The Applicants submitted that the JSA supports tourism through a combination of enhanced capacity, lower fares, better quality of services and higher promotional expenditure in Europe. NECG estimated that, without the JSA, there would be likely to be a reduction of between 3,800 and 10,700 tourists visiting Australia per year over the next five years resulting in a loss of national income of between \$58 million and \$353 million over that period. NECG subsequently revised the range to between \$33 million and \$318 million.

Product and service benefits

5.30. The Applicants claim that the JSA will give rise to a number of customer service benefits, other than increased flights, which are difficult to quantify but are nonetheless of real benefit to consumers. These benefits are said to include:

- broader availability of schedule options for passengers including more one-stop services to more destinations;
- greater availability of discount fares; and
- provision of higher quality "seamless" travel services, especially in places where Qantas does not have its own offices.

International competitiveness of the Australian airline industry

5.31. The Applicants submitted that the success of Qantas as an international flag carrier is important to Australia and that, in the 2001/02 financial year, it accounted for approximately two per cent of Australia's GDP, contributed $800 million to Australia's exports, purchased $2.4 billion of Australian goods and services and employed over 37 000 people.

5.32. The Applicants submitted that, overall, the JSA makes Qantas more internationally competitive. Without the JSA Qantas' presence in a number of overseas markets and its position as a strong national flag carrier would be weakened and its ability to support and benefit the Australian economy and society would be lessened.

Total public benefits

5.33. NECG originally estimated that the JSA is likely to result in at least $402 million to $561 million in benefits to Australia over the next five years in real terms with the actual outcome depending on the extent to which other airlines replace reductions in capacity made by the Applicants if the JSA is not authorised. This range of benefits was subsequently revised to be between $355 million and $510 million.

Conclusion

5.34. The Applicants submitted that the JSA gives rise to a wide range of significant public benefits while creating little or no anti-competitive detriment and that the JSA should be reauthorised for an indefinite term.

Scope and terms of authorisation sought

5.35. The Applicants sought an authorisation of unlimited duration so as to enable them to plan for the future with confidence, particularly with respect to major investments in aircraft and IT systems. Alternatively a term of authorisation of ten years was sought.

The NECG Report

5.36. An outline of the issues raised in the NECG Report is presented below. Issues raised in the report are discussed in more detail throughout this Draft Determination as appropriate

5.37. A full copy of the NECG Report (subject to any claims for confidentiality) is on the Commission's public register.

5.38. NECG submitted that its economic analysis demonstrates the importance of the JSA in facilitating further expansion in trade and investment between Europe and Australia, specifically in relation to the growth in the trade of services such as tourism and the expansion of Australia's aviation links with Europe.

5.39. NECG also submitted that the JSA contributes to economies of density in Australia's links with South East Asia and, as a result, is a crucial component of Australia's wider transport links with regional neighbours.

Hub effects and the Kangaroo Route

5.40. NECG stated that it is currently not possible to operate non-stop flights on the Kangaroo Route as the distance between Europe and Australia is such that flights must stop *en route* to refuel, relieve crew and service aircraft. NECG submitted that this has two consequences.

5.41. First, consumers have a very wide range of choices in deciding how to fly between Australia and Europe. NECG submitted that, for example, Asian and Middle Eastern sixth freedom airlines have a natural base for operating on the route and they can link flights between their home base, Australia and Europe. NECG submitted that, given the number of these airlines, competitive pressures on the route are intense.

5.42. Secondly, the length of the Kangaroo Route lends itself to hub and spoke operations in which economies of density are achieved by concentrating traffic on long sectors. NECG submitted that Asian and Middle Eastern carriers can carry out this traffic aggregation at their home hub – the airport which accounts for the bulk of interconnectivity in their network – and it is this hub which they use as the stop-over point for flights between Australia and Europe. In contrast, the Applicants cannot use their home hub as a stop-over point for the route – the stop-over point will essentially be a spoke in the network.

5.43. NECG submitted that the implications of this are wide ranging. The ability of an airline such as Qantas to operate multi-stage services viably depends on the ease with which it can replace traffic that terminates at an intermediate point (eg Singapore) with traffic from the intermediate point to terminal points (eg London). NECG submitted that Asian and Middle Eastern carriers have an advantage in securing traffic at the intermediate point because, for example, it is easier for Singapore Airlines to attract passengers in Singapore than in would be for any other airline as a result of greater connectivity out of Singapore.

5.44. NECG submitted that non-Singapore carriers operating Kangaroo Route flights through Singapore face the following penalties:

- they will be more constrained than the hub carrier in constructing a commercially attractive range of frequencies and destinations out of and into the intermediate point because they will not have direct access to bilateral rights of the intermediate point;

- to the extent that there are scale economies in operating a transit facility, they will face higher resource costs than does the hub carrier at the intermediate point;

- they will have greater difficulty in attracting traffic at the intermediate point and hence in securing reasonable loads on each sector; and

- the traffic they do attract is likely to be lower yielding depressing their yield on the route as a whole.

5.45. NECG submitted that the JSA materially reduces these disadvantages to Qantas and BA as a result of:

- Qantas and BA being able to better collect and manage traffic at the terminal ends of the Kangaroo Route – for example, Qantas can secure seats from BA on heavily booked, peak time, connecting flights into and from its European destinations;

- Qantas and BA securing economies at the intermediate point as a result of combining their load and coordinating their flights into the intermediate point – BA supports the route with the single sector passengers between Europe and the mid-points and Qantas contributes single sector passengers between Australia and the mid-points;

- the Applicants coordinating bilateral rights so as to develop schedules and networks that better match consumer needs, are commercially attractive and operationally efficient – for example, the rights between Singapore and Paris Charles de Gaulle are limited by the French Government but preferential access to BA's European network, with high frequencies in and out of Paris, reduces the adverse impacts these constraints would otherwise have on Qantas' ability to compete on the French route; and

- the cost savings achieved through higher loads and the greater frequency and reach that load and close coordination of flights allows make the Applicants both more competitive at the terminal ends of the route and at the intermediate points.

5.46. NECG submitted that, without the JSA, the Applicants would not have been able to develop the "mini-hub" that they currently operate in Singapore.

Anti-competitive detriment

5.47. NECG submitted that the Proposed Arrangements do not cause any detriment from the standpoint of Australian society. More specifically, NECG submitted that the JSA does not materially lessen competition in any market.

5.48. NECG submitted that the key market in the consideration of this matter is the market for passenger air travel between Australia and Europe. NECG submitted that competitive disciplines in this market are effective and have been so at all times since the JSA was authorised. NECG submitted that the presence of Asian carriers has expanded, largely at the expense of European carriers, who have almost entirely withdrawn from the Kangaroo Route. NECG submitted that there is no reason to think that these competitive pressures will abate and that the success of Emirates in expanding its market highlights the degree to which the market remains open to new entrants and to expansion by existing players.

5.49. Likewise, NECG submitted that there is no evidence of competitive pressure being or becoming ineffectual or weakening in any of the other relevant markets such as the market for the transport of air freight.

5.50. NECG also submitted that there are no significant flow-on effects from the JSA that would prevent or lessen competition in the provision of Australian domestic aviation services.

5.51. NECG submitted that the JSA is, in fact, far more likely to promote competition as it makes Qantas and BA more effective competitors to Asian and Middle Eastern airlines.

5.52. NECG submitted that without the JSA there would be reductions in flight frequency and capacity offered by the Applicants when compared to the future with the JSA. The decrease in frequency would be of the order of 38% with a Qantas' capacity reduction in the range of 23% to 32% and a BA reduction of up to 67%.

5.53. In relation to the responses of competitors in the future without the JSA, NECG examined two extreme situations and submitted that the reality of competitor response is likely to lie somewhere in between. If all the capacity removed by the Applicants is replaced by other carriers there is a theoretical possibility of a small anti-competitive detriment. However, it is most likely that prices and output would remain unchanged from the future with the JSA.

5.54. At the other extreme if no capacity is replaced by other carriers, prices would be likely to be higher and capacity lower without the JSA than with the JSA.

Public benefits

5.55. NECG submitted that its assessment indicates that there would be public benefits as a result of lower prices and higher output associated with the reauthorisation of the JSA.

5.56. A summary of the public benefits estimated by NECG to accrue to Australia is presented in Table 5.1 below.

Table 5.1 Original summary of Australian benefit estimates: 2003-2007

Public benefit	**Lost JSA capacity replaced**	**Lost JSA capacity *not* replaced**
Cost savings	$43 million	$43 million
Tourism	$58 million	$353 million
Net exports	$301 million	$165 million
Total	$402 million	$561 million

5.57. NECG submitted that, given the substantial public benefit, allied with a competitive benefit as a result of lower prices and higher output, the reauthorisation of the JSA would be beneficial to Australia.

5.58. In response to a request for further information, the Applicants advised the Commission on 7 August 2003 that, as a result of Qantas' suspension of services to Rome, the NECG estimates of the net benefits associated with the JSA fell by $25 million. The revised summary of public benefits provided by NECG at that stage appears in Table 5.2 below.

Table 5.2 Summary of Australian benefit estimates, incorporating suspension of Qantas services to Rome: 2003-2007

Public benefit	JSA capacity replaced	Capacity not replaced
Cost savings	$43 million	$43 million
Tourism	$33 million	$328 million
Net exports	$301 million	$165 million
Total	$377 million	$536 million

5.59. On 22 January 2004 the Applicants provided the Commission with a further revised set of NECG estimates relating to the position before and after the suspension of the Qantas services to Rome. Table 5.3 below shows the supplied revised estimates not taking into account the Qantas' Rome suspension.

Table 5.3 Revised summary of Australian benefit estimates, preceding suspension of Qantas services to Rome: 2003-2007

Public benefit	JSA capacity replaced	Capacity not replaced
Cost savings	$43 million	$43 million
Tourism	$58 million	$414 million
Net exports	$440 million	$271 million
Total	$541 million	$728 million

5.60. Table 5.4 below shows the estimates in Table 5.3 revised to take account of the Qantas Rome suspension. The estimates are reduced by up to $218 million as a result of the suspension of the Rome services.

Table 5.4 Revised summary of Australian benefit estimates, incorporating suspension of Qantas services to Rome: 2003-2007

Public benefit	JSA capacity replaced	Capacity not replaced
Cost savings	$43 million	$43 million
Tourism	$33 million	$318 million
Net exports	$279 million	$149 million
Total	$355 million	$510 million

5.61. None of the above estimates take account of the suspension of Qantas' services to Paris announced in June 2004 with effect from October 2004.

Period of authorisation

5.62. NECG submitted that the performance of JSA Routes over the past seven years of authorisation should provide the Commission with comfort that there is no serious risk of competitive constraints weakening in the foreseeable future.

5.63. NECG also submitted that an extended or indefinite period of authorisation would substantially enhance the benefits to the community from the JSA. NECG submitted that this would facilitate efficient investments that might not be undertaken were the JSA to be authorised for a short duration.

Commission requests for further information

5.64. As part of its assessment process, the Commission may, if necessary, request that Applicants provide it with further information to assist in the evaluation of Applications for authorisation.

5.65. The Commission made a number of such requests for additional information from the Applicants in this case and this information is addressed as appropriate elsewhere in this document.

6. Submissions lodged by third parties

6.1. The Commission sought submissions from interested parties in relation to the Applicants' request for interim authorisation and on the merits of the Applications, particularly in relation to the potential public benefits of the Proposed Arrangements and the anti-competitive detriment likely to result from the Proposed Arrangements.

6.2. The Commission received submission from the following parties:

- Australian Business Travel Association (ABTA);
- Australian Federation of Travel Agents (AFTA);
- Department of Industry, Tourism and Resources (DITR);
- Department of Transport and Regional Services (DTRS);
- Hobart International Airport Pty Ltd (Hobart Airport);
- New South Wales Premier's Department (NSW Govt);
- Queensland Government Aviation Steering Committee (Qld Govt);
- Skywest Airlines Pty Ltd (Skywest);
- Tourism Tasmania
- VIP Logistics Pty Ltd (VIP Logistics);
- Virgin Atlantic;
- Virgin Blue; and
- Hon Alannah MacTiernan MLA, Minister for Planning and Infrastructure (WA) (WA Govt).

6.3. An outline of these submissions is at **Appendix A.**

6.4. Full copies of all submissions made to the Commission in respect of the Applications are available on the Commission's public register.

7. Statutory Basis for Assessment

7.1. The Commission's assessment of the Applications is made in accordance with the various statutory provisions set out in the Act. The relevant provisions and the context for the Commission's assessment are detailed below.

7.2. Section 45 of the Act prohibits the making of or the giving effect to contracts, arrangements or understandings that have the purpose or effect of substantially lessening competition in a market or which contain an exclusionary provision.

7.3. The Applicants lodged application A30226 pursuant to subsection 88(1) of the Act for authorisation under that subsection to make and give effect to an arrangement (the JSA) that is or might be an exclusionary provision within the meaning of section 45 of the Act.

7.4. The Applicants lodged application A30227 pursuant to subsection 88(1) of the Act for authorisation under that subsection to make and give effect to an arrangement (the JSA) that might have the purpose or effect of substantially lessening competition within the meaning of section 45 of the Act.

7.5. Subsection 90(6) of the Act provides that the Commission shall not make a determination granting authorisation under subsection 88(1) in respect of a provision (not being an exclusionary provision) of proposed arrangements unless it is satisfied, in all the circumstances, that the provision would result in a benefit to the public and that that benefit would outweigh the detriment to the public constituted by any lessening of competition that would result, or would be likely to result, from the making and giving effect to the proposed arrangements.

7.6. Subsection 90(7) of the Act provides that the Commission shall not make a determination granting authorisation under subsection 88(1) of the Act in respect of a provision (not being an exclusionary provision) of arrangements unless it is satisfied, in all the circumstances, that the provision has resulted, or is likely to result, in a benefit to the public and that that benefit outweighs or would outweigh the detriment to the public caused by any lessening of competition that has resulted, or is likely to result, from giving effect to the arrangements.

7.7. Subsection 90(8) of the Act provides that the Commission shall not make a determination granting authorisation under subsection 88(1) in respect of a provision of proposed arrangements that is, or may be, an exclusionary provision unless it is satisfied, in all the circumstances, that the provision would result, or would be likely to result, in a benefit to the public that the proposed arrangements should be allowed to be made.

The relevant test

7.8. Whilst there is some variation in the language between the tests for subsections 90(6) and 90(7) and the test for subsection 90(8), the Commission has until recently adopted the previous view of the Trade Practices Tribunal (now the Australian Competition Tribunal) that, in practical application, the tests are essentially the same.

7.9. This view has now been reconsidered by the Australian Competition Tribunal (the Tribunal) and it has found that the two tests are not precisely the same. In particular the Tribunal considered that the test under section 90(6) was limited to a consideration of those detriments arising from a lessening of competition. It was the Tribunal's view that the test under subsection 90(8) was not so limited.

7.10. However with respect to the application of Qantas and BA the Commission is satisfied that any public detriment can directly or indirectly be linked to a lessening of competition. Consequently, the difference in the tests identified by the Tribunal does not affect the assessment of these applications.

Common assessment

7.11. The Commission has applied a common assessment of the Applications and considers each of the applications within this Draft Determination.

7.12. Subsection 90A(13) provides that, where the Commission is of the opinion that two or more applications for authorisation that are made by the same person involve the same or substantially similar issues, the Commission may treat the applications as if they constitute a single application and may prepare one draft determination in respect of the applications and hold one conference (if requested) in relation to that draft determination.

Draft determination

7.13. Subsection 90(4) states that the Commission shall state in writing its reasons for a determination made by it.

7.14. Subsection 90(5) of the Act provides that, before making a determination (the final determination) in respect of an application for authorisation, the Commission shall comply with the requirements of section 90A.

7.15. Subsection 90A(1) of the Act sets out that, before determining an application for an authorisation (other than an application for an authorisation under subsection 88(9) of the Act), the Commission shall prepare a draft determination in relation to the application.

8. Market definition

8.1. The first step in assessing the competitive effects and the public benefit/detriment of the conduct for which authorisation is sought is to consider the relevant market(s) in which that conduct occurs.

8.2. In MCA it was noted in relation to establishing whether or not the conduct under scrutiny results, or is likely to result in, net public benefit:[11]

> *"That task will generally entail, as the most important element, an understanding of the functioning of relevant markets with and without the conduct for which authorisation is sought."*

Markets generally

8.3. Section 4E of the Act states that a market for goods or services includes other goods or services that are substitutable for, or otherwise competitive with, the first goods or services.[12] The courts have established that both demand and supply side substitution must be taken into account in determining the relevant market. QCMA is often cited when seeking to explain how markets are defined:[13]

> *"A market is the area of close competition between firms or, putting it a little differently, the field of rivalry between them... Within the bounds of a market there is substitution between one product and another and between one source of supply and another, in response to changing prices. So a market is the field of actual and potential transactions between buyers and sellers amongst whom there can be strong substitution, at least in the long run, if given a sufficient price incentive... Whether such substitution is feasible or likely depends ultimately on customer attitudes, technology, distance and cost and price incentives.*
>
> *It is the possibilities of such substitution which set the limits upon a firm's ability to 'give less and charge more'. Accordingly, in determining the outer boundaries of the market we ask a quite simple but fundamental question: If the firm were to 'give less and charge more' would there be, to put the matter colloquially, much of a reaction?"*

8.4. In establishing the market boundaries, the Commission seeks to include all those sources of closely substitutable products, to which consumers would

[11] *Re Media Council of Australia and Ors* (1996) ATPR ¶ 41-497

[12] The Commission identifies the relevant market by determining the smallest area over which a profit maximising monopolist would impose a "small but significant and non-transitory increase in price" (SSNIP), or equivalent exercise of market power. By including all substitution possibilities, the process of market definition identifies all the sources of competition that effectively constrain the price and output decisions of the relevant entities. Market definition is not an end in itself but rather a tool of analysis.

[13] *Re Queensland Co-op Milling Association Ltd & Defiance Holdings Ltd* (1976) ATPR ¶ 40-012.

turn in the event that the firm attempted to exercise market power. The Commission looks at both the demand and supply sides of the market and defines up to four different dimensions:

- geographic market: which may be local, state, national or international depending on where trade occurs;
- product market: based on whether products are close substitutes for one another;
- functional market: defines at what level the conduct in question occurs, for example, retail or wholesale; and
- temporal market: the period of time over which substitution possibilities may arise.

8.5. The market must be defined only to the extent necessary to determine the effect of the Proposed Arrangements on competition. If market boundaries are too narrow so that actual or potential sources of competition are excluded, then the proposed conduct will appear to have greater anti-competitive effect than is actually the case. On the other hand, the market may be defined too widely to include products or geographic areas that are not close substitutes. In such circumstances the anti-competitive effects of the proposed conduct will appear to be weaker than they actually are.

The Commission's general view of air transport sector markets

Previously stated views of the Commission

8.6. The Commission has previously expressed views on markets relevant to air transport in its Determinations A90565 (*Qantas and BA*) of 12 May 1995, A90649 and A90655 (*Ansett Australia, Ansett International, Air NZ* and *Singapore Airlines*) of 22 July 1998, A30202 (*Qantas and BA*) of 10 May 2000, A90408 (*IATA Passenger Agency Program*) of 13 November 2002 and A30220-3 and A90862-3 (*Qantas and Air New Zealand*) of 9 September 2003.

8.7. In these determinations the Commission generally concluded that there were three broad product dimensions in markets of relevance to air transport:

- passenger transport;
- freight transport; and
- the sale of air transport.

Passenger transport

8.8. The Commission has consistently stated that the most important dimensions of the passenger transport market are the geographic and product dimensions.

Geographic market

8.9. The Commission has previously distinguished between the domestic and international markets mainly on the basis of the different regulatory environments.

Domestic

8.10. An important element of the regulatory distinction is cabotage policy which restricts the carriage of passengers between points in Australia to domestic airlines. Government specified ownership restrictions effectively prevent most foreign international carriers from operating on Australian domestic routes. The exception is that the designated airlines of New Zealand may, under the Single Aviation Market Agreement reached between the governments of Australia and New Zealand, conduct operations between points in Australia.

8.11. Foreign persons, including foreign airlines, are allowed to have up to 100 per cent equity in an Australian domestic airline, unless this is contrary to the public interest. While a foreign airline is prevented under cabotage from carrying domestic passengers in Australia, it can operate a wholly owned subsidiary in the domestic market.

8.12. The Commission has previously noted that, while foreign carriers were prevented from operating in the Australian domestic market, they could have a presence through code sharing, with the Government allowing foreign carriers to code share to all points in Australia on Australian domestic airlines. This policy only relates to international passengers continuing their international voyages beyond their point of entry into Australia.

International

8.13. When examining international air transport passenger markets, the Commission has consistently stated that while a regional approach to market definition is the most appropriate approach for many international air services, it is not universally applicable and market definition will be considered on a case by case basis.

8.14. When stating its position on the Restated JSA in A30202, the Commission stated that it saw no reason, on the basis of the material put before it at the time, to depart from the regional basis of market definition.

Product market

8.15. In Determination A30220-2 and A90862-3 the Commission stated that it was increasingly of the view that there are separate markets for business and leisure travellers. In forming this view the Commission took into account the way fares and conditions of travel are structured by airlines, the relative contribution of business travellers to airline revenue, and the impact of loyalty programs and corporate travel contracts.

8.16. The Commission noted in particular the existence of a highly specialised travel agency industry dedicated to servicing the needs of business travellers.

Freight

8.17. In A30220-2 and A90862-3 the Commission reaffirmed its previously stated views on air freight: that is, different types of freight represent different market segments rather than different types of markets, and the availability of indirect route options renders a regional market approach appropriate.

Sale of air travel

8.18. While the Commission has generally identified the sale of air travel market as one of the markets relevant to the air transport of passengers, in A90408 it recognised that this market should embrace not only those organisations able to sell tickets directly to the public (airlines and IATA accredited agents), but also licensed agents which are not IATA accredited.

8.19. The Commission believes that the *geographic market* for the sale of air travel (in both international and domestic trades to consumers located in Australia) has traditionally tended to be the whole of Australia, but not outside of Australia.

8.20. However, in A90408 the Commission recognised that, with the development of internet web sales sites by both agents and airlines, and the potential for purchases of domestic travel to be made from overseas from such sites, the geographic dimension of the air travel market boundary is becoming increasingly blurred.

8.21. In A90408 the Commission reaffirmed its belief that the *product market* in ticket sales includes tickets sold directly by airlines to travellers (including electronic tickets) as well as those sold through indirect channels (for example, travel agents). The Commission considered that tickets sold by airlines are an important part of the airline travel product market with airlines increasingly promoting sales of their own products through both internet sales and aggressive press advertising.

8.22. The Commission also suggested that if a single market could not be assumed for business and leisure travellers then there could also be separate markets for the sale of air travel to business and leisure travellers.

FUNCTIONAL MARKET

8.23. The Commission has previously noted that while airlines fill the role of wholesalers to the travel agent industry for air travel as well as retailing air travel in their own right, consumers can purchase tickets from any segment of the distribution system, including retail travel agents, airlines and package tour operators (wholesalers).

Market definition comments made by the Applicants

Geographic

8.24. The Applicants submitted that, having regard to previous Commission decisions and analysis in the NECG Report accompanying their submission, the Australian markets primarily affected by the JSA are:

- the markets for the provision of passenger air services between:
  - o Australia and South East Asia; and
  - o Australia and Europe.
- the markets for the provision of freight services between:
  - o Australia and South East Asia; and
  - o Australia and Europe.

8.25. The Applicants also submitted that it may be relevant to discuss domestic air passenger services in Australia for the purpose of considering the impacts of the JSA on domestic competition, but that it is extremely unlikely the JSA would have any adverse impacts in ancillary markets such as for the supply of IT or engineering and maintenance services.

8.26. The Applicants stated that they are of the view that, for the purposes of market definition, there is no relevant distinction between business and leisure passengers, economy and business/first class cabins or between different fare classes. It is contended that there is a single product market for air passengers and that different cabins in an aircraft or different passenger types represent different segments of the passenger market rather than different markets.

Market definitions suggested in submissions

AFTA

8.27. AFTA noted that, in terms of product differentiation, airlines offer clear and distinct products within the cabin. AFTA stated that there is no substitutability between economy and business class travel and believes evidence contained in the NECG Report regarding yield and inventory management supports the view that there are clearly separate markets for business and leisure travel.

8.28. AFTA also considered that it is relevant for the Commission to consider the market for travel agency services when responding to the application for authorisation of the JSA.

Virgin Atlantic

8.29. Virgin Atlantic submitted that markets that are affected by the JSA are Europe–Australia, Europe–South East Asia and South East Asia–Australia, and that within each of these geographic areas markets are differentiated according to origin and destination and purpose of travel.

8.30. Virgin Atlantic also submitted that a distinction has to be made between time-sensitive passengers and non-time-sensitive passengers and that every origin destination pair constitutes an economically distinct pair, with Heathrow being a separate market in its own right.

The Commission's view on market definition

Passenger transport

8.31. While the Commission has historically examined passenger transport in the first instance in terms of geographic markets, in order to be able to respond to the claim from Virgin Atlantic that there are different geographic characteristics for different passenger types, the Commission intends on this occasion to first examine whether there are different markets for different passenger groups.

Product

8.32. In A30220-2 and A90862-3 the Commission stated that it was increasingly of the view that there are separate markets for business and leisure travellers. The typical business traveller was seen as requiring flexibility, short stay and short lead booking times. The Commission suggested that airlines had already recognised the distinction between business travellers and leisure travellers in the way that fares and attached conditions of travel are structured.

8.33. Premium classes (first and business) satisfy these requirements but at a relatively fixed and high price. Within economy class deep discounted low fares are normally associated with advance purchase, no flexibility and no refunds and are not suited for business passengers. The business traveller's requirements can generally only be met through an economy ticket at the high end of the price range.

8.34. The Commission also noted that airlines are tailoring product to meet passenger markets. On the Sydney–Gold Coast route, where leisure travellers predominate, Qantas utilises its low cost subsidiary Jetstar on most flights. However Qantas full service flights under the Qantas brand have been retained at peak times when high yielding business passengers travel. Similarly Australian Airlines is a single class product designed to meet the needs of inbound international travellers. In the same vein Singapore Airlines has introduced a service between Singapore and Los Angeles aimed at higher paying passengers with two product classes being a business class and an executive economy class which features wider seats and a bigger seat pitch than standard economy seats.[14]

8.35. The Commission has previously drawn attention to comments from the general manager of United Airlines in Australia emphasising the importance of the contributions of business travellers to airline revenue, with about ten per cent of the passengers accounting for 50 per cent of revenue.[15]

8.36. Virgin Atlantic, in suggesting that time-sensitive passengers constitute a distinct group, or market, stated that they represent a group of passengers on whose time corporations place a high valuation, and hence their employers are prepared to pay more for particular aspects of service quality, such as

[14] Geoffrey Thomas, "*Luxury all way to LA*", The West Australian, 23 October 2003.
[15] Stuart Washington, "*Defying gravity*", Business Review Weekly, 25 July 2003.

schedule convenience, superior food and entertainment options and business tools.

8.37. The European Commission (EC) has also recognised differences between time-sensitive and non-time-sensitive travellers. In its decision[16] on a proposed alliance between Lufthansa and Austrian Airlines the EC stated:

> *"(47) The Commission further distinguishes between time-sensitive and non-time-sensitive customers. The former wish to reach their destination in the shortest possible time, they are not flexible in terms of time of departure/arrival and they need to have the option of changing their reservations at short notice. Non-time-sensitive customers, on the other hand, are more price sensitive and accept longer journey times."*

8.38. In the same decision the EC expresses the view that there is an overlap between time-sensitive passengers and business travellers:

> *"Footnote 10. Generally speaking, business travellers are more time sensitive than leisure travellers and tend to book fully flexible tickets. The second group of passengers are not time-sensitive but pay more attention to the price. These passengers accept longer journey times and may choose indirect flights if they are less expensive than direct ones.*

8.39. The US Department of Justice (DOJ) also recognises a distinction in passenger types. In a filing to the US Department of Transportation (DOT) in relation to a proposed alliance between American Airlines and British Airways , DOJ stated:[17]

> *"There are two separate relevant product markets in each city pair between the U.S. and the U.K.: a time sensitive (or "business") market, and a leisure market that is not time sensitive. Business travelers will tend to choose non-stop service when it is available, while leisure travelers will consider one stop alternatives."*

8.40. The Commission's views as to how airline fare structures effectively recognise different passenger groups are reaffirmed by DOJ in another filing[18] with the DOT. DOJ, when responding to the airlines' arguments that they do not have the ability to charge high fares to time sensitive passengers, stated:

> *"In essence the parties would have DOT believe that the complicated pricing structures and sophisticated yield management systems that carriers have constructed (at great cost) to allow them to segment demand and discriminate between business and leisure passengers are ineffective."*

[16] EC Decision COMP/37.730 – AuA/LH of 5 July 2002.
[17] Docket OST-97-2058, page 8.
[18] Docket OST-2001-11029 of 17 December 2001, page 17.

8.41. The New Zealand Commerce Commission (NZCC) in its decision of 23 October 2003 on a proposed alliance between Qantas and Air New Zealand also addressed the issue of product differentiation and stated that some demand characteristics are generally attributable to particular passenger segments and not to others. At paragraph 223 of its determination the NZCC stated:

> *"……These characteristics are broadly categorised for business and leisure passengers as follows:*
>
> - *Business passenger characteristics:*
>   - *time sensitivity; considerable emphasis placed on flight frequency and scheduling;*
>   - *travel at beginning and end of the day; demand fare flexibility; want direct routes;*
>   - *do not want weekend stops;*
>   - *less concerned about price – less elastic demand; and*
>   - *more concerned about air-points, comfort, service, etc.*
> - *Leisure passenger characteristics:*
>   - *Less time sensitive;*
>   - *Like stopovers, particularly backpackers;*
>   - *Will accept restrictions and penalties on changing fares;*
>   - *Price is primary factor in choice of airline (willing to trade lower price for convenience) – more elastic demand; and*
>   - *Not so concerned with air points, full service, etc.*

8.42. The NZCC also stated at paragraph 225:

> *"Based on the matrix of factors above, the Commission considers that there is a differentiation between business and leisure passengers, particularly in regard to price and flight frequency, and this is further emphasised by the ability of airlines to successfully discriminate between the two segments."*

8.43. On the basis of the material and views presented above the Commission is satisfied that there are two distinct groups of passengers, *business passengers* (who are generally not sensitive to price but are sensitive to other factors) and *leisure travellers* (who are generally price sensitive).

8.44. Mr Michael Swiatek, Air New Zealand General Manager (Vice President) Joint Ventures, has made reference to approaches to identifying demand from passengers with different price elasticities in a statement[19] filed with the Australian Competition Tribunal:

> *"Para 64(b) the price elasticity of the passenger. This is a measure of the sensitivity of each passenger to changes in price. Passenger price elasticity is however difficult to measure:*
>
> - *it is difficult to find data which is highly accurate and therefore it is often the case that a passenger characteristic such as "purpose of trip" is used in the place of passenger price elasticity data. The main purposes which are used for classification are leisure and "visiting friends and relatives" (VFR), both viewed as elastic, and business, viewed as less elastic;*
>
> - *it is often the case that true passenger O&Ds are a mix of different passengers from a price elasticity perspective; "*

8.45. There remains the question as to whether the groups constitute separate markets for the purpose of the Commission's assessment of the JSA.

PASSENGER GROUP MARKETS

8.46. The NECG Report contended that analysis of demand and supply substitution tends to suggest that there are no separate customer markets. It was claimed that on the demand side there is likely to be a degree of substitution and while a first class fare may not be a demand side substitute for an economy class fare, it is quite plausible that there is a "chain of substitution" from the most budget economy class to first class fares. It is claimed that this chain is such that any attempt to profitably exercise a SSNIP[20] over only one segment of that continuum would be defeated by substitution.

8.47. On the supply side, NECG argued that there are likely to be significant economies of scope associated with serving a wide range of customers with different demand profiles, as compared with specialising in serving only one type of customer. It is also argued that airlines adjust the capacity they offer into the different segments in line with changes in demand.

8.48. NECG summarised the position by saying there is a broad range of fare types, the complexity of fares going well beyond a simple distinction in a cabin class basis. Passengers shift between these fare types in line with relative prices, and airlines adjust their offering in the different fare types so as to maximise revenue in line with changing supply/demand balance.

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[19] Statement dated 8 March 2004 to the Australian Competition Tribunal in the matter of an Application to the Tribunal for a review a decision of the Commission to decline an application (A30220-22 and A90862-3) for an alliance between Qantas and Air New Zealand.

[20] See footnote 12.

8.49. NECG added that, as a matter of commercial reality, all the airlines serving the routes affected by the JSA provide full service, so as to secure economies of scope, including by optimising their ability to engage in price discrimination. Supply side substitution, on what is clearly a significant scale, then occurs through ongoing adjustment in cabin configuration with the extent of the space allocated to the various cabins varying in line with relative profitability.

8.50. AFTA stated that premium class passengers are predominantly travelling on business and (and therefore the cost of the travel is not borne by the individual) or the beneficiaries of frequent flyer/loyalty programs, whereas economy class passengers predominantly self fund their purchase.

8.51. AFTA also considered that airlines offer clear and distinct products within the cabin. What is offered to economy travellers is vastly different to the premium class product. There is clearly no substitutability between economy and business class travel. The airlines market each class quite separately. Further the structure of the fares offered by airlines is an acknowledgement of the product differentiation: for example, economy class fares are offered on a seasonal basis, a differentiation which does not apply to business or first class fares.

8.52. AFTA noted that in its experience while there has been a downward trend in the price of economy travel on the relevant routes during the term of the JSA the cost of premium class tickets have in fact risen considerably both in dollar and real terms. AFTA suggested that the evidence contained in the NECG Report regarding yield and inventory supports the view that there are clearly separate markets for business and leisure travel.

8.53. From the Commission's perspective it seems that important determinants in the degree of demand substitutability applicable to JSA routes are:

(i) the concerns of business and leisure travellers when facing long haul and extremely long haul travel; and

(ii) price.

8.54. The JSA Australia-Europe route is one of the longest in the world, normally taking around 24 hours with a minimum of one stop. Even the Australia-South East Asia route typically involves eight to nine hours of travel.

8.55. As seen above, regulators have consistently identified time sensitivity and fare flexibility as key issues with business travellers. On long haul, comfort also appears to be a key factor. The 2002 IATA Corporate Travel Survey identified delays and physical discomfort as the two major concerns of business travellers when undertaking long haul travel.

8.56. Airlines have recognised this need for comfort with the introduction of sleeper berths, initially in first class, but increasingly in business class. On the JSA routes Cathay Pacific, Singapore Airlines and British Airways provide sleeper berths in business class. Qantas has just commenced offering such facilities late in 2003.

8.57. Mary Rossi Travel, a business travel agency, stated that research shows that travellers in business class first of all want comfort. They want to be able to sleep and have flexibility.[21] The public relations manager in Australia for Cathay Pacific says in the same article that about 80 per cent of the seats in business class are taken by people actually travelling for company business, so the cost does not affect them personally. They want to get off a long haul flight rested and ready to work and that is what business class offers.

8.58. The DOJ stated in its earlier referred filing to the US DOT that it believes that many corporations are sensitive to their employees' convenience and are willing to pay large premiums to minimise that inconvenience. DOJ points to an American Express Travel Survey which showed 39 per cent of corporations use number of flight hours to determine whether employees may travel in first or business class, when concluding that even among companies with strict travel policies, many permit their employees to incur the large added expense of business class where international flights, or flights in excess of six to eight hours are involved.

8.59. The Commission believes that in recognition of the comfort factor on long haul and given that business travellers are not personally incurring expenditure, they would be averse to moving down in fare class even if those fares are considerably lower and travel flexibility could be achieved at the lower levels. Table 8.1 below shows that full flexible economy fares are only marginally lower than business class fares for a substantially inferior travel experience. Qantas acknowledged at a meeting with the Commission on 27 November 2003 that the difference between discount business class fares and fares used by business travellers in the economy cabin is low. While Qantas does market a restricted flexible economy fare for use only on Qantas flights, for the potential travel examined there was only limited access to such fares on the Qantas website at the time. The Commission considers that the typical business class traveller would seem unlikely to respond to higher fares in business class or lower fares in economy through a change in travel behaviour.

8.60. The substantial gap between the lowest economy fare levels and flexible economy and business class fares suggests that the price sensitive leisure travellers, who are not time-sensitive and do not need flexible fares, are unlikely to respond to a decrease in business class fares or an increase in economy fares by moving upward in the fare structure. A more likely response to an increase in economy fares is that they will look to other destinations or not travel at all.

[21] Christine Hogan, "*When travel means business*", Sydney Morning Herald, 14 October 2003.

Table 8.1 Selected Qantas fares by destination and fare class*

Airline fare Class	Sydney/ London	Sydney/ Bangkok	Sydney/ Singapore	Sydney/ Auckland	Sydney/ Perth
Business					
Flexible	$9,704	$6,645	$5,468	$2,212	$2,487
Lowest fare	$9,704	$4,934	$4,334	$1,972	$2,487
Full flexible Economy	$9,248	$5,570	$4,545	$1,552	$1,504
*Restricted flexible economy***	$3,816	Not available	Not available	Not available	$1,244
Cheapest restricted economy	$2,212	$1,199	$985	$566	$334

* Fares are return fares obtained from the Qantas web site on 17 November 2003 for departures in mid February 2004 and a one week stay at the destination concerned.
** Fully flexible but only on Qantas flights.

8.61. A study undertaken by the Department of Finance[22] in Canada supports this proposition. The study which included an examination of demand elasticities in the long haul international travel market found:

> *"The median values are low (0.265) for business travel and close to unity (1.04) for leisure travel. This seems reasonable since long haul international business travel has relatively few close substitutes, making demand insensitive to fare changes. On the other hand, international leisure travellers are more likely to postpone trips to specific locations, or shop around for locations offering more affordable fares. In the vacation market, international travel competes more directly with domestic travel for vacation destinations."*

8.62. On the basis of the above evidence business passengers are unlikely to respond to a SSNIP whereas leisure passengers will respond. Business passengers, being heavily price inelastic on long haul international flights, will also be highly unlikely to alter their selection of cabin class in response to a SSNIP, thereby refuting the NECG proposition of a "chain of substitution".

8.63. An indication of the inelasticity of business class is provided by Qantas publicly announcing that the cost of introducing its new business class sleeper berths would be met by a fare increase. The 10% price increase advised by Qantas is symptomatic of a market where prices are derived on a cost plus basis rather than a product of competition.

8.64. The unambiguous price sensitivity of leisure travellers also challenges the NECG chain of substitution argument for such travellers. In any geographic

[22] Canadian Department of Finance, Air Travel Demand Elasticities: Concepts, Issues and Measurements: 1 January 2003.

market such travellers when faced with a SSNIP are more likely not to travel than to accept a higher fare for identical service.

8.65. Thus the Commission does not agree as suggested by NECG that there is a chain of substitution from the most budget economy class fares to first class fares. Such a proposition would also seem inconsistent with the lack of product differentiation for different fares within each fare class. A full economy fare traveller receives exactly the same in-flight service as the lowest restricted fare traveller. Apart from the flexibility factor, the difference in most restricted fares paid by the public is attributable to airlines' yield management systems and the state of demand at the time of purchase.

8.66. NECG argues in terms of supply side substitution that airlines adjust the capacity they offer into the different segments in line with demand. Within economy class this is seen to occur through the re-allocation of seats between different inventory classes as part of yield management. With respect to cabin classes NECG states that the specialised assets required to provide a specialised business cabin do not appear to be so significant as to prevent supply side substitution. NECG points to historical and recent changes in the configuration of Qantas aircraft as an example of supply side substitution.

8.67. In its Merger Guidelines the Commission states that on the supply side the Commission will consider which suppliers could, without significant investment, switch their production and/or distribution facilities to supply a substitute product to that supplied by the merged firm, or switch from supplying another geographic area to that supplied by the merged firm.

8.68. To accept the NECG supply side substitution argument in relation to different fare levels within the economy class cabin is to accept that each fare level constitutes a different product. Different terms and conditions associated with different fares will often involve different products (for example, fully flexible fares versus fares with restrictions). But in many cases, the consumer cannot differentiate between the "product" and the only effective difference appears to be price. In these cases, it would appear that the same product is being offered at differing prices according to supply and demand conditions. NECG even acknowledges this when it says *"airlines adjust their offerings in the different fare types so as to maximise revenue in line with changing supply/demand."*[23]

8.69. From the Commission's perspective then there is a key input to the provision of airline passenger services, an economy class seat on a specific flight. This input is capable of generating different products: a fully flexible fare or deeply discounted, heavily conditioned fare, for example. Alternatively, the input may generate the same product at different prices, which may vary over time depending on supply/demand. Some economy class seats are always held back by airlines for late booking passengers who are generally business travellers prepared to pay higher fares. In the Commission's view, these fares

[23] NECG Report, page 42.

constitute different products from other economy fares that are more restricted. But different fares do not always constitute different products.

8.70. Whether different economy class products exist in different markets, or rather supply-side substitution integrates the field of rivalry for these products, can be tested by observing market outcomes. If competition in the provision of the alternate products is effective, prices for the different products will be driven down to the point where returns on each product are equated and suppliers are indifferent between the supply of the different products. (This does not mean that all prices will be the same because the supply costs of different products may vary.) Thus returns on a fully flexible fare for a business traveller will equate to returns on fares for leisure travellers, taking account of all costs of supply including the risk associated with with-holding the supply of seats for 'last-minute' business travellers. But the evidence available to the Commission in the form of fares quoted in the market (see Table 8.1 above) suggests that, even when all of these costs are taken into account, returns on economy class business travellers are significantly higher than returns on economy class leisure travellers.

8.71. In any case, supply side substitution in the provision of economy class seats for business and leisure travellers may not be sufficient to integrate the field of rivalry for business travellers and leisure travellers overall. This is because many business travellers would not consider the option of an economy class fare. A study prepared for the European Commission has concluded that:

> *"Consideration of supply-side substitutability constraints should lead to market aggregation only when supply side substitution is found to be nearly universal, i.e. when production substitution among a group of products is found to be technologically feasible and economically viable for most, if not all, firms selling one of more of those products."* [24]

8.72. NECG claims that the evidence shows that airlines constantly update cabin configurations in response to changes in demand. Historical information provided by NECG shows that Qantas tends to have changed configuration every two or three years. NECG claims recent changes were made in response to reduced demand for business class seats following the terrorist attacks in the United States on 11 September 2001.

8.73. While changes in demand may have accounted for some of the changes pointed to by NECG, it cannot be assumed that all cabin configuration changes are a product of demand change. Factors such as competition and/or cost efficiency factors can also promote such changes. Qantas submitted in its submission supporting Application A30202 that competition in premium cabins is focussed on quality of service rather than price. The most recent changes to Qantas cabin configurations have accompanied the introduction of

[24] Dr Atilano Jorge Padilla, The role of supply-side substitution in the definition of the relevant market in merger control", A Report for DG Enterprise A/4, European Commission, June 2001.

Skybeds in business class to match the facilities provided by the airline's key competitors.

8.74. Common sense suggests that if supply side substitution is to have the effect of constraint then the period between the occurrence of a SSNIP and market entry in response should not be overly protracted. US Merger Guidelines, for example, state in this respect that the new entrants "should be likely to respond to a SSNIP by switching their production to the relevant market product (or geographic market) within one year and without the expenditure of significant sunk costs of entry and exit". The Commission's Merger Guidelines state that the Commission will consider substitution possibilities over the longer period, "but still in the foreseeable future".

8.75. The Commission considers that cabin reconfiguration is a substantial and costly exercise and unlikely to occur on the JSA routes within a reasonable period in response to a SSNIP.

8.76. For the reasons stated above the Commission does not believe that there are supply side substitution factors which would lead it to conclude that there are not separate markets for business and leisure travellers on long haul routes.

8.77. After examining both demand and supply side substitutability the Commission considers that:

- there are separate markets for business and leisure travellers on long haul routes;
- comfort, travel time and flexibility in making and changing travel arrangements are the primary concerns of business travellers while leisure travellers are price driven; and
- fares payable in premium cabin classes and fully flexible economy fares best represent business traveller fares.

8.78. The Commission therefore intends to proceed with its assessment of the Applications on the presumption that there are separate markets for business and leisure travellers.

8.79. The view formed by the Commission in relation to long haul travel should not be taken to imply that the Commission considers that there are also separate markets for business and leisure travellers on all routes. Depending on levels of frequency and given the lesser importance of the comfort factor, it is possible that the degree of substitution across fare structures in short haul markets could be significant and point to a single passenger market on those routes.

Geographic markets

8.80. In looking to a regional approach to market definition on international passenger travel routes previously, the Commission took account of the extent of indirect travel as a factor in travel with passengers having the option of travelling directly to a destination or via a number of countries. The demand for indirect travel to a particular destination was seen as reflecting demand to other countries within the same region in that those other countries may be used in travelling to the ultimate destination.

8.81. The regional approach to geographic markets on JSA routes still appears appropriate for leisure passengers. Leisure passengers' well established price elasticity[25] suggests they have the propensity to substitute different destinations within targeted regions if services to their first preference destination incur a SSNIP. Leisure passengers' insensitivity to travel time (relative to their sensitivity to price) implies they will also accept the disutility of indirect flights and/or low frequency services. By implication, leisure passengers will generally consider substituting an indirect route for a direct route if there is a significant price differential.

8.82. The same time-sensitive factor that contributed to the Commission concluding that there were separate markets for business and leisure travellers suggests that the regional definition may not be appropriate for business travellers and that there could be different geographic markets for different passenger groups.

8.83. Virgin Atlantic submits that when there is a choice, time-sensitive passengers do not want to fly indirectly as this always involves additional time, inconvenience and a risk of missing one's connection or losing luggage. Virgin Atlantic cites decisions of the EC[26] and the United Kingdom Office of Fair Trading[27] which acknowledged the preference of time-sensitive travellers for direct flights. Virgin Atlantic also suggests that Heathrow is a destination in its own right.

8.84. The expectation would be that most time sensitive passengers would have specific non-substitutable destinations and with time at a premium would favour direct travel utilising routes with the minimum of stops. Functionally, this implies that business passengers would not consider substituting travel on other city pairs or even other routes if a SSNIP was imposed on the shortest route between their nominated city pairs.

8.85. Table 8.2 below provides an analysis of selected South East Asian destinations by whether passengers travelled directly or indirectly. In examining the results account has to be taken of the availability of services on a port to port basis, including the frequency and availability of flights from all Australia ports to the countries concerned.

8.86. The time sensitive nature of business passengers' travel between their desired city pairs implies they select the flight that reaches their destination first. In many regions this objective is normally met by utilisation of non-stop services. However some city pairs between Australia and South East Asia are served by relatively infrequent services (eg Melbourne to Hanoi only has two

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[25] Canadian Department of Finance, Air Travel Demand Elasticities: Concepts, Issues and Measurement:1.
[26] European Commission, 14 July 1999, IV/D-2/34.780.
[27] Notice of consultation issued pursuant to Rule8[1]{a} of Schedule 1 of the EC Competition Law Enforcement Regulations 2001, dated 9 August 2002, Case CP/1535-01, at paragraph 65.

services per week). Thus there are some city pairs where high frequency one stop services (generally through Singapore) will be more attractive for business passengers in terms of transit times than low frequency non stop services.

Table 8.2 Travel between Australia and selected* South East Asian countries of origin/final destination by purpose of journey and route: 2002**

Country	Business/convention		Holiday/VFR		All travel	
	Direct	Indirect	Direct	Indirect	Direct	Indirect
Singapore	94%	6%	87%	13%	89%	11%
Thailand	77%	23%	78%	22%	78%	22%
Malaysia	65%	35%	68%	32%	68%	32%
Indonesia	72%	28%	86%	14%	82%	18%
Philippines	64%	36%	71%	29%	69%	31%
Vietnam	17%	83%	44%	56%	41%	59%

* The selected countries together account for 98 per cent of travel between Australia and South East Asian countries in the period concerned.

**Direct route is defined to comprise travel on an airline which offers non-stop services between Australia and the country concerned.

8.87. The high (94 per cent) direct percentages for Singapore for business travel reflect the availability of direct daily flights from all Australian capital cities to Singapore by Qantas and BA and Singapore Airlines.

8.88. For Thailand, Qantas and BA only provide direct services (daily) from Sydney and Thailand, and Thai Airways provides services from Perth, Brisbane, Melbourne and Sydney but with daily frequency only from Sydney. Not unexpectedly, the direct travel percentages are lower than for Singapore.

8.89. At the other end of the scale is Vietnam where only 17 per cent of travel is direct for business compared to 44 per cent for leisure travel. The only direct services available to Vietnam are with Vietnam Airlines which operates two services a week from Melbourne and three from Sydney. Such frequencies act against the business traveller who would typically look to an alternative of the most attractive indirect travel which suits their timing requirements. Under these circumstances given Singapore Airlines' Australian coverage and frequency, and proximity to Vietnam, it is not surprising that this airline achieves the highest market share of business travellers (39 per cent). For leisure travellers, where timing is not as critical, Vietnam Airlines is a more acceptable alternative and a higher percentage than business travellers take the direct services.

8.90. The Commission considers that the above analysis supports the proposition that for South East Asian destinations the point to point market is the appropriate market for analysis of business travel. The reasonably high percentages of indirect travel in markets where direct services are available also suggest that leisure travellers are not averse to taking indirect routes where price is lower.

8.91. Any analysis of traveller preferences in the market between Australia and Europe must be significantly different from the type of analysis undertaken above for South East Asia. All travel between Australia and European destinations takes 24 hours or longer and requires at least one intermediate stop.

8.92. The proposition that business travellers look for the shortest journey time would be demonstrated by a preference for one stop travel over two stop travel. In this context, in the interest of maintaining parity at the Australian end of the journey on airport access, the most appropriate analysis involves comparison between European destinations served by both the Applicants and Singapore Airlines. Other mid-point airlines do not have a good coverage of Australian ports and could involve an additional stop, for example within Australia, to access a European destination.

8.93. Tables 8.3a, 8.3b and 8.3c below examine the business and convention markets and holiday and VFR (visiting friends and relatives) markets for travel involving European origins and destinations. Specifically the market shares of the Applicants and Singapore Airlines are compared in circumstances where: (i) all airlines operate one stop services (Table 8.3a); (ii) the Applicants operate two stop services and Singapore Airlines operates a one stop service (Table 8.3b); and (iii) all the airlines operate two stop services (Table 8.3c).

8.94. It can be seen that Singapore Airlines generally increases its market share relative to the Applicants when it has less stops *en route*. The airline's higher market shares for business travellers than leisure travellers on such routes is consistent with the proposition that business passengers have a stronger preference for the most direct flights.

Table 8.3a Market share of travel by purpose for one stop European routes serviced by both the Applicants and Singapore Airlines: 2002

County of origin/destination	Business/convention travel		Holiday/VFR travel	
	Qantas/BA	Singapore Airlines	Qantas/BA	Singapore Airlines
United Kingdom	60.0%	13.8%	44.0%	18.1%
France	53.7%	18.5%	46.4%	13.8%
Germany	43.7%	23.9%	40.6%	18.2%
Italy	52.9%	15.4%	50.7%	15.9%

Source: ABS

Table 8.3b Market share of travel by purpose for European routes serviced by the Applicants with two stops and Singapore Airlines with one stop: 2002

County of origin/destination	Business/convention travel		Holiday/VFR travel	
	Qantas/BA	Singapore Airlines	Qantas/BA	Singapore Airlines
Denmark	45.4%	24.2%	42.8%	20.4%
Greece	15.6%	25.1%	7.9%	25.8%
Netherlands	40.9%	25.0%	41.2%	15.6%
Switzerland	32.1%	35.4%	30.9%	29.3%

Source: ABS

Table 8.3c Market share of travel by purpose for two stop European routes serviced by both the Applicants and Singapore Airlines: 2002

County of origin/destination	Business/convention travel		Holiday/VFR travel	
	Qantas/BA	Singapore Airlines	Qantas/BA	Singapore Airlines
Spain	61.7%	12.7%	42.9%	27.8%
Sweden	51.1%	21.0%	48.3%	26.6%

Source: ABS

8.95. For the UK, France, Germany and Italy, the Applicants average 3.12 times the market share of Singapore Airlines on business travel. For Denmark, Greece, the Netherlands and Switzerland the one less stop incurred by Singapore Airlines sees the Applicants' market share reduced to 1.26 times that of Singapore Airlines. On routes where all carriers have two stops, Spain and Sweden, the Applicants' market share increases again to 3.65 times that of Singapore Airlines.

8.96. The impact of extra stops is most evident for travel with Greece where Singapore Airlines substantially exceeds the market share of the Applicants. Being located on the Eastern side of Europe travellers to Greece from Australia using the Applicants' services effectively fly over and beyond Greece to the UK and then have a substantial trip back to it. A comparison of flying times shows a six hour saving from origin to destination by travelling with Singapore Airlines compared to a Qantas/BA service.

8.97. It would be expected that, following the suspension of direct services by Qantas to Rome in 2003 and given the significant distance from London to Rome, Singapore Airlines' one stop service would see it substantially improve its business traveller market share to Rome as well.

8.98. Recognition of the importance of minimising stops is provided by the behaviour of Qantas itself which is consistently entering code share arrangements with other carriers to enable it to provide one stop services to European destinations. Since the suspension of its Rome services Qantas has entered a code share with Cathay to Rome. It has also entered, or is planning to enter, code share arrangements with Finnair to Finland, with Swiss to Zurich and with Gulf Air to Athens.

8.99. The analysis above supports the proposition that the relevant geographic market for business travel between Australia and Europe is between city pairs by the most direct route. Time sensitive business passengers with inelastic demand characteristics would be unlikely to switch to a two stop service in response to a SSNIP on a one stop service. The movement in market shares in favour of Singapore Airlines in Table 8.3b above indicates that one-stop services between Australian and European destinations are preferred by business passengers over two-stop services.

8.100. Virgin Atlantic has claimed that Heathrow should be treated as a separate geographic market for business travellers due to its close proximity to the centre of London, its convenient schedules and its extensive range of flight connections.

8.101. The Applicants have claimed that "there can be no separate product market for fights to and from London Heathrow Airport". They suggested that the difference in transfer times from Heathrow and Gatwick to London city are negligible in the context of the length of flights from Australia and that the Virgin Atlantic argument of greater connectivity from Heathrow to Europe is irrelevant because of the large number of airlines operating out of Gatwick and because of the availability of alternative hubs in Europe.

8.102. The Commission acknowledges that there are a number of decisions and studies, such as the DOJ submission[28] to the DOT of 17 December 2001 on alliances between US and UK airlines, which support the Virgin Atlantic view that Heathrow is the London airport of choice for time sensitive business and are persuasive.

8.103. The preference of time sensitive travellers for Heathrow is supported by the higher airline yields and greater number of high fare paying (primarily business passengers) noted upon by the OFT.[29] The transfer time arguments raised by Qantas would seem just as relevant to trans-Atlantic passengers but the DOJ has cited a range of studies showing the almost universal preference of business passengers for Heathrow over Gatwick.[30] The connectivity and European hub arguments of the Applicants may have some relevance for leisure travellers but they have little application for time sensitive business travellers with a London destination objective.

8.104. The Commission also notes that most mid-point carriers, with the exception of Emirates, which operate between Australia and London operate out of Heathrow. Emirates operates out of a number of other UK cities in addition to Heathrow.

[28] Docket OST-2001-11029
[29] OFT Case CP/1535-01, decision of 1 November 2002.
[30] Docket OST-2001-11029.

8.105. For the reasons presented above the Commission intends to proceed with its examination of international passenger market aspects of the JSA on the premise that the geographic market for business travellers is a point to point market and for leisure travellers a regional market.

8.106. For the purpose of this authorisation the Commission does not need to treat Heathrow as a separate destination. The Commission notes that for UK destined passengers Heathrow would be the preferred airport for accessing London or for achieving connections to destinations in the UK other than London. It may be that constraints in accessing Heathrow could give rise to barriers to entry for business passenger travelling to destinations in the UK.

8.107. In the absence of journey purpose data for points in Australia the Commission will examine business passengers markets at the Australia end on the basis of all points in Australia.

Freight

8.108. The NECG Report states that in freight, as compared to air passenger services, there is significantly greater scope for indirect services to provide effective substitutes for direct services. It is suggested that in this respect defining the geographic scope of air freight markets to be country to region based on indirect substitution possibilities seems appropriate.

8.109. The Commission will assess the freight aspects of the JSA on the premise utilised in earlier decisions that different types of freight represent different market segments rather than different types of markets and will use a regional market approach.

Sale of air travel

8.110. No information has been provided which suggests the Commission should depart from its view of the sale of air travel market as expressed in A90408.

9. The future without the Proposed Arrangements – the Counterfactual

The "future with-and-without test"

9.1. The Commission's evaluation is in accordance with the statutory tests outlined in Part 7 of this Draft Determination. As required by the tests, it is necessary for the Commission to assess and weigh the likely public benefits and detriments flowing from the Proposed Arrangements.

9.2. In doing so, the Commission uses the "future with-and-without test" established by the Australian Competition Tribunal to identify and measure the public benefit and anti-competitive detriment generated by the arrangements proposed to be authorised.[31]

9.3. Under this test, the Commission considers the public benefits and anti-competitive detriment generated by the Proposed Arrangements when the authorisation is granted with the arrangements which would apply or occur if authorisation was not granted. The scenario of arrangements taken to occur when authorisation is not granted is referred to as the "counterfactual".

9.4. Often the counterfactual simply involves the future without the Proposed Arrangements. However, this is not always the case as there may be elements of the arrangements for which authorisation is sought which parties may pursue even in the absence of authorisation.

9.5. The counterfactual provides the benchmark against which anti-competitive detriment and public benefits are assessed. In examining prices to consumers associated with specific conduct, for example, the Commission would expect to compare estimates of prices under the Proposed Arrangements with prices under the base position (the counterfactual).

9.6. It can be seen that the state of the market selected as the counterfactual can be critical in terms of determining net public benefit. In the majority of authorisation cases coming before the Commission, the counterfactual is represented by the status quo. However, this need not necessarily be the case and depends on likely or imminent developments in the markets concerned.

Interested party views on the factual and counterfactual

9.7. The Commission did not receive any submissions from interested parties which specifically discussed the likely situation in the future without the JSA. Rather, submissions from interested parties focused on the likely situation in the future without the JSA in terms of anticompetitive detriment and public benefits. These points are more appropriately considered in the parts of this Draft Determination dealing with those aspects.

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[31] See, for example, *Re Australasian Performing Rights Association* (1999) ATPR ¶41-701.

The factual claimed by the Applicants

9.8. The Applicants submitted that, in order to be as accurate as possible in their predictions of the future with and without the JSA, Qantas and BA individually considered what they would be likely to do if the JSA were not re-authorised and what they plan to do if it continues. The Applicants submitted that the resulting combined counterfactual schedule was used by NECG as a basis for assessing benefits and anti-competitive detriment.

9.9. Under the JSA, the Applicants have in place arrangements which feature coordinated scheduling in relation to their operation of services between Australia and Europe, Australia and South East Asia, and Europe and South East Asia. Qantas and BA 'hub' services between Australia and Europe through Singapore and Qantas and BA each operate a daily service between Australia and Europe via Bangkok.

9.10. Table 9.1 below shows Qantas' current schedules on JSA routes.

Table 9.1 Current schedule: Qantas, Northern Summer 2003*

Route	Frequency+	Aircraft
Sydney-Singapore-London	7	747-400
Melbourne-Singapore-London	7	747-400
Sydney-Singapore-Frankfurt	7	747-400
Sydney-Singapore-Melbourne	4	767-300
Brisbane-Singapore	7	747-300
Perth-Singapore	7	767-300
Perth-Singapore	1	747-400
Perth-Singapore-Rome^	3	747-400
*Perth-Singapore-Paris***	3	747-400
Adelaide-Darwin-Singapore	3	767-300
Sydney-Bangkok-London	7	747-400

* Effective March 2003 ^Services to Rome were suspended in June 2003.
**Services to Paris are to be suspended from October 2004.
+ Round trips per week

9.11. Table 9.2 below shows BA's current schedules on JSA routes.

Table 9.2 Current schedule: BA, Northern Summer 2003*

Route	Frequency+	Aircraft
London-Singapore-Sydney	7	747-400
London-Singapore-Melbourne	7	747-400
London-Bangkok-Sydney	7	747-400

* Effective March 2003
+ Round trips per week

9.12. The Applicants submitted that, in a future with authorisation, they would maintain and expand current capacity under the JSA. Qantas and BA would also continue to operate a hub at Singapore.

9.13. Tables 9.3 and 9.4 below show schedules proposed to be operated by Qantas in the short/medium and long terms if the JSA is authorised. The Commission notes that all of the schedule and aircraft changes over the short/medium and long term that are proposed by the Applicants are actually changes that are implemented by Qantas. The Applicants do not propose any changes in the capacity or frequencies operated by BA over the next five years.

9.14. Table 9.3 below shows that, in the short/medium term, the Applicants envisage:

- an increase in frequency on the Sydney-Singapore-Melbourne route from four round trips per week to seven round trips per week:
- the cessation of a weekly Perth-Singapore B747-400 service; and
- the addition of two Perth-Singapore-Paris services per week.

9.15. On the basis of the schedules in Table 9.3 below and seating configuration details supplied by the Applicants, in the short to medium term, there is no increase in seats operated to the United Kingdom, there is an increase of 6% in seats operated to Singapore by Qantas (an increase of 5% for the JSA as a whole) and an increase of 20% in seats operated between Australia and continental Europe (assuming the continued suspension of Rome services).

Table 9.3 Factual schedule: Qantas, Years 2-3[32]

Route	Frequency+	Aircraft
Sydney-Singapore-London	7	747-400
Melbourne-Singapore-London	7	747-400
Sydney-Singapore-Frankfurt	7	747-400
Sydney-Singapore-Melbourne	7	767-300
Brisbane-Singapore	7	747-300
Perth-Singapore	7	767-300
Perth-Singapore-Rome^	3	747-400
Perth-Singapore-Paris^	5	767-300
Adelaide-Darwin-Singapore	7	747-400
Sydney-Bangkok-London	7	747-400

+ Round trips per week.
^Services to Rome and Paris have been assumed not to operate in the factual scenario

9.16. The Applicants submitted that, in the longer term, it is likely that they would increase frequency by 13% and capacity by 19% over the next five years, as compared to the current schedule.

9.17. An analysis of the schedules in Table 9.4 below and information provided by the Applicants shows that (excluding Rome services) over the next five years capacity provided by JSA services under the claimed factual would increase by 21% overall with increases of:

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32 NECG Report, page 125.

- 10% between Australia and the United Kingdom;
- 15% between Australia and Bangkok;
- 27% between Australia and Singapore; and
- 40% between Australia and continental Europe.

Table 9.4 Factual schedule: Qantas, Year 5[33]

Route	Frequency+	Aircraft
Sydney-Singapore-London	7	747-400
Melbourne-Singapore-London	7	A380
Sydney-Singapore-Frankfurt	7	747-400
Sydney-Singapore-Melbourne	7	A330
Brisbane-Singapore	7	747-300
Perth-Singapore	7	A330
Perth-Singapore-Rome	7	747-400
Perth-Singapore-Paris	7	747-400
Adelaide-Darwin-Singapore	7	A380
Sydney-Bangkok-London	7	A380

+ Round trips per week

9.18. Capacity increases come from a Qantas move from Boeing 747-400 aircraft to Airbus A380 aircraft on one Sydney-Singapore-London service and the Sydney-Bangkok-London service and a switch from B767-300 to A330 aircraft on Sydney-Singapore-Melbourne and Perth-Singapore services.

9.19. Changes in frequency and capacity also arise from an increase in Perth-Singapore-Paris round trips from three per week (currently) to seven per week and an increase in Adelaide-Darwin-Singapore services from three round trips per week to seven round trips per week.

9.20. On 21 June 2004 Qantas announced that it was withdrawing services from Paris effective from 31 October 2004. At the same time it announced a code share on daily Air France services out of Singapore to Paris. None of the above tables take account of these changes to Paris services.

The Commission's views on the claimed factual

9.21. The Commission is of the view that, in order to have regard to the future with-and-without test, it is important to not only evaluate the likely situation in the future without the JSA (the counterfactual) but to also evaluate whether the factual scenario put forward by the Applicants is realistic.

9.22. Key factors for the Applicants in determining their future presence on routes (both with and without the JSA) will be factors such as demand conditions (including changes in passenger mix), profitability and performance, and the strategic direction of the airlines.

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33 ibid, page 126.

9.23. The factual scenario as presented is characterised by the nominated schedules. The task of the Commission is to assess whether the postulated schedules are reasonable in the light of its examination of the markets involved from information supplied by the Applicants and available generally to the public.

9.24. The Commission notes that while Qantas and BA's overall performance did deteriorate in recent years, this result was in line with the general downturn in the aviation industry that followed the terrorist attacks in the US in 2001 and, more recently, the severe acute respiratory syndrome (SARS) outbreak and the war in Iraq. There is general acceptance that the aviation industry has started to recover from these shocks and industry predictions are that growth rates and performance will return to pre-2001 rates in the near future and the most recent results of Qantas and BA reflect such improved outcomes.

9.25. In this regard, the Commission notes recent International Civil Aviation Authority (ICAO) projections that predict a rise in world passenger traffic by 4.4 per cent in 2004 and, by 2005, a return to 2000 volumes.[34] More specifically the Australian Tourism Forecasting Council report for December 2003 predicted an overall tourism increase in 2004 of 7.6% with increases from Singapore of 7.5%, Thailand 15.3%, the United Kingdom of 4.8%, Germany of 4.6% and France of 7.3%.

9.26. NECG observed that, while there has generally been a downward trend in both profitability and contribution margins since 1999/2000, Qantas' 2002/03 results show an improvement in profit performance. NECG also submitted that profitability is likely to further improve if general air travel trading conditions ease and the longer term growth in international air travel continues.

9.27. The Commission notes that since the Applicants lodged their supporting submissions on 6 May 2003 Qantas has taken initiatives in relation to the Australia–UK route which are not reflected in the factual scenarios lodged with the Commission. These initiatives involve the acquisition of slots at Heathrow airport and making application to the International Air Services Commission (IASC) for capacity which would enable Qantas to operate additional flights to the United Kingdom.

9.28. In January 2004 Qantas was reported to have bought two slots at Heathrow airport.[35] This purchase gives Qantas an additional two landing and take off slots at Heathrow and enables the airline to operate an additional 14 services per week to the UK over and above the 21 services it currently operates.

9.29. On 17 February 2004 Qantas applied to the IASC for seven additional services to the UK with three to commence from November 2004 and the remaining four to be phased in over the following twelve months. The services were to operate from Eastern Australia through mid-points to be

[34] Robertson, Robin (2003), "Airlines wake up to a brave new world", *Australian Financial Review,* Supplement, 20 November 2003, p.3.
[35] Clive Mathieson, Steve Creedy, "Qantas gets its coin into London slot", *The Australian*, 21 January 2004.

decided later. The IASC has allocated seven services to Qantas to be progressively utilised by 1 November 2005.[36]

9.30. On 18 May 2004 Qantas issued a press release stating that, subject to IASC approval, it planned to increase its flights to the UK from 21 to 28 per week over two years, four services operating via Hong Kong and three via Singapore. Qantas also stated that it had applied to add a further three weekly services via Hong Kong (presumably rather than Singapore) which could not occur until April 2006.

9.31. In a submission to the IASC dated 4 June 2004 Qantas has indicated that it will move to 35 services weekly to the UK over the next three to five years.[37]

> *"All Qantas expansion to the UK over the next three to five years will be through increased capacity to London – Heathrow, initially with an increase from the current 21 to 28 B747-400 services weekly. Later increases will be undertaken with additional Heathrow frequencies (another daily) and equipment upgrading to the 500 plus seater A380 aircraft (currently on order)."*

Hub operations under the factual scenario

9.32. The Applicants have stated that if the authorisation is obtained they will continue to build their 'mini-hub' in Singapore and operate it consistent with factual scheduling information they have provided.

9.33. It would seem to the Commission that it is possible that, in the longer term, the development of alternative hubs by other airlines may put pressure on the Singapore hub. Virgin Atlantic has announced that from 7 December 2004 it will introduce services between Australia and the UK via Hong Kong. Emirates' intended use of A340-500 aircraft over Dubai, for example, will reduce flying time between Australia and the UK by around two hours compared to operations over the Singapore hub.

9.34. The Commission agrees that the Applicants are likely to continue to 'hub' services between Australia and Europe in Singapore in the longer term. The hub allows consolidation and distribution of passengers flying from and to Australian capital cities and the location at Singapore provides a focus for operations and marketing for the Applicants in South East Asia.

9.35. However the Commission notes that since Qantas and BA lodged their Application Qantas has announced plans to effectively operate a hub in Hong Kong by 2006. Hong Kong is already serviced by Qantas from all capital cites in Australia except Adelaide and Darwin.

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[36] IASC Determinations [2004] IASC 102 of 1 April 2004 and [2004] IASC 112 of 30 July 2004.
[37] Page 8 of letter to IASC of 4 June 2004 headed "Application for UK Capacity – Supplementary Submission".

Future demand for air travel and the factual scenario

9.36. In assessing the Applicants' claims in relation to growth in frequency and capacity in the factual scenario, the Commission has looked in the first instance at historical passenger trends on the routes served by the Applicants, recent route performance and industry projections.

9.37. Estimates of tourism growth published[38] by DITR, envisage passenger growth of the order of 4.5 per cent per annum over the next five years (compared to long term annual growth rates on JSA routes of over six per cent). This is consistent with ICAO growth projections referred to above and if experienced on JSA routes would see total growth on those routes over the next five years of the order of 25%.

9.38. The Tourism Forecasting Council outlook for inbound tourism as released in April 2004 envisages inbound tourism growth from relevant areas over the next five years as follows:

- Singapore - +34%;
- United Kingdom - +25%; and
- Other Europe - +28%.

9.39. The growth projections above compare with the submission by the Applicants which shows that under a scenario where the JSA is authorised (the factual) they would increase capacity overall on JSA routes (that is, out of Australia) by around 21 per cent.

9.40. When compared to the figures cited above, the factual put forward in their supporting submission by the Applicants seems reasonable at the aggregate level. However the Commission notes there are significant disparities in growth across JSA routes in the factual. In relation to the number of seats offered by Qantas in the factual, over the long term, there is an increase in seats operated between Australia and the UK of 10%, an increase in seats between Australia and South East Asia of 26% and an increase in seats operated between Australia and continental Europe of 40%. There is no projected increase in the number of seats operated by BA.

9.41. Growth on the UK route at only 10% does not seem likely to match market growth. There are already very high load factors being experienced on this route. DTRS statistics show Qantas had load factors of nearly 90% over 2002 and 84% in 2003. NECG has acknowledged that passengers have been spilled due to the high load factors on JSA services.[39] BA experienced load factors of around 75% in 2002 and 72% in 2003 on the same route.

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[38] Latest Inbound Visitor Movements, October 2003, Tourism Division, Department of Industry Tourism and Resources.
[39] NECG Report, page 134.

9.42. The Applicants have claimed that increases in Qantas' services to Paris will lessen pressure on UK services by removing passengers from UK direct flights who would otherwise transit Heathrow to Paris.

9.43. Notwithstanding this claim (now overtaken by Qantas' withdrawal of services to Paris), the Commission is of the view that it is likely, under the frequency and capacity increases planned over the next five years by the Applicants (as indicated in their supporting submission) under the JSA if authorised, that the Australia-UK routes would be significantly constrained in terms of the supply of economy capacity to the market. Given the significant contribution in capacity terms the Applicants make to the UK route and barriers to entry facing other airlines looking to expand into Heathrow, passenger access to this route would look to become increasingly difficult over the next five years.

9.44. On the basis of confidential information put before the Commission on historic load factors across the airlines' cabins, it appears to the Commission that supply side growth has been driven by changes in the demand characteristics of high yielding passengers rather than of economy passengers.

9.45. Capacity growth under the factual to Singapore and Thailand at 21% and 15% is broadly consistent with demand projections. However the 133% planned capacity growth (all Qantas) to France seemed relatively high, given proposals for other continental Europe services, even prior to Qantas' withdrawal of its Paris services. No growth in capacity is planned for Germany and services to Rome have been suspended.

9.46. Qantas originally indicated that its ability to service Paris has been constrained by current bilateral arrangements with the airline being limited to three services per week. Qantas expects additional capacity to become available over the next five years which will enable it to respond to what it describes as a strong business traveller presence on this route and expand from three services per week to seven. Following its withdrawal from Paris Qantas has not indicated whether it would re-enter the route if further capacity became available.

9.47. The views expressed by Qantas at the potential for expansion of the Paris route do not seem consistent with views expressed by NECG on the route when examining the counterfactual:

> *"Given the current financial performance of the Rome, Paris, Frankfurt and [**Confidential-**] London services, all would be candidates for capacity reduction."*

9.48. In relation to the number of seats operated by Qantas out of Australia and into South East Asia, there is a similarly large divergence in the rate of growth of seats offered on different routes. There is minimal growth planned in seats from Brisbane (7%), moderate levels of growth in seats offered from Melbourne and Sydney (10% and 26% respectively) and high growth out of Perth (38%) and Adelaide/Darwin (133%).

9.49. It is not clear to the Commission why such high levels of growth are planned for Adelaide/Darwin and Perth in particular in the factual. Qantas has suggested that the two regions will be subject to strong tourism development initiatives. However no material has been presented to the Commission which suggests that these are high growth markets relative to other Australian destinations.

Summary of the Commission's views on the claimed factual

9.50. Overall, while the Commission has some misgivings over the likely mix of capacity and flights claimed by the Applicants in their supporting submission to occur over the next five years under an authorised JSA, the changes projected in the total quantum of capacity made available by the Applicants on the JSA routes over the same period as stated in their submission appear reasonable.

9.51. The Commission is concerned however at the reliability which can be ascribed to projections of this type given recent Qantas initiatives to expand capacity to the UK. In May 2003 Qantas advised the Commission by submission that if the JSA continued it would not be increasing the number of flights it operated to the UK any time in the next five years. Just nine months later Qantas applied for capacity on the UK route which would increase its number of services on the route by over 30% and has subsequently indicated to the IASC that it would increase its number of services to the UK within a five year period by nearly 70%, from 21 flights per week to 35.

The Counterfactual claimed by the Applicants

Background to the Applicants' claimed counterfactual

The Applicants

9.52. The Applicants submitted that, in order to understand the impact of the loss of the JSA on the Applicants' business, an appreciation of the underlying economic characteristics of the arrangement is required, especially the extreme long haul nature of the Australia – Europe route which means that aircraft must stop at a mid-point to change crew and refuel.

9.53. The Applicants submitted that the combination of sectors between Australia and Europe that an airline adopts will depend on where the carrier is based. The Applicants submitted that a carrier based at either end of the route (such as Qantas and BA) will fly first to a mid-point and then continue the same service to the ultimate destination – the mid-point will be in either Asia or the Middle East.

9.54. The Applicants contrasted this with a carrier that has its base of operations at a mid-point. Such a carrier can operate on the Australia – Europe route by combining any of the independent single sector flights that it operates between its hub and ports in Australia with any of the flights that it operates from its hub to parts of Europe.

9.55. The Applicants claimed that endpoint carriers such as Qantas and BA are disadvantaged because, at the mid-point, many passengers disembark, thus leaving the endpoint carrier with only a partly full plane for the end sector to the ultimate destination. By way of example, the Applicants submitted that almost half of Qantas' passengers travelling from Australia to Singapore disembark in Singapore and do not continue on, or connect to, a JSA flight to Europe.

9.56. The Applicants claimed that yields on the Australia – Europe route have progressively reduced over the past eight years and that end point carriers have found it increasingly difficult to operate the route with many such as Air France, Alitalia, Lufthansa, Olympic Airways and KLM being forced to cease services to Australia.

9.57. The Applicants submitted that the majority of carriers on the Australia – Europe route are mid-point carriers which can operate each sector of the route separately, drawing feed for each destination from the whole of the carrier's network. The Applicants submitted that such hub systems create economies of density and make services to a wider range of destinations viable.

9.58. The Applicants claimed that the JSA counteracts the Applicants' individual disadvantages by giving each carrier the ability and the financial incentive to:

- support Australia – Europe route services from both ends of the route to alleviate the 'end sector' problem for each airline;
- combine and coordinate traffic to create a 'mini-hub' in Singapore where Qantas and BA are able to provide feed to each other's flights (it is claimed neither airline has sufficient traffic to support a mini-hub on its own); and
- combine resources to create joint sales and support operations in Singapore, Bangkok and elsewhere in Asia, which allows Qantas and BA to support Australia – Europe route services more effectively at the mid-points.

NECG views on Australia – Europe services

9.59. The NECG Report submitted to the Commission in support of the Applications examined the "economics" of operating the Australia – Europe route, the operation of hub and spoke networks and the advantages of operating a hub a mid-point on the route.

9.60. NECG submitted that the benefits of operating a hub and spoke network include:

- higher traffic densities for airlines by channelling passengers through a hub airport which concentrates passengers to each destination on a single aircraft;
- increased possible city pair combinations at a minimal incremental cost through the addition of a new spoke;
- significant cost efficiencies;
- economies of scale through the use of larger aircraft;

- improved traffic density and cost savings allow routes that are not economically viable to serve in a point to point network to become viable in a hub and spoke network; and
- greater flight frequency.

9.61. NECG also submitted that there are some costs associated with operating a hub and spoke network as a result of increased travel time and additional costs due to greater complexities of passenger flows, baggage handling and more complex flight scheduling. However, NECG noted that, on longer haul routes, additional travel time due to hubbing is less significant and, given that the operation of a direct service is not an option on the Australia – Europe route, the additional costs associated with operating a hub are largely irrelevant.

9.62. NECG contended that the need for a stopover increases the extent of competitive pressure on a route because passengers have access to a greater range of airline options as they can choose to travel with any of the carriers servicing either of the endpoints through any intermediate point. NECG also submitted that this increased competitive pressure also impacts on the level of fares and, consequently, reduces margins and unit revenues on sectors that involve transit through a mid-point.

9.63. NECG submitted that, on through flights operated by an endpoint carrier, the carrier must replace passengers that disembark at the first stop in order to avoid the second sector continuing with empty seats. Further, NECG submitted that endpoint carriers, unlike Middle Eastern and Asian carriers, are unable to change aircraft at the mid-point to match the different demands they may have on each sector. In this regard, NECG submitted that while 50 per cent of Qantas' passengers flying from Australia disembark at Singapore, passengers joining Qantas' flights at Singapore to travel to Europe only make up 20 per cent of total Singapore to Europe passengers.

9.64. NECG submitted that it is substantially easier for a mid-point airline to sell seats at the mid-point than it is for endpoint carriers and that, accordingly, it is difficult for Qantas to compete with Singapore Airlines in selling seats in Singapore to a European destination and to Australia.

9.65. NECG submitted that Asian carriers and Emirates have a significant advantage over Qantas and BA in terms of their respective strength at home airports.

Services operated by the Applicants under the counterfactual

The Applicants

9.66. The Applicants submitted that, without reauthorisation of the JSA, they would cease operating JSA services as an integrated alliance but BA would retain its shareholding in Qantas and its right to appoint two directors on the Qantas Board and both parties would continue to be members of the **one**world alliance.

9.67. The Applicants submitted that, without the JSA, Qantas and BA would directly compete on overlapping routes and cooperative activities would be greatly reduced and limited to the core of activities provided under **one**world, such as reciprocal recognition of frequent flyer benefits and lounge access.

9.68. The Applicants submitted that, even on routes where their networks do not overlap, code sharing is unlikely as Qantas and BA would each seek to maximise their own traffic on the long haul sectors on which their services overlap. By way of example, the Applicants submitted that Qantas would be unlikely to grant code sharing rights to BA on Singapore-Perth services because of the likelihood that this would assist BA to "steal" passengers from Qantas on the London-Singapore sector.

9.69. The Applicants submitted that a reduction in services operated on the Australia - Europe route would be inevitable as a result of:

- reduced feed contributed from one airline to the other;
- reduced connectivity; and
- the flow on effect to the networks of the Applicants from removing weakened spokes from the Applicants' mini-hub in Singapore.

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

9.71. BA claimed that absent the JSA it would most likely reduce its daily through services to Australia from Europe from three to two. In the longer term BA says it would most likely further reduce its through services to one daily, plus two daily services from London terminating in Singapore and Bangkok respectively.

9.72. The counterfactual proposed by the Applicants would see reductions in the seat capacity on the Australian – Europe route in the longer term of 66% for BA and between 28% and 42% for Qantas compared to what would be operated under the JSA.

Table 9.5 Expected factual and counterfactual frequencies per week

Route	Airline	Currently	Medium term		Long term	
			JSA	No JSA	JSA	No JSA
Australia to Singapore/Bangkok	Qantas	56	60	51	66	47
	BA	21	21	14	21	7
Singapore/Bangkok to Europe	Qantas	34	36	28	38	24
	BA	21	21	21	21	21
Australia to Europe through flights	Qantas	34	36	28	38	24
	BA	21	21	14	21	7

9.73. The Applicants have not provided the Commission with details of the schedules they would operate under the counterfactual (as they did with the factual scenario). Qantas has advised the Commission that the provision of detailed schedule information was considered inappropriate given the uncertainty surrounding exactly which schedules were likely to be operated in the counterfactual scenario. Qantas stated that for this reason the counterfactual on which NECG's Report was based did not detail the exact destination or aircraft type to be used but merely set out the number of frequencies to be operated. These frequencies appear in Table 47 in the NECG Report which shows frequency by sector combinations. Table 9.5 above shows the current schedules on a similar basis to the claimed counterfactual frequencies.

NECG views on the counterfactual

9.74. The NECG Report discussed the likely impact on both Qantas and BA of the loss of the JSA. NECG claims that the future without the JSA would likely involve a substantial reduction in services operated by both the Applicants on the Australia – Europe route as a result of reduced connectivity, reduced feed from one airline onto the other and the flow on effect to the network of removing weakened spokes.

IMPACT ON QANTAS

9.75. NECG submitted that, under the JSA, BA has an incentive to feed traffic on to Qantas's services from Europe as BA receives a share of all benefit generated by those Qantas services.

9.76. NECG further submitted that:

- this incentive is evidenced by the feed that the JSA parties provide each other (information relating to feed was provided to the Commission on a confidential basis);
- without the JSA the only benefit that BA 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 under the **one**world prorate system, for example, selling a London-Frankfurt sector as a single journey delivers much greater revenue to BA than selling the sector as part of a long haul itinerary with Qantas providing the long haul sector.
- BA has recently introduced intra-European capacity and is therefore unlikely to have spare capacity at peak times to allocate to Qantas passengers with BA receiving far less in prorate payment than the yield it could obtain by reserving that capacity for intra-European business travellers; and
- it is unlikely that Qantas would be able to replace lost BA feed (confidential information provided), which is extremely important for Qantas' Frankfurt, Paris, Rome and London services, from other sources without the JSA.

9.77. NECG suggested that BA is likely to become an active competitor for Qantas' passengers and, in particular, high yielding passengers. However NECG submitted that there may be some offsetting effects as Qantas may retain some passengers previously connected to BA flights and may recover passengers previously spilled due to high load factors currently on JSA services.

9.78. NECG also submitted that any losses incurred by Qantas would be fully borne by it and not shared with BA as would be the case in the factual scenario.

9.79. NECG expected that, given the financial performance of continental European flights, Qantas' schedule would be unsustainable in the face of the expected loss of revenue it would suffer in the counterfactual scenario. NECG anticipated that it is likely that, without the JSA, Qantas would withdraw at least ten services per week between Australia and Europe and rationalise services between Singapore and Australia:

- a sustainable schedule for Qantas in the long term would be not more than 24 weekly services to Europe (a reduction of at least ten services from the current schedule and 14 services when compared to the factual schedule); and
- the reduction in European services would undermine the financial performance of the Sydney and Melbourne to Singapore services and even more severely impact the secondary Australian city services because Qantas' European services provide significant feed to Qantas and BA services between Singapore and Australia.

9.80. NECG stated that in the absence of the JSA Qantas could not maintain the current number of services between Australia and Singapore. NECG stated that Qantas has estimated that a sustainable level of services on this route would be likely to be 23 weekly services (which is equivalent to a reduction of five services from the factual schedule).

IMPACT ON BA

9.81. NECG submitted that, in the counterfactual scenario, Qantas would lose the incentive it currently has (in the form of the benefit sharing agreement) to sell BA operated services on a Qantas code (particularly on the Australia - mid-point sector) and would most likely direct this traffic onto Qantas operated services wherever possible.

9.82. In relation to passengers connecting to Qantas, NECG considered that given the relative depth and breadth of the BA 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 BA. London-Singapore-Perth on BA-Qantas with the JSA, for example, could be served by Qantas-Qantas but not BA-BA in the counterfactual scenario.

9.83. According to NECG the JSA benefit sharing arrangements provide Qantas with an incentive to sell BA operated JSA services, including through direct channel sales, stopover connections on a journey beginning on a Qantas service or where Qantas has a sales presence and BA does not. Without the JSA, these sales could be at risk.

9.84. NECG suggested that, absent the JSA, there is likely to be a redistribution of traffic between Qantas and BA and their competitors on the JSA routes:

- BA would lose a proportion of its traffic at risk and recover a proportion of the Qantas traffic at risk as each carrier aims to direct traffic onto its own services.
- due to the competitive nature of the JSA routes, it is likely that BA would lose a higher proportion of the BA traffic at risk than would be recovered from the Qantas traffic at risk because BA would be competing not just with Qantas but also with every other carrier on these routes to both retain the Qantas influenced traffic on BA routes and capture the BA influenced traffic on Qantas services.

9.85. NECG stated that while it is difficult to determine the precise impact on revenue of the removal of the JSA it is likely that BA's potential losses would be unsustainable and capacity would ultimately have to be reduced. The appropriate responses by BA could include:

- reducing the number of Australian cities served; and/or
- changing to smaller aircraft; and/or
- redistributing Australian cities served.

9.86. NECG submitted that, in the counterfactual scenario, BA would propose sustaining levels of capacity [from London] to both Singapore and Bangkok where it has a local selling force and advantage at the UK end of the routes, whilst limiting exposure on the southern sector.

9.87. NECG considered that over the longer term, without the JSA, losses would continue and would necessitate further capacity reductions. BA would sustain capacity on the northern sector, minimising exposure on the southern sector, with a focus on Sydney as the largest single route.

The Commission's views on the claimed counterfactual

9.88. It is necessary for the Commission to assess whether the counterfactual advanced by the Applicants is the most reasonable and likely in all the circumstances, and taking into account the routes and markets involved, the relationship between the Applicants, the performance expectations of the Applicants and the range of alternative options open to the Applicants.

9.89. After careful examination of the material submitted by the Applicants and submissions made by interested parties the Commission has a number of reservations about the counterfactual put forward by the Applicants.

9.90. The Applicants' counterfactual would see them reduce capacity on the Australia - Europe route by around 35% compared to the factual over a period of five years when:

- their load factors on the route are already extremely high;
- demand on the route is expected to grow by around 25%; and

- other major competitors on the route already have high load factors and their ability to expand into the most popular destination may be restricted;

9.91. The Applicants' counterfactual would see them operate in a way which:

- ignored the equity and oneworld alliance relationship between them;
- did not attempt to utilise potential synergies used to good effect in other markets such as code sharing on non-overlapping routes; and
- made no attempt to preserve the dual hub (Singapore and London) approach to route operation to the maximum extent possible while maintaining competition on overlapping routes.

Mid-point versus end-point carriers

9.92. It would seem to the Commission that the current JSA arrangements with their effective hubs at London and Singapore provide the Applicants with substantial network advantages over most carriers on the Australia - Europe route. The Singapore hub allows an effective distribution of passengers between Singapore and the main cities in Australia which can only be matched by a mid-point carrier providing individual services from their mid-point to each of those cities. Some airlines, such as Singapore Airlines, Thai Airways, Malaysia Airways and Cathay Pacific are able to do this, to differing degrees. Others, such as Japan Airlines and Royal Brunei, do not and do not have an incentive to maximise connectivity at their home port for passengers to or from Australia. Passengers flying Japan Airlines between Australia and Europe, for example, typically face an overnight stop at Narita or a connection waiting time of up to seven hours.

9.93. BA also benefits from code share access to Australian destinations beyond the international gateways, such as to Canberra and Cairns, and across the Tasman Sea to New Zealand.

9.94. Similarly the JSA arrangements through the hub at Heathrow built around BA's European services are able to offer many more destinations in Europe than most mid-point carriers. Qantas for example code shares on BA flights to five destinations within the UK (apart from London) and fourteen destinations in continental Europe, in addition to its direct services to Frankfurt and Paris. BA operates to 35 destinations in the UK and (either directly or through partner airlines) to 105 destinations in Europe. Singapore Airlines operates to two destinations in the UK (including London) and eight destinations in continental Europe.

9.95. Many of the advantages claimed to accrue to mid-point carriers over end point carriers would appear to the Commission to be countered by the JSA arrangements or offset by similar advantages accruing to the Applicants.

9.96. The Applicants and NECG both claimed that a mid-point airline has significant competitive advantages both on the demand side and on the supply side in terms of costs. According to NECG:

- the scale effects on costs that Singapore Airlines can achieve at Singapore may outweigh the scale advantages on costs that BA may achieve at Heathrow or Qantas may achieve at Sydney;
- Singapore Airlines can better align supply with demand on the second leg out of its hub airport at Singapore due to its greater availability of aircraft in this part of the world than can the JSA partners;
- on the demand side, Singapore Airlines can offer more destinations from Singapore and fly into Singapore from more origin ports than the JSA partners, simply because Singapore is Singapore Airlines' global hub and this is particularly significant in attracting high yielding business passengers; and
- Singapore Airlines have a significant marketing and brand presence at Singapore which further reinforces its advantages in attracting higher yielding passengers at Singapore.

9.97. The Commission notes NECG's submission that Singapore Airlines benefits from cost advantages as a result of operating a hub at a mid-point on Australia-Europe routes. However the Commission is of the view Qantas is likely to have similar cost advantages (for Australia-Singapore routes at least) at Sydney and BA similar cost advantages at Heathrow. NECG has provided no detail of relative costs to support the contention that Singapore Airlines' advantages in this regard outweigh those of Qantas and BA.

9.98. The comparison of the network implications of the mid-point carrier's hub to hubs of the Applicants above does not establish that Singapore Airlines necessarily has advantages in being able to satisfy demand across a wider range of destinations.

9.99. Singapore Airlines may have a potential marketing and sales presence advantage in Singapore. However this advantage is likely to be offset by the similar advantages Qantas and BA have in Australia and Europe respectively.

9.100. The Applicants claimed endpoint carriers were disadvantaged compared to mid-point particularly because of the need to replace passengers which disembarked at the mid-point. Qantas claimed around half of passengers on flights to Singapore disembarked at Singapore and Qantas and BA are able to minimise the impact of losing these passengers by aggregating passengers from hubs in Australia.

9.101. The Commission notes that one third of seats on Qantas flights from Australia to Singapore do not continue on to Europe. In this sense it would be surprising if any less than one third of passengers arriving in Singapore did not continue to Europe. Assuming all seats on relevant JSA services were taken the loss of 50% of passengers at Singapore would leave the Qantas services going through to Europe with load factors of around 75%. Such load factors do not take into account the 20% of passengers arriving in Europe acknowledged by the Applicants as starting their journey in Singapore.

9.102. The fact that in its counterfactual schedules BA postulated flights from the UK terminating at the Asian mid-points also suggests that there is substantial traffic between Europe and the mid-points which needs to return and is available to fill seats becoming vacant at the mid-points as a result of passengers from Australia not flying through to Europe, without the airlines needing to have a joint sales and marketing presence in Singapore.

9.103. The Commission finds that there is an inconsistency between the Applicants' claims of the advantages of mid-point carries over endpoint carriers when Qantas in particular is strongly resisting Singapore Airlines and Cathay Pacific entering the Australia – US market as end point carriers and BA has similarly resisted Cathay Pacific's entry onto the London - New York route[40].

9.104. Overall the Commission considers that many of the advantages claimed by the Applicants and NECG to accrue to Singapore Airlines (and other mid-point carriers) are offset by the JSA arrangements or by similar advantages that accrue to the Applicants.

9.105. An important question in the context of the counterfactual and how the Applicants would behave absent authorisation is the extent to which they could preserve those offsets absent authorisation.

Issues arising with the claimed counterfactual

9.106. It seems to the Commission that given the strength of the markets concerned, likely future growth and probable constraints on growth into London Heathrow (which accounts for 50% of Europe passengers as an origin or destination) there are strong incentives for Qantas and BA absent authorisation to grow with the market or at least maintain their level of presence rather than retreat.

9.107. NECG has presented confidential profitability data in support of the marginality of the connectivity on JSA routes and the likelihood that any loss of passengers through reduced connectivity would lead to capacity reduction decisions. The Commission notes that the route has historically been profitable for both airlines but like many other routes its performance declined in 2001/02. The Commission also notes that in a number of instances NECG analysis predicating capacity reductions was based on 2001/02 data and the last six moths of 2002. The Commission does not consider that such selective information is necessarily a reliable guide to historical performance or future activity given the difficult trading circumstances facing airlines during this period and notes that NECG itself has stated that "*profitability is likely to improve if general air travel trading conditions ease and the longer term trend of growth in international air travel continues*".[41]

9.108. Assuming that absent authorisation Qantas and BA competed on routes where their services overlapped an important issue for the Commission to consider is whether Qantas would be able to achieve route densities sufficient for it to maintain its Singapore hub. A related question is whether there would be

[40] "Air deal may boost competition", UK Financial Times, 28 November 2003.
[41] NECG Report, page 123.

scope for BA to contribute to the Singapore hub absent authorisation. A similar issue at the Europe end is whether Qantas would continue to have access to BA services out of Heathrow into Europe.

9.109. While selling a London – Frankfurt sector as a single journey under the JSA may deliver additional revenue to BA above its standard pro rate share for a Sydney-London-Frankfurt service where Qantas operates the long haul sector, by implication Qantas pays that additional revenue. It would seem to the Commission that there is no impediment to, and indeed an opportunity for, Qantas to pay an equivalent cost of access to Frankfurt under the code share agreement in a counterfactual scenario. Indeed the Commission understands that it is not unusual for a short haul compensation factor to be built into a pro rate agreement.

9.110. Qantas is involved in a multitude of code share agreements around the world in circumstances which are outside an alliance such as the JSA and which have proven acceptable financially to both Qantas and the partner airline. The Applicants have suggested that BA would not enter such a code share because the two airlines are competing on through sectors between Australia and Europe.

> *"Under the counterfactual, Qantas and British Airways would directly compete on overlapping routes…Even on networks where their routes do not overlap, codesharing is considered unlikely, since Qantas and British Airways would each seek to maximise its own traffic on the long haul sectors on which their services overlap."*[42]

9.111. At a meeting with the Commission on 16 January 2004 Qantas appeared to back away from this view and not rule out code sharing totally. Qantas stated that BA and Qantas would be unlikely to enter into code share arrangements where they competed with each other on parallel routes absent authorisation of the JSA. However Qantas did not rule out code sharing at the end of those routes stating that to the extent any code share relationship developed it would be restricted to tag end services along the line of those conducted with Cathay Pacific and American Airlines.

9.112. The Commission also notes that Qantas has entered a code share with Cathay for services from Hong Kong to Rome when both airlines compete on the Australia - Hong Kong route.

9.113. Similarly while BA and Cathay compete on the long haul route between Hong Kong and London they still code share at each end of the route. Cathay code shares on BA services out of Heathrow to 16 destinations in Europe and BA code shares on Cathay services to Asian destinations beyond Hong Kong. BA and American Airlines while competing across the Atlantic have entered into code share arrangements at either end of the route.

[42] Qantas and BA (2003), *Submission to the ACCC on support of the Application for Authorisation of the Restated Joint Services Agreement*, May 2003, p.12. See also

9.114. The Commission also notes submissions made by Qantas on a number of occasions when applying to the IASC for code sharing rights with various airlines. Qantas has claimed that code sharing results in the following benefits:

- tourism and consumer benefits: providing passengers with additional service opportunities, including options for travel to and from regional cities as a result of greater connectivity;
- industry structure: improved ability to market routes, improvements in loads and revenue, improvements in the viability of routes and the further development of routes; and
- competition benefits: improved ability to compete for traffic, the ability to sustain and expand services and the ability to respond in the future to changes in demand through resumption of full services by retaining a customer base, a marketing role and market intelligence.[43]

9.115. While the Commission recognises that Qantas and BA may not seek to code share on overlapping routes in the absence of the JSA, the Commission is of the view that there is an incentive for them to engage in some form of code sharing arrangement on routes which do not overlap in order to maximise their traffic. The need for each airline to be able to distribute services at both ends of the route reinforces the attractiveness of a reciprocal code sharing arrangement in the absence of the JSA.

9.116. The Commission notes that even without code sharing there is an opportunity for the airlines to use interline arrangements available under the **one**world alliance. However the Commission also notes the inconsistency with which the Applicants regard the value of such interline arrangements offered under marketing alliances when offered between themselves as when offered by their Star Alliance competitors. Qantas and BA see little potential for such interlining arrangements between them absent the JSA, but when considering access to Europe through ports other than Heathrow they see[44] interline alternatives offered by Star Alliance airlines as "*highly substitutable with an itinerary that involves flying via Heathrow*":

> *"For example, a passenger may fly with Singapore Airlines to Frankfurt and connect there to a flight within Europe with Lufthansa. Lufthansa is part of the Star Alliance with Singapore Airlines and operates a comprehensive network of flights within Europe from its hub in Frankfurt."*

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[43] See, for example, IASC (1998), Determination IASC/DEC/9824 in relation to Qantas and BA code shares on the France (Route 1) route; IASC (1998), Determination IASC/DEC/9823 in relation to Qantas and BA code shares on the Germany route; IASC (1999), Determination IASC/DEC/9903 in relation to Qantas and China Eastern code shares on the China route; IASC (1998), Determination IASC/DEC/9822 in relation to Qantas and BA code shares on the Italy route; IASC (1998), Determination IASC/DEC/9816 in relation to Qantas and Japan Airlines code shares on the Japan route; and IASC (2000), Determination [2000] IASC 203 in relation to Qantas and Japan Airlines code shares on the Japan route.

[44] Page 2, Attachment 1 to letter of 7 August 2003 from Qantas to the Commission.

9.117. The submission from NECG that BA has recently introduced intra-European capacity and therefore is unlikely to have spare capacity to allocate to Qantas passengers ignores the fact that those passengers are already being accommodated by the BA services. A more relevant issue is whether, if BA did not want to carry such passengers, it would be able to find higher yielding passengers to replace them.

9.118. There may also be an incentive for BA to offer to carry Qantas code share passengers even at relatively low yields if Qantas provides reciprocal services at the Australia end of the route.

9.119. NECG submitted that under the counterfactual the loss of incentive by BA to feed traffic onto Qantas continental flights from both ends will threaten those flights, even if Qantas may recover passengers spilled due to high load factors on JSA services, and lead to the termination of some of those flights. NECG further submits that the loss of these services, combined with the loss of BA feed and increased BA competition would see a reduction in the number of flights between Australia and Singapore, especially to smaller capital cities in Australia.

9.120. The claim of passenger loss on the Qantas continental routes seems inconsistent with Qantas' assertions of a level of future demand that would see it expand services to Paris from three seven a week under the factual. It could also be reasonably expected that BA passengers on Qantas one stop services to Paris or Frankfurt would change to Qantas bookings rather than stay with BA and experience a two stop service through Heathrow. The submitted counterfactual's elimination of the code share and reduction in the availability of interline seats would also tend to push passengers destined for the continent to the Qantas continental services rather than through Heathrow.

9.121. Ultimately however NECG's arguments on the impact of the loss of the JSA on Qantas' continental Europe services have largely been overtaken by developments with Qantas withdrawing from the Rome and Paris routes.

9.122. The Commission is not satisfied that under the counterfactual there would necessarily be a reduction in the numbers of passengers carried on Qantas continental Europe services or that there would be consequential flow on effects to Australia – Singapore services.

9.123. NECG suggested that BA would reduce capacity because it is likely that BA would lose a higher proportion of the BA traffic at risk than would be recovered from the Qantas traffic at risk. NECG stated this would arise 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 traffic on the Qantas services."*

9.124. The Commission does not find the above logic persuasive. In the first instance Qantas would be subject to the same competition pressures as BA. Secondly while NECG has provided the Commission with (confidential) figures for the BA passengers considered to be at risk it has not provided similar figures for the number of Qantas passengers similarly at risk. Given that visitors from the UK outnumber residents travelling to the UK by a ratio of two to one it would not surprise if there were more passengers at risk for Qantas than BA assuming a general preference by passengers to fly with their national carrier. In any event the level of postulated loss is still less than anticipated growth in the market.

9.125. The Commission also notes that loss of feed from Singapore to capital cities other than Sydney and Melbourne may not prove decisive for BA as 84% of all travellers between the UK and Australia depart/disembark at Melbourne and Sydney. There is also an opportunity for Qantas to provide code share services between Singapore and other cities. It has been submitted that if the airlines were competing they would be reluctant to provide code share services to each other. As discussed above in relation to code sharing between the two airlines at the Europe end, the Commission does not consider this assertion either logical from a commercial perspective given the relationship between the airlines or consistent with the practice of the airlines on other routes

9.126. Discussion of the claimed counterfactual above has focussed on the services of Qantas and BA which hub through Singapore. Aside from those services each airline also operates daily services from Sydney to the United Kingdom through Bangkok.

9.127. It would seem to the Commission that these are virtually stand alone services to the extent that they are not as dependent on feed from other services in either direction as are other through to Europe services and given the high load factors into the UK are likely to be supported just as much under the counterfactual as within the JSA. Under these circumstances the Commission sees these services as highly likely to be retained under the counterfactual.

9.128. The above analysis of the counterfactual has concentrated on aspects of the JSA associated with scheduling and the operation of route. The Commission notes that there are other aspects of the JSA covering activities such as purchasing, engineering and maintenance and frequent flyer programs which have not been addressed in the counterfactual submitted by the Applicants.

The Commission's view of the likely counterfactual

9.129. The Commission does not believe that the counterfactual proposed by the Applicants:

- is consistent with the strength of the markets concerned and likely growth in those markets;
- recognises the relationship between the two carriers and the incentive that provides the carriers to maximise co-operation; or

- is consistent with the behaviour of the Applicants on other routes under similar circumstances.

9.130. By way of example the Commission has difficulty in understanding why BA under the counterfactual would refuse to allow Qantas, an airline in which it has a significant equity share, to code share on BA services into Europe. BA is quite prepared to provide such code share facilities to other airlines, such as Cathay Pacific and American Airlines, with whom it does not have an equity link, and who are also long haul competitors for BA.

9.131. In the Commission's view a more realistic counterfactual would see Qantas and BA maximising their cooperation on current JSA routes at the route ends, through code sharing and interlining under the **one**world pro rate agreement, while competing on overlapping services.

9.132. The Commission recognises there may be some slippages in custom from the loss of an alliance which allows joint yield management and price fixing, but at the same time notes the strong growth expected on the route over the next five years as evidenced by the recent decisions of Qantas to provide 14 additional services to the UK within the next five years. Under these circumstances the Commission intends to proceed with its analysis of the authorisation application lodged by Qantas and BA on the basis that will be little difference in the aggregate capacity offered by Qantas and BA regardless of whether the JSA is authorised or not.

9.133. The Commission would also note that it could hardly be expected to accept with any confidence any estimate of capacity to be operated by the Applicants over a five year period under the counterfactual when:

- Qantas acknowledged in a letter to the Commission of 22 January 2004 that "*the provision of detailed schedule information was considered inappropriate given the uncertainty surrounding exactly which schedules were to be operated in the counterfactual scenario*"; and

- Qantas was not even able to provide estimates of how it would operate under the JSA which would prove reliable over a twelve month period:

    : Qantas stated in mid 2003 it would not increase its services to the UK in the next five years but has since announced an additional 14 services per week;

    : Qantas also stated in mid 2003 it would increase its services to Paris from three per week to seven over the next five years but has since announced it is withdrawing from the route apart from a code share presence on Air France operated flights out of Singapore.

10. Commission Assessment – Anticompetitive Effects of the Proposed Arrangements

The Commission's approach to detriment assessment

10.1. The JSA for which the Applicants are seeking authorisation states that Qantas and BA will coordinate their business activities including scheduling, marketing, sales and pricing. It is further agreed that as part of this coordination process Qantas and BA may agree on fares, fare products, incentives and discounts. On this basis the JSA is likely to have the effect of fixing or controlling prices for the purposes of section 45A of the Act.

10.2. It is the task of the Commission, for the purposes of assessing the authorisation applications, to assess the extent to which the Proposed Arrangements results or would be likely to result in a lessening of competition in relevant markets and the extent of any associated or separate detriment.

International passenger transport markets

Trends in and nature of international passenger traffic on JSA routes

10.3. Tables 10.1 and 10.2 below show changes in the passenger shares of the Applicants and other airlines over the period of the JSA to date on JSA routes.

Table 10.1 Airline passenger shares, JSA Europe routes, derived from country of origin/destination, years ended 31 December 1994, 1998 and 2003 (per cent)

Airline	United Kingdom			Total Europe		
	1994	1998	2003	1994	1998	2003
Qantas	35.5	31.2	32.6	34.2	31.4	33.6
BA	14.9	14.4	10.1	7.5	7.7	8.0
QF/BA Alliance	***50.3***	***45.5***	***42.7***	***41.8***	***39.2***	***41.6***
Singapore Airlines	7.9	12.7	16.9	12.8	14.8	17.5
Air New Zealand	4.6	3.7	3.5	2.7	2.3	2.8
Ansett	0.7	1.1	..	0.2	0.7	..
Cathay Pacific	6.5	5.8	3.6	4.0	3.3	4.0
Malaysia Airlines	5.0	7.5	9.2	4.2	8.0	7.9
KLM	2.5	2.4	0.0	2.9	3.5	0.0
Japan Airlines	2.4	2.9	4.1	1.0	1.3	3.2
United Airlines	2.3	1.5	1.0	1.4	0.9	1.0
Thai International	1.5	1.9	3.0	2.8	4.5	4.4
Alitalia	0.7	0.5	0.0	5.3	4.2	0.0
Lufthansa	0.5	0.0	0.0	4.8	0.0	0.2
Emirates	0.0	0.0	9.0	0.0	0.0	7.2
Others	14.9	14.6	7.0	16.1	17.4	10.2
Total (%)	*100.0*	*100.0*	100.0	*100.0*	*100.0*	*100.0*
(Passenger numbers '000)	1,227	*1,633*	2,080	*2,479*	3,226	*3,902*

Source: ABS

Table 10.2 Airline passenger shares, JSA South East Asia routes, derived from country of origin/destination, years ended 31 December 1994, 1998 and 2003 (per cent)

Airline	Singapore			Thailand			Total SE Asia		
	1994	1998	2003	1994	1998	2003	1994	1998	2003
Qantas*	49.7	32.0	40.0	44.9	27.3	15.4	41.3	31.6	25.8
BA	7.4	15.7	6.0	9.5	15.6	8.7	3.9	7.8	3.5
QF/BA Alliance	***57.2***	***47.7***	***46.0***	***54.4***	***42.9***	***24.1***	***45.2***	***39.4***	***29.3***
Singapore Airlines	34.0	35.4	46.0	2.3	8.0	12.0	14.5	17.8	23.8
Air New Zealand	0.6	0.4	0.4	5.2	0.3	0.5	1.4	0.3	0.4
Ansett	0.0	0.2	..	0.1	0.2	..	3.3	5.6	..
Cathay Pacific	0.1	0.3	0.3	0.7	1.5	1.5	0.9	0.5	0.8
Malaysia Airlines	1.1	8.6	2.1	1.1	2.6	2.0	9.7	12.6	15.6
KLM	0.0	0.1	..	0.0	0.0	..	0.0	0.0	0.0
Japan Airlines	0.0	0.1	0.0	0.0	0.0	0.1	0.0	0.0	0.0
United Airlines	0.1	0.1	0.1	0.1	0.1	0.0	0.1	0.1	0.1
Thai International	0.0	0.1	0.2	27.3	39.6	56.6	4.6	6.3	10.3
Alitalia	0.0	0.1	..	5.3	2.0	..	0.8	0.3	..
Lufthansa	1.1	0.0	0.0	0.3	0.0	0.0	0.1	0.0	0.0
Emirates	0.0	0.0	2.8	0.0	0.0	0.1	0.0		1.0
Others	6.8	7.0	2.1	3.1	2.9	3.1	19.4	16.9	18.7
Total (%)	*100.0*	*100.0*	*100.0*	*100.0*	*100.0*	*100.0*	*100.0*	*100.0*	*100.0*
(Passenger numbers '000)	*569*	*768*	*804*	*283*	*378*	*416*	*2,128*	*2,861*	*2,751*

**Includes passengers on Australian Airlines. Source:ABS*

10.4. Table 10.1 shows that the individual and aggregate shares of Qantas and BA of Europe traffic have remained relatively constant over the period of the JSA to date, with Qantas having a consistent share of around 34% share, BA a share of 8% and the two airlines with an aggregate share at around 42%. Over the period of the JSA the volume of Australia – Europe traffic has increased by around 60%.

10.5. A number of mid-point carriers have increased their market shares significantly since 1994 including Singapore Airlines (from 12.8% to 17.5%), Malaysia Airlines (4.2% to 7.9%), Thai International (2.8% to 4.4%) and Emirates (0% to 7.2%). At the same time a number of European carriers who held an aggregate share of around 13% have left the route.

10.6. The UK is the most popular origin/destination in Europe accounting for over 50% of all passengers travelling between Australia and Europe. The Applicants combined share of UK traffic has fallen from 50% to 43% over the period of the JSA with mid-point carriers again increasing their shares.

10.7. Table 10.2 shows that the Applicants' combined share of SE Asia traffic has fallen from 45% to 29% over the period of the JSA. The most substantial falls have occurred on the Thailand route and reflect at least in part reduced capacity operated to that destination.

10.8. As stated earlier the Commission intends to assess competition aspects of the JSA in terms of two international passenger markets, the leisure passenger market and the business passenger market. Such an analysis will require analysis of journey purpose statistics for air passengers produced by ABS. Journey purpose statistics are only available for short term travel by Australian resident and foreign visitors.

Table10.3 Type of journey for passengers on JSA routes, year ended 31 December 2003 (per cent)

Type of journey	Europe region	SE Asia Region
Long Term		
Long term resident departures	1.0	0.4
Long term resident returning	1.2	0.4
Long term visitor arrival	0.9	1.4
Long term visitor departure	0.4	0.7
Non assisted settlers	0.6	0.6
Other resident departures	0.4	0.2
Total long term	*4.4*	*3.7*
Short term		
Short term resident departures	17.4	25.1
Short term resident returning	17.1	24.8
Short term visitor arrivals	30.6	22.5
Short term visitor departures	30.5	23.9
Total short term	*95.6*	*96.3*
All passenger movements	***100.0***	***100.0***

Source: ABS

10.9. Table 10.3 above shows that passengers on short term travel accounted for over 95% of international passenger travel into and out of Australia in 2003.

Table 10.4 Purpose of journey for short term passengers on JSA routes, year ended 31 December 2003 (per cent)

Purpose of journey	Europe region	SE Asia region
Business	8.0	13.2
Convention	2.5	2.9
Exhibition	0.2	0.1
Employment	2.6	2.0
Education	2.5	4.7
Holiday	47.9	48.9
Visit friends/relatives	28.8	19.3
Not stated	5.3	5.9
Other	2.2	3.0
Total	*100.0*	*100.0*

Source: ABS

10.10. Table 10.4 above shows the purpose of travel for short term passengers with an origin or destination in Europe or South East Asia in 2003. For the purpose of examining leisure passenger markets the Commission is going to regard as leisure travellers those travelling for the purpose of holidays or to visit friends or relatives. Such travellers made up 76.7% of all short term travel to or from Europe and 68.2% of all travel to or from South East Asia in 2003.

10.11. For the purpose of examining business passenger markets the Commission is going to regard as business travellers those travelling for the purpose of business and conventions. Such travellers made up 10.5% of all short term travellers to or from Europe and 16.1% of all short term travel to or from South East Asia in 2003.

10.12. The Commission is aware that Virgin Atlantic is to commence services between Australia and England via Hong Kong in December 2004 and that Qantas plans to commence additional services to England over Hong Kong and Singapore from November 2004.

10.13. Provisions in the JSA state that the agreement applies to services of the Applicants between Australia and Europe, including services involving intermediate points such as Hong Kong. However given that Qantas and BA do not currently compete on the Australia – Hong Kong route nor would do so if the JSA was not authorised the Commission does not believe that at this stage the JSA will impact on competition in markets involving the Australia - Hong Kong route.

10.14. The Commission would also note that Hong Kong is not regarded as part of the SE Asian group of countries and is normally included in a group of counties described as North Asia which includes China, Hong Kong, the Republic of Korea, the Democratic Peoples' Republic of Korea and Japan.

Market for leisure passengers

Market shares

Table 10.5 Leisure travellers, airline market share by region for year ended 31 December 2003 (per cent)

Airline	Europe region	SE Asia region
Qantas*	31.1	22.3
BA	6.7	2.8
QF/BA Alliance	***37.8***	***25.1***
Singapore Airlines	15.5	19.2
Malaysia Airlines	7.3	13.8
Thai International	3.5	9.3
Cathay Pacific	3.4	0.6
Emirates	6.7	0.8
Austrian Air	3.0	0.6
Others	22.8	30.6
Total	*100.0*	*100.0*

*Includes passengers on Australian Airlines. *Source*: ABS.

10.15. Table 10.5 above shows airline market shares for the leisure passenger markets of Europe and SE Asia. The Applicants have a joint share of 25.1% of the SE Asia leisure passenger market of which BA contributes 2.8%. Three other airlines in the market have substantial shares being Singapore Airlines (19.2%), Malaysia Airlines (13.8%) and Thai International (9.3%).

10.16. The Applicants have a joint 37.8% share of the Europe leisure passenger market with BA contributing 6.7%. Three other airlines have shares equal to or in excess of BA's share being Singapore Airlines (15.5%), Malaysia Airlines (7.3%) and Emirates (6.7%).

10.17. The contribution of BA to the JSA shares of Europe and South East Asia traffic routes has declined in recent years as a result of changes in the capacity operated by the Applicants on those routes. BA has reduced its overall number of flights from Australia to the UK from 24 to 21 per week and Qantas has increased the number of flights it operates to Europe from 27 in 1998 to 34 in 2003 (prior to the withdrawal of its three services per week to each of Rome and Paris).

Views of the Applicants and interested parties

10.18. The *Applicants* do not consider that there are separate markets for leisure and business travellers and have not addressed competition in those markets specifically.

10.19. In terms of competition generally the Applicants have submitted that on the basis of seven years observation the JSA has been pro competitive and is likely to continue to be so:

- the effect of the JSA has been to increase rather than decrease capacity on JSA routes. BA and Qantas have significantly increased capacity on JSA routes over the period of the JSA;
- the aggregate market shares of mid-point carriers have increased substantially, whilst those of the Applicants and European carriers have fallen;
- barriers to entry and expansion, particularly for mid–point carriers are low;
- price competition has remained intense (with benchmark passenger fares falling in real terms); and
- the range and quality of passenger services provided by Qantas and BA and their competitors has continued to improve, indicating that product competition has also been strong on JSA routes.

10.20. *AFTA* submitted that there has been a downward trend in the price of economy travel on the relevant routes during the term of the JSA.

10.21. *DITR* did not make a distinction between leisure and business travellers but submitted that there does not appear to have been any significant lessening of competition on the JSA routes since the JSA was last authorised and that it does not believe that there are any major competition concerns over the short to medium term.

10.22. In relation to the anti-competitive detriment associated with the JSA, DITR submitted that it largely agrees with the Applicants' submission that the JSA has been pro-competitive and that competition in markets for air travel between Australia and Europe and South East Asia has been intense. DITR submitted that competition is expected to increase over time.

10.23. DITR submitted that, while it is difficult to know how airfares would have moved in the absence of the JSA, it does not appear to have provided any degree of market power to the Applicants in order to significantly influence prices in the fare categories of relevance to tourism.

10.24. *DTRS* submitted that competition on the Kangaroo Route from other carriers provides downward pressure on fares, encouraging savings to be passed on to consumers.

10.25. DTRS submitted that anecdotal evidence suggests that prices have consistently reduced in real terms over the last 30 years and that technological improvements, reduced regulation and competition have played a role in this. DTRS said that it is difficult to attribute lower fares to specific factors such as the JSA. DTRS submitted that, in the absence of the JSA, it is likely that competition would continue downward pressure on ticket prices.

10.26. DTRS submitted that despite the level of market share enjoyed by the JSA partners, their position is not dominant and their total market share remains at less than 50 per cent.

10.27. *The Qld Govt* submitted that, given that there are 13 airlines that provide services on the Kangaroo Route (and a further 13 that operate on code share arrangements) and that the benchmark economy fare is lower today than it was in May 1995, it appears that the JSA is not having any detrimental impact on competition on the Kangaroo Route.

10.28. *Virgin Atlantic* stated that it does not have access to information on passengers travelling between European cities other than London and Australia and South East Asia. It cited data from a UK CAA 2002 Passenger Survey Which shows that Qantas and BA had a joint 32.4% share of leisure passengers travelling between London and Australia with other airline shares of note being 21.5% for Singapore Airlines, 14.1% for Malaysian Airlines, 9.4% for Japan Airlines and 5.3% for Emirates.

10.29. Virgin Atlantic also cited data from the survey which examined leisure travel movements between London and individual cites in Australia and between London and Singapore and Bangkok.

10.30. Virgin Atlantic did not specifically say that the market share achieved by the Applicants in the market for leisure travellers raises competition concerns but did refer to European Commission statements that suggest a dominant position can generally be said to be exist once a market share of 40% to 45% is reached.

10.31. Virgin Atlantic raised a number of barriers to entry claimed to be relevant to the JSA including air services restrictions, access to Heathrow, the contribution of time sensitive passengers to route viability, flight frequency, airport presence, loyalty programmes, feed traffic and abuse of dominant position. Most of these claims are directed towards what Virgin Atlantic described as time sensitive passengers who are embraced by what the Commission describes as business travellers. The Commission will address these Virgin Atlantic claims when examining the business passenger market except where a claim has general relevance or relevance specific to the leisure passenger market.

The Commission's view of international leisure passenger markets

10.32. On the basis of the joint market shares for Qantas and BA of 37.8% in Europe and 25.1% in SE Asia it is unlikely that the JSA is currently having an anti-competitive impact in those leisure passenger markets. The Applicants' aggregate market share is at relatively low levels and the BA contribution to the aggregate share is small with a significant number of airlines in each market having greater market shares than BA. In other words there would not necessarily be significantly increased competition in the leisure passenger market if authorisation was not granted and as a result BA competed with Qantas.

10.33. Comments from interested parties as to competition and fare levels, and material produced by the Applicants in relation to yields and discount fares for economy passengers, the type of fare typically used by leisure travellers, are consistent with the view of the Commission that the Europe and SE Asia leisure passenger markets are currently subject to significant levels of competition and not adversely affected by the JSA.

10.34. The Commission is also not aware of any developments in these leisure passenger markets over the next five years which would be likely to see the JSA give rise to anti-competitive detriment of note in that period. Qantas is known to be planning to substantially expand its capacity to the United Kingdom by double daily flights over the next five years. However there is no indication of any planned significant increases in capacity by BA. Under these circumstances BA would be likely to continue to make a minor contribution to the Applicants' combined share of the leisure passenger markets.

10.35. It is likely that decisions made by Qantas to withdraw services from Rome and Paris will increase the competitive position of other airlines flying to Europe who can offer one stop services to these destinations.

10.36. The Commission also notes that there is evidence of increased competition in leisure markets of late or planned in the future with Gulf Air, Emirates and Qatar airways entering both markets and Virgin Atlantic soon to enter the Europe market via Hong Kong.

10.37. Virgin Atlantic has raised a number of what it describes as barriers to entry. In determination A30202 the Commission stated that the relevance of barriers to entry depends on market concentration. If market concentration is low barriers are less relevant, and conversely with high market concentration. In the leisure passenger markets of concern here the low market concentrations observed above suggest entry barriers are generally not an issue.

10.38. While it is widely acknowledged, as claimed by Virgin Atlantic, that Heathrow is capacity constrained this condition should generally not be regarded as a barrier to market entry of note in the context of the Europe regional geographic criterion adopted by the Commission for assessing the leisure passenger market.

10.39. The Commission believes that contrary to Virgin Atlantic claims loyalty programs are not likely to impact on the JSA leisure travel markets. Corporate deals are not relevant to leisure passengers. The frequent flyer programs of Qantas and BA would still apply absent authorisation and operate to a significant degree. The BA and Qantas schemes are not symmetrical and the BA scheme is not attractive to many leisure passengers in requiring full fare travel as an entry prerequisite. The Qantas scheme also provides less points for travel on BA marketed flights than Qantas marketed flights for the discount economy fares used by leisure travellers.

10.40. In A30202 the Commission recognised barriers on JSA routes in Japan and Hong Kong in the form of bilateral restrictions which prevented Australia and UK designated carriers from operating Australia – UK services through mid-points in those two countries.

10.41. Recent intergovernmental negotiations appear to have resulted in some relaxation of Hong Kong restrictions as they apply to both UK and Australian carriers. However even though Virgin Atlantic has announced an intention to commence services from 8 December 2004 between the UK and Australia via Hong Kong there remains some doubt as to whether the airline has the imprimatur of the European Commission.

10.42. Virgin Atlantic has also raised feeder traffic as an issue. At the Australian end such problems would exist given the current structure of the Australian domestic market regardless of the JSA. The Commission notes also that Virgin Atlantic advised the Commission on 10 June 2004 that it will talk to Virgin Blue about interlining. On 4 June 2004 Virgin Blue announced[45] initiatives designed to capture a greater share of domestic on-carriage from international passengers.

Market for business travellers

10.43. In Part 8 of this Draft Determination the Commission stated that it would assess the implications of the JSA for the international business passenger market and that the appropriate geographic market for business passengers is a point to point market.

[45] Tansy Harcourt, "Virgin sets sights on inbound travellers", Australian Financial Review, 4 June 2004.

10.44. For the purposes of assessing the impact of the JSA on the international business passenger market the relevant routes are those involving points between which Qantas and BA would be likely to compete for business passengers absent the JSA. Until recently such routes would have involved routes between points in Australia and:

- Singapore;
- Thailand;
- Rome;
- Paris;
- Frankfurt; and
- London.

10.45. In 2003 Qantas withdrew from the Rome route and in 2004 it has withdrawn from the Paris route. Accordingly those routes will not be considered as part of the Commission's assessment. While Qantas has announced it will commence services in late 2004 from Australia to the UK via Hong Kong the Commission will not consider the Australia - Hong Kong business passenger market at this stage given that BA does operate on that route.

10.46. The statistics of journey purpose used by the Commission in its assessment do not include data at the city level. The Commission will therefore conduct its analysis at a country level. This approach would only have limitations in circumstances where there is a range of international access airports in a particular country which may be used by business travellers in accessing different destination in that country, bearing in mind the preference of the business traveller for direct travel.

Market shares

10.47. Table 10.6 below shows airline shares of the business passenger market between points in Australia and Singapore and Thailand respectively.

10.48. The Applicants had a substantial 47.4% joint share of the Singapore market in 2003 and captured 63.3% of the Australian resident business passengers travelling to Singapore. However BA only contributed 7.2% of the Applicants' overall share and there was substantial competition from Singapore Airlines which had a 47.2% share of the market. There was no other competitor airline of note in the Singapore market.

10.49. The Applicants had a joint 35.7% share of the Thailand market in 2003 with Qantas capturing 23.4% and BA 12.3%. Other airlines with significant shares in the Thailand market were Singapore Airlines with 12.9% and Thai International with 46.9%.

Table 10.6 Business travellers, airline market share for Singapore and Thailand, year ended 31 December 2003 (per cent).

Airline	Singapore			Thailand		
	Residents	**Visitors**	**Total**	**Residents**	**Visitors**	**Total**
Qantas*	52.9	22.9	40.2	29.1	12.0	23.4
BA	10.4	3.0	7.2	16.1	4.9	12.3
QF/BA Alliance	***63.3***	***25.9***	***47.4***	***45.2***	***16.9***	***35.7***
Singapore Airlines	32.4	67.3	47.2	15.5	7.8	12.9
Malaysia Airlines	1.3	1.3	1.3	1.0	2.0	1.3
Thai International	0.1	0.3	0.2	36.3	68.1	46.9
Cathay Pacific	0.3	0.2	0.3	0.8	1.8	1.2
Emirates	1.7	2.0	1.8	0.0	0.0	0.0
Austrian Air	0.0	0.0	0.0	0.3	0.0	0.2
Others	0.9	3.0	1.8	0.9	3.4	1.8
Total	*100.0*	*100.0*	*100.0*	*100.0*	100.0	*100.0*

*Includes passengers on Australian Airlines. *Source*: ABS.

10.50. In the Germany business passenger market Qantas and BA held a 43.2% share in 2003, with Qantas having a 36.0% share and BA 7.2%. There was substantial competition from other airlines with Singapore Airlines having a 22.0% share and three other airlines having shares of 6.0% or more. Most of the other major airlines in the market operate to Frankfurt though Emirates also flies to Dusseldorf and Munich.

Table 10.7 Business travellers, airline market share for the United Kingdom and Germany, year ended 31 December 2003 (per cent).

Airline	United Kingdom			Germany		
	Residents	**Visitors**	**Total**	**Residents**	**Visitors**	**Total**
Qantas*	49.5	35.6	42.2	45.1	26.7	36.0
BA	18.5	18.0	18.2	9.4	4.9	7.2
QF/BA Alliance	***68.0***	***53.6***	***60.4***	***54.5***	***31.3***	***43.2***
Singapore Airlines	9.7	13.8	11.8	16.0	28.1	22.0
Malaysia Airlines	4.1	6.7	5.5	3.4	4.0	3.7
Thai International	1.7	2.6	2.2	6.6	10.6	8.6
Cathay Pacific	4.9	4.9	4.9	2.9	1.8	2.3
Emirates	5.1	7.4	6.3	5.9	6.0	6.0
Austrian Air	0.7	0.7	0.7	3.7	8.5	6.0
Others	5.8	10.3	8.2	7.0	9.7	8.2
Total	*100.0*	*100.0*	*100.0*	*100.0*	*100.0*	*100.0*

*Includes passengers on Australian Airlines. *Source*: ABS.

10.51. Table 10.7 shows that in 2003 the Applicants had a substantial joint share amounting to 60.4% of the United Kingdom business passenger market with Qantas capturing 42.2% of the market and BA 18.2%. The Applicants had a joint share of 68.0% of Australian business passengers travelling to the United Kingdom.

10.52. The next largest market share after the Applicant was held by Singapore airlines with 11.8% followed by Emirates with 6.3% and Malaysia Airlines with 5.5%.

10.53. Business passengers made up 8.7% of short term passengers with origin/destination the United Kingdom compared to leisure passengers who made up 80.4% of such travellers.

10.54. Most airlines offering services between Australia and the United Kingdom operate through Heathrow in the United Kingdom. The exceptions of note are Malaysian Airlines which provides four services per week to Manchester from Kuala Lumpur, in addition to its 18 services per week to London Heathrow, and Emirates. Emirates operates from Dubai to Birmingham (two services per week), Glasgow (three services per week), London Heathrow (28 services per week), London Gatwick (21 services per week) and Manchester (14 services per week).

Views of the Applicants and interested parties

10.55. As stated earlier the *Applicants* do not consider that there are separate markets for leisure and business travellers and have not addressed competition in each of those markets specifically.

10.56. As also stated earlier, the Applicants have submitted that on the basis of seven years observation the JSA has been pro competitive and is likely to continue to be, as evidenced by increased capacity on JSA routes, increased market share by mid-point carriers, barriers to entry and expansion being low, intense price competition and strong product competition. The Commission will assume these comments as submitted are also directed towards business travellers.

10.57. The Applicants have also supplied confidential trend data relating to loads, yields and earnings per passenger in the various seat classes.

10.58. *AFTA* submitted that whilst there has been a downward trend in the price of economy travel on the relevant routes during the term of the JSA the cost of premium class tickets has in fact risen considerably both in dollar and real terms.

10.59. *Virgin Atlantic* has submitted data from the UK CAA 2002 Passenger Survey which shows that of passengers travelling between London and Australia for business purposes 57.8% flew with the Applicants.

10.60. Virgin Atlantic submitted that there exist a number of barriers to entry in relation to JSA markets with some having direct pertinence to time sensitive passengers and London as a destination. Virgin Atlantic submitted that:

- Heathrow, earlier described by Virgin Atlantic as the airport of choice for business travellers, is effectively full and as a result both incumbent and new entrants cannot significantly increase their provision of services to and from Heathrow by scheduling new services;

- attracting a substantial proportion of time-sensitive passengers is crucial to the commercial success of a carrier's operations in the type of markets in which Qantas/BA and Virgin Atlantic operate;
- the frequency of flights in a market provided by a carrier is important to time sensitive passengers as it guarantees flexibility should the need to change flights arise. It is submitted that Qantas and British Airways offer the most frequent service between London and Australia;
- the larger a carrier's slot holding and airport presence the greater the level of market power it enjoys in markets where this airport is an endpoint;
- Qantas and BA have advantages over smaller carriers as a result of loyalty programmes in the form of frequent flyer programmes, corporate deals and travel agent commission override schemes; and
- Qantas is the only potential provider of domestic feed in Australia and improved feed relative to competitors increases a carrier's market power.

The Commission's view of international business passenger markets

10.61. On the basis of the market share data presented in Table 10.6 above the Commission does not believe that the JSA raises significant competition issues in the Singapore and Thailand business passenger markets at the moment. In the case of Singapore BA is a relatively minor contributor and the alliance faces a single airline with equivalent market share in the form of Singapore Airlines.

10.62. In the case of Thailand the JSA partners have an inferior market share to Thai International and Singapore Airlines is also a substantial contributor to the market.

10.63. The Commission also does not believe that the JSA is likely to raise significant competition concerns in the two markets over the next five or so years under normal circumstances. The share of the Applicants in both markets has declined over the period of the JSA to date. It is possible that Qantas' significant expansion plans could see some increase in the alliance's share of the Singapore market. However the apparent disinclination of BA to expand in that market under the factual suggests it would maintain its relatively minor market share.

10.64. The Commission similarly does not believe that the JSA raises competition concerns in the Germany business passenger market at the moment nor is likely to do so in the medium term. Table 10.7 shows that BA only has a minor portion of the alliance's 43.2% share of the market and there are a number of other significant competitors with shares around or higher than the BA share including Singapore Airlines, Thai International, Emirates and Austrian Air. Given the spread of competition and the recent expansion of services by Emirates and Austrian Air from Australia, the Commission considers it unlikely that the JSA will raise competition concerns in this market over the next five or so years under normal circumstances.

10.65. Table 10.7 shows that the Applicants have a substantial joint share of the United Kingdom business passenger market, holding a share in excess of 60%. Qantas has the largest share in the market at 42.2% and BA the second largest at a significant 18.2%. The next largest share is held by Singapore Airlines with 11.8%. The Applicants also have a share of Australian resident business passengers in the market approaching 70%.

10.66. Where such concentration thresholds are identified the Commission normally looks to barriers to entry to ascertain whether or not the ability of existing carriers to expand in the market, or new carriers to enter it, are constrained.

10.67. The Commission believes that from the material before it, it is clear that Heathrow airport is slot constrained and the ability of carriers to enter or expand in markets involving Heathrow in the short to medium term is extremely limited. There can be no clearer evidence of this constraint than the preparedness of Qantas to pay nearly 20 million pounds in January 2004 for slots enabling two additional return flights per day at Heathrow.[46]

10.68. To the extent that, as discussed earlier, Heathrow is the airport of preference for carriers offering services between Australia and the UK, the Commission believes that slot access at Heathrow provides a barrier to entry affecting the market for business passengers between Australia and points in the UK.

10.69. On the basis of the observed joint current market shares of the Applicants, the Heathrow barrier to entry and the likelihood that Qantas and BA would be competitors absent the JSA, the Commission believes that the JSA leads to a substantial lessening of competition in the market for business passengers travelling between points in Australia and points in the UK.

10.70. The Commission also notes that Qantas intends to utilise the slots it purchased at Heathrow to offer an additional 14 flights per week from Australia to the UK over the next five years, with seven services to be introduced in the next twelve months.

10.71. The Commission believes the additional services to be offered by Qantas can only significantly increase the joint share of the Applicants of the business passenger market between points in Australia and points in the UK.

10.72. The Commission considers that joint market shares at such levels raise competition concerns and would be expected, depending on the market involved, to potentially impact on price, service and product choice.

10.73. The market for business travellers is relatively price inelastic, as discussed earlier. Information provided by Qantas on fares and yields tends to confirm this view with discount economy fares falling substantially in real terms over the period of the JSA while fares for travellers in premium cabins (which are likely to have a higher business traveller component) have remained relatively unchanged in recent years in a period when exogenous shocks have seen a

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[46] Dominic O'Connell, "*Heathrow gold rush has airlines circling*", The Australian, 24 February 2004.

supply side surplus in the industry. Qantas has advised the Commission in this context that the difference in discount business class fares and fares used by business travellers in the economy cabin is low. A cost plus approach to premium cabin fares is reflected in advice to the Commission from Qantas that with the introduction of Skybed to Qantas services between Sydney/UK Europe, published business class fares will increase by approximately 10%.

10.74. While it would be expected that most business travellers would not be paying their own fares, any increases in fares attributable to the JSA would still represent an impost on the Australian business sector for Australian resident business travellers.

10.75. Qantas has previously advised the Commission that in the premium cabins airlines compete on product not on price. The Commission believes the impact of the JSA on product competition is reflected in the timing of introduction of flat beds in business class. While BA introduced such facilities in 2000 in response to initiatives taken by other carriers, Qantas has not moved to introduce beds in business class until 2004. The Commission considers that in the absence of the JSA it is likely that Qantas would have introduced business class beds much earlier.

10.76. Virgin Atlantic has submitted that attracting a substantial proportion of time sensitive passengers is crucial to the commercial success of a carrier's operations in long haul markets. The Commission acknowledges that higher yielding passengers such as business passengers contribute disproportionately to the overall revenue of a carrier. However there is no suggestion that in terms of any market involving the JSA this has been a barrier to other carriers to date. Any advantage achieved by the Applicants on Australia–UK route, for example, looks to be offset by the similar advantages achieved by mid-point carriers on their third and fourth freedom routes, eg in 2003 Singapore Airlines captured 47.2% of business travellers on the Australia – Singapore route, and Thai International captured 46.5% of such travellers on the Australia Thailand route.

10.77. While Virgin Atlantic has claimed that Qantas and BA have advantages over smaller carriers as a result of loyalty programmes the Commission does not believe that any such advantages are necessarily a result of the JSA. A reciprocality of frequent flyer programs would exist between Qantas and BA regardless of the JSA as a result of their **one**world linkages. In any event their schemes are not symmetrical with Qantas having a more generous and open scheme than BA. Given it is the only Australian carrier with both a significant domestic and international presence Qantas would be strongly positioned to make corporate deals regardless of the JSA, and especially given its **one**world connections. This strength was recognised by the Commission when providing authorisation to the Star Alliance Joint Corporate Programme.

10.78. The Commission notes that Virgin Atlantic is entering the Australia–UK route from 8 December 2004 with daily services over Hong Kong to Sydney. However given that Virgin Atlantic is already operating successfully between the UK and Hong Kong and carrying business passengers, the scope for any dramatic impact on the joint UK business passenger market share of the Applicants would appear limited.

International freight transport market

Market shares

10.79. In other determinations the Commission has noted that the majority of air freight to and from Australia is carried on passenger flights and as such the level of competition within the air freight market is dependent upon many of the same factors as within the passenger market.

10.80. Consistent with the international passenger markets the Commission will focus on routes covered by the JSA when examining competition in international air freight markets. It is essentially only on JSA routes that both Qantas and BA maintain an operating presence and there is a potential for a lessening of competition by the proposed conduct.

10.81. Data relating to air freight services is less comprehensive than for passenger services and is based on uplift/discharge point rather than origin or destination. As a result statistics of cargo discharged in SE Asia in Table 10.8 include cargo destined for both Europe and SE Asia. It is only by looking at the combined figures that an appreciation of the market share of the Applicants is obtained. Even so it is apparent from Table 10.8 that the Applicant's share of the relevant cargo markets is in decline. Their combined share of the aggregate SE Asia and Europe market has fallen from 40.0% in 1994 to 32.6% in 1998 and 23.8% in 2003.

Table 10.8. Airline freight market shares, JSA routes, 1994, 1998 and 2003 (per cent)

Airline	**Europe**			**SE Asia**		
	1994	**1998**	**2003**	**1994**	**1998**	**2003**
Qantas	45.2	35.3	28.3	27.9	20.9	16.6
BA	27.5	24.4	19.9	4.3	6.9	4.2
Qantas/BA	***72.7***	***59.7***	***48.2***	***32.2***	***27.8***	***20.8***
Singapore Airlines				35.9	40.3	39.4
Malaysia Airlines				9.2	15.5	18.1
Garuda				8.4	3.2	2.7
Thai International				6.9	5.9	9.3
Philippine Airlines				4.1	1.8	0.8
Lufthansa	10.7	0.0	4.6			
KLM	6.0	12.1	..			
Martinair	0.0	18.1	33.6			
Other	10.6	10.1	13.6	12.3	5.5	8.9
Total	*100.0*	*100.0*	*100.0*	*100.0*	*100.0*	*100.0*
Tonnes	35,150	34,780	30,211	157,808	198,204	248,363

Source: DTRS

Views of the Applicants and interested parties

10.82. The Applicants have suggested that air freight markets will typically be more competitive than air passenger markets because of the additional discipline imposed by competition from dedicated air freight aircraft and the possibility for indirect routings and intermodal substitution for many classes of freight.

The Commission's view on international air freight markets

10.83. On the basis of the current and declining market shares of the Applicants in air freight markets on JSA routes the Commission does not believe that the JSA raises competition concerns at this stage in those markets.

Domestic passenger market

10.84. The primary way that an international alliance can lessen competition in this market is by directing domestic on-carriage or feeder traffic to a particular carrier, in this case Qantas, at the expense of the competitive position of other domestic carriers.

10.85. Domestic on-carriage linked to international flights accounts for 15% of Qantas domestic operations according to the Qantas 2003 Annual Report. Such on-carriage would accrue from all international airlines visiting Australia following the failure of Ansett Australia and the absence of a Star Alliance aligned domestic carrier. Table 4.3 shows that BA accounted for 3.3% of all international passengers travelling to and from Australia in 2003.

Views of the Applicants and interested parties

10.86. The *Applicants* have submitted that competition in the domestic market has not been and will not be affected by the JSA. It is claimed that Qantas' domestic services do benefit from some international feed, but that the level of this feed is too low to have any real effect on domestic competition.

10.87. *Virgin Blue* has submitted that the Applicants have failed to properly analyse the anti-competitive effect of the JSA in Australian domestic trunk and regional markets as they have not had regard to the extent to which Qantas takes advantage of its market power in markets for the provision of international air services and its position as the only provider of these services who also provides domestic trunk and regional services, in order to lessen the ability of its competitors in domestic trunk and regional air services to compete.

10.88. *DTRS* submitted that should the Commission undertake analysis of the impact of the JSA on the domestic market it may be appropriate to consider the implications of lack of competition in the domestic Business Class market segment for international Business Class travel.

The Commission's views on the domestic passenger market

10.89. In A30202 the Commission accepted that the JSA would not lessen competition in the Australian domestic market. While the structure of the domestic market has changed following the failure of Ansett there is still at this stage no reason to believe that the JSA is significantly lessening competition in the domestic passenger market.

10.90. The feeder traffic which Qantas receives from BA would be likely to accrue to Qantas regardless of the JSA given the **one**world linkage. In any event BA only accounts for a very small percentage of passengers travelling to and from Australia.

10.91. While Qantas may operate from a position of advantage, as the only carrier with a substantial international and domestic presence, in being able to bundle services it would hold such an advantage regardless of the JSA. The only way that the JSA can be considered anti-competitive in this context is by the extent to which it increases any Qantas advantage. As stated above, BA only accounts for a very small percentage of Australian international travellers overall.

10.92. Given Qantas is the only carrier in the Australian domestic market to offer Business Class services and given Virgin Blue is a one class airline the Commission does not believe that the JSA can have an anti-competitive impact in the Business Class segment of the domestic market as suggested by DTRS.

Sale of air travel market

10.93. In Determination A30202 the Commission stated that it did not consider that the JSA at the time would lead to a lessening in competition in the airline ticket sales market.

10.94. The *Applicants* submitted that this view should continue to apply under current market conditions with BA accounting for just 2.5% of all international traffic to and from Australia in 2001/02.

10.95. *AFTA* submitted that it did not believe that the JSA lessened competition in the market for travel agency services but would be concerned if the Applicants attempted under the guise of the JSA to jointly reduce commissions payable to travel agents.

The Commission's view on the sale of air travel market

10.96. The Commission does not consider that any material has been put before it which would suggest that the JSA is currently having, or likely to have in the medium term, a detrimental impact on competition in the sale of air travel market.

Summary of findings

10.97. In A30202 the Commission expressed the view that the JSA was likely to lessen competition in markets where both airlines had an operational presence. The Commission was particularly concerned at the potential for the Applicants to raise prices to a greater extent than would occur if the JSA was not in place and Qantas and BA were in direct competition.

10.98. In raising its concerns the Commission referred to uncertainty at the permanence of emerging competition from sixth freedom carriers and the status of Australia's only other significant international carrier at the time, Ansett International.

10.99. Some four years later it is apparent that sixth freedom carriers have consolidated their position on JSA routes and are providing strong competition in most markets contested jointly by the Applicants and look likely to do so for the medium term.

10.100. On the basis of market share it is unlikely that the Applicants are able to exert market power over prices in the SE Asia and Europe markets for leisure passengers. Asian carriers exercising third and fourth freedom rights are providing strong competition between Australia and their home countries in SE Asia and BA is only a minor contributor to this market. The Applicants' joint share is stronger in the Europe leisure passenger market but there is strong competition from sixth freedom carriers with three achieving market shares at least equal to those of BA and Singapore airlines achieving a share more than twice the size of the share of BA.

10.101. It is likely that in the short to medium term strong competition will continue in leisure markets serviced by the JSA especially with Qantas withdrawing services from continental Europe destinations and potential increased competition from airlines such Gulf Air, Emirates, Qatar Airways and Virgin Atlantic entering the Europe market.

10.102. The impact of the JSA on competition in some business passenger markets is more problematic. In the Thailand and Singapore markets for business passengers the home carriers are substantial suppliers of business passenger travel and BA makes only a relatively small contribution to the combined market share of the Applicants. BA makes a similar small contribution to the market for business passengers to points in Germany which are also well served by a number of other airlines.

10.103. The Commission's main concern is in the market for business passengers to points in the UK where the Applicants have a substantial market share and are the two largest suppliers of services to the market. This concern is compounded by barriers to entry and expansion in the market which are high as a result of slot constraints at Heathrow Airport. The Commission also notes that Qantas' recent purchase of slots at Heathrow may enable it to expand capacity in the medium term while other carriers are constrained. Under these circumstances the medium term prospect is one of the Applicants' strengthening their position in the market.

10.104. The JSA could lessen competition in all international passenger markets where both airlines have an operational presence. However the UK business passenger market is the only market where the lessening of competition seems substantial. The leisure passenger markets are highly competitive.

10.105. While there is undoubtedly detriment arising from a substantial lessening of competition in the UK business passenger market the Commission believes the scale of detriment assessed needs to take into account the range of international air passenger markets affected by the JSA overall and the specific nature of the JSA's impact in the UK business passenger market.

10.106. Normally when there is a lessening of competition of the extent evident from the JSA in the UK business passenger market it would be expected to impact on prices or fares. The Commission believes that such fare increases are likely to occur in this market but given the relatively price inelastic nature of demand in the business passenger market there would be no fall off in demand. Consumers would be indirectly affected as the price increases are passed on by the businesses employing the business passengers.

10.107. It has previously been submitted to the Commission that airlines compete for business passengers on quality of service not price. The Commission believes that the reduced competition in the UK market is reflected in the delay taken by Qantas in moving to flat beds in business class cabins relative to BA and other airlines on JSA routes. Qantas is likely to have introduced such services earlier absent the JSA.

10.108. UK business passengers accounted for around 3% of all passengers travelling on JSA routes and around 9% of passengers travelling between Australia and the UK. The Commission understands that the high yielding fares paid by business passengers means that they make a contribution to airline revenue in proportionally excess of their numerical presence. However judging by the level of competition in leisure passenger markets there is no suggestion at this stage that this revenue factor is impacting generally on competition in international air passenger markets.

10.109. The Commission also acknowledges that Qantas, and therefore BA through its **one**world affiliation, has a natural advantage over other airlines in attracting Australian resident business travellers through its domestic market presence. This advantage would apply even in the absence of the JSA.

10.110. The Commission does not believe that the JSA has resulted in a substantial lessening of competition, and therefore detriment in other markets potentially affected by the JSA being the international freight market, the domestic passenger market, and the sale of air travel market.

11. Commission Assessment – Public Benefits arising from the Proposed Arrangements

11.1. The Commission must be satisfied that the Proposed Arrangements result in a benefit to the public that outweighs any detriment arising from anti-competitive conduct. The Commission will also consider the extent to which the benefits claimed by the Applicants represent benefits to the public.

11.2. There must be a nexus between the claimed public benefits and the conduct for which the authorisation is sought. Consistent with the "future-with-and-without test" outlined in Part 9 of this Draft Determination, the Commission compares the public benefit and anti-competitive detriment generated by the Proposed Arrangements in the future with those likely to be generated if the authorisation is not granted. Public benefits which may accrue in the future irrespective of whether or not authorisation is granted for the Proposed Arrangements may not be accorded weight of any substance.

Public benefits claimed by the Applicants

11.3. The Applicants claimed the JSA permits them to support each others services in such a way as to enable each airline to operate more services than would be sustainable without the JSA. It is claimed that the JSA enables Qantas and BA to replicate some of the network and density benefits enjoyed by mid-point carriers by facilitating the operation of a mini-hub for Qantas and British Airways in Singapore. It is submitted that the types of public benefits arising from the JSA include:

- cost savings and efficiencies;
- lower fares;
- an increase in net exports;
- additional employment;
- increased tourism;
- product and service benefits; and
- increased international competitiveness of Qantas.

11.4. The Applicants originally claimed that on the basis of the supporting submission from NECG that the JSA is likely to result in benefits to Australia of at least $402 million to $561 million in benefits over the next five years in real terms. Table 11.1 below shows the specific benefits claimed by NECG.

11.5. The Applicants stated that a range of expected benefits has been estimated because of the difficulty in assessing the extent to which other airlines are likely to replace capacity withdrawn by the Applicants if the JSA is not authorised.

Table 11.1. NECG estimation of Australian benefits from JSA, 2003-2007

Benefit	Lost JSA capacity replaced	Lost JSA capacity not replaced
Cost savings (Qantas only)	\$43m	\$43m
Enhanced schedule options	>0	>0
Tourism	\$58m	\$353m
Net exports	\$301m	\$165m
Yield management	>0	>0
International competitiveness	>0	>0
Total	>\$402m	>\$561m

11.6. The figures in Table 11.1 were subsequently revised by NECG to take into account errors and the withdrawal of Qantas' services to Rome. After adjustment the claimed range of total benefit is between \$355 million and \$510 million.

11.7. The latest NECG figures do not take account of Qantas' subsequent withdrawal from the Paris route.

Cost savings and efficiencies

Views of the Applicants and interested parties

11.8. The Applicants have claimed cost efficiency savings from a number of sources including operational cost savings and sharing overhead costs especially in the area of IT development and operations, but also through joint facilities such as sales and airport services.

11.9. The majority of claimed cost savings for Qantas are associated with IT and embrace yield management systems, reservations systems and other shared facilities. Cost savings are claimed to arise through economies of scope and through saving the cost of dismantling and separating integrated facilities if the JSA does not proceed.

11.10. Other cost saving are submitted to come from shared facilities such as sales teams, retail shops, telephone sales, customer service facilities and lounges.

11.11. Operational cost savings are submitted to derive from a number of cost sources. For example under the counterfactual it is claimed that there will be insufficient traffic to facilitate the replacement of B767-300 aircraft with the more efficient A330 on the Perth - Singapore route. Other efficiencies are claimed to arise because operational costs at Singapore can be spread across more flights.

11.12. A number of interested parties have supported the view that the JSA gives rise to cost and efficiency savings, including the WA Govt and DTRS. On the other hand Virgin Atlantic does not believe that there are any substantial public benefits from the JSA given there are no returns to scale in the provision of air transport services and the arrangement has probably resulted in an increase rather than a decrease in management costs.

The Commission's view on cost savings and efficiencies

11.13. In Determination A30202 the Commission stated that it would be surprising 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. No material presented to the Commission provides a basis for the Commission to resile from that position.

11.14. However the Commission believes that the actual costs savings likely to be achieved, while still significant, would be lower than those claimed by the Applicants. In particular the Commission considers that:

- cost savings associated with the counterfactual schedules advanced by the Applicants cannot be relied upon;
- some shared facilities which do not raise overt competition concerns, such as joint lounges, are likely to occur absent the JSA; and
- no recognition has been made of costs associated with operating the alliance, e.g. management costs.

11.15. The Commission has previously stated[47] in relation to cost savings benefits that when such benefits are not passed on to consumers those benefits are likely to be accorded a lower weight by the Commission. In expressing this view the Commission noted that the level of competition in a market will affect both the durability of the benefit and the likelihood and extent of the benefit being passed through to consumers.

11.16. The Commission is satisfied that, with the exception of the market for business travellers between the UK and Australia, all other international markets involving the JSA are subject to competition sufficient for there to be pressure for savings to be passed on to consumers.

Lower fares

Views of the Applicants and interested parties

11.17. The Applicants claimed that the JSA results in higher levels of capacity on JSA routes than is otherwise likely to be the case. They also claimed the JSA facilitates significant operational and overhead cost efficiencies and savings as well as enabling them to jointly manage yields. They claimed that given the intensely competitive nature of the JSA routes these cost efficiencies and savings have been and will continue to be passed on to consumers in the form of lower fares.

11.18. The NECG Report has attempted to analyse the impact on prices of capacity reductions by the Applicants under the counterfactual advanced by the Applicants under scenarios where the lost capacity is replaced by foreign

[47] Determination A30220-22 and 90862-3, para.13.65.

carriers or not replaced at all. NECG concluded from this analysis that reauthorisation of the JSA will lead to lower prices and higher levels of output than if the JSA were not authorised.

11.19. *AFTA* submitted that in its experience while there has been a downward trend in the price of economy travel on the relevant routes during the term of the JSA, the cost of premium tickets has risen both in dollar and real terms.

11.20. *DITR* submitted that the JSA does not appear to have provided any degree of market power to the Applicants in order to significantly influence prices in fare categories of relevance to tourism. DITR considered aggressive price competition on many JSA routes has been the norm and on the whole Qantas' fares have been significantly influenced by their competitors. DITR noted that dramatic and turbulent events impacting on the industry have added to the price competition between airlines and productive efficiency.

11.21. *Virgin Blue* submitted that it would not expect the discontinuation of the JSA to result in a significant decrease in capacity on JSA routes and that accordingly the Applicants' claims of lower air fares are spurious.

11.22. The *WA Govt* submitted that the greater availability of discount fares to consumers is more a result of the overall industry capacity on the Kangaroo route than the JSA itself. The WA Govt also submitted that because of bilateral capacity restrictions if the Applicants were to significantly reduce capacity it would be likely to impact on air fares.

11.23. *DTRS* submitted that it is difficult to attribute lower fares to specific factors such as the JSA. DTRS considered that the Kangaroo route is highly competitive and that it is likely that competition would continue to maintain downward pressure on ticket prices in the absence of the JSA.

The Commission's view on lower fares

11.24. In Determination A30202 the Commission acknowledged that a reduction in fares is a public benefit and that a reduction in fares had occurred on JSA routes since the implementation of the agreement. The Commission considered at the time that the JSA had provided the Applicants with the ability to lower fares but the extent to which fares were lowered was a product of the level of competition in the market.

11.25. The Applicants have claimed that a representative economy bench mark fare has fallen by 25% since the JSA was implemented. In assessing the current authorisation application from Qantas and BA the Commission is required to assess future public benefit and its primary interest is in future fare levels. Historical fare levels are only relevant to the extent that they can provide a guide to future fare levels.

11.26. Information provided by the Applicants on aggregate yields achieved on JSA routes suggest that fares have remained reasonably steady over the past three years. The high level of competition for leisure passengers and the impact of various industry shocks look to have been constraining factors on price in this period.

11.27. These developments are particularly evident in premium cabin yields. The Applicants have provided confidential information to the Commission on yields achieved in the first and business class cabins over the period of the JSA and claimed that the average price of travel in both cabins has declined substantially in recent years. From the Commission's perspective the information appears to show that fares in these categories were increasing steadily in both dollar and real terms prior to September 2001 but have stabilised in dollar terms and fallen slightly in real terms since then, presumably in response to reduced demand.

11.28. For leisure passengers, at least, the prospect appears to be one of continued strong competition and pressure on fares on JSA routes, especially from mid-point carriers. For business travellers in higher fare categories, especially on the UK route, the future is not as clear.

11.29. On the basis of the strong level of competition currently evident in the leisure passenger market the ability of the Applicants to have an impact on economy fare prices would seem limited at this stage. Under these circumstances the Commission could hardly attribute a public benefit of lower fares in the market generally to the JSA. The cost savings acknowledged by the Commission above as accruing to the Applicants from the JSA assist them to offer lower fares in a competitive market. The extent of that benefit has already been recognised as a cost saving.

11.30. On the material before it the Commission is not satisfied that fares payable by business travellers, especially in premium cabin classes, will stay at the current claimed low levels. Premium cabin fares have risen substantially previously during the term of the JSA. In the short term given the market power of the Applicants in the UK business traveller market, the inelastic nature of the business travel market, the reduction in premium cabin capacity to Europe following Qantas' withdrawal from Paris and Rome, the reduction in business class seating capacity on Qantas flights following the introduction of flat beds and the stated intention of Qantas to increase fares to cover flat bed costs, fares for many business travellers are likely to increase.

11.31. Fares for business travellers in the longer term are likely to be a product of market growth, the level of competition and the impact of Qantas additional double daily services to the UK.

11.32. The Commission does not consider that a public benefit of lower fares will arise from the JSA in the short to medium term.

Net exports

Views of the Applicants and interested parties

11.33. The *Applicants* claimed that the JSA enables Qantas to support many more services on JSA routes than it would be able to do absent authorisation. They claimed that without the JSA there would be the equivalent of at least three fewer B747-400s flying on JSA routes and Qantas would be likely to carry at least 270,000 fewer passenger over the next five years than it otherwise would.

11.34. The Applicants in their original application claimed that if the JSA is not reauthorised then on the basis of estimates appearing in the NECG Report:

- approximately $418 million in nominal terms in export earnings will be lost over the next five years from the lost passengers;
- import replacement of up to $285 million could be foregone if the capacity reductions by Qantas are all replaced by foreign carriers; and
- the overall impact on real consumption of additional exports and import replacements would be between $165 million and $301 million in real terms over the next five years.

11.35. A subsequent submission from the Applicants revised the NECG overall impact figure to a range of between $271 million and $440 million in recognition of errors. After adjustment to take into account the suspension of Qantas services to Rome, the range reduced to between $149 million and $279 million. No estimates have been provided of the impact of the withdrawal of Qantas' Paris services.

11.36. *DTRS* submitted that any developments that reduce an Australian based carrier's market share to the benefit of non-Australian carriers are likely to have a negative impact on net exports.

The Commission's view on net exports

11.37. The claims by the Applicants of net export benefits associated with the JSA are dependent on capacity reductions flowing from the counterfactual schedules they have advanced. The Commission does not accept the counterfactual advanced by the Applicants for reasons explained in Part 9 earlier and therefore does not accept that there would necessarily be capacity reductions by the Applicants if the JSA was not authorised. The Commission accordingly does not accept that there are net export benefits arising from the JSA.

11.38. Even if there were capacity reductions the Commission does not believe that the estimates of net export benefits submitted by the Applicants nor the methodology used by NECG to generate estimates can be relied upon for reasons described below.

11.39. The Applicants have stated that based on the analysis of section 11.4 of the NECG Report the claimed capacity reduction would lead to a loss of $418 million in export earnings in nominal terms over the next five years. This figure does not appear in the referred section of the NECG Report and it is not clear to the Commission how the figure was derived by the Applicants. An examination of confidential data supplied by the Applicants in Table 63 of the NECG Report suggests that the net export loss on the value of ticket sales (assuming reduced capacity was not replaced by foreign carriers) would be of the order of $78 million rather than $418 million. Similarly from confidential information available in Table 64 the additional net export losses on ticket sales if the reduced capacity was replaced by foreign carriers would be of the order of $544 million not $285 million.

11.40. Most importantly any estimate of the balance of payment impact of capacity reductions based exclusively on ticket sales revenue grossly overstates the impact of the reduction. Such an approach does not take into account:

- decreased expenditure overseas by Qantas on fuel, maintenance, airport charges, catering, crew costs, etc;
- increased expenditure in Australia by foreign airlines on airport charges, crew costs, catering, etc; and
- capital or leasing costs associated with aircraft used by Qantas which are invariably imported.

11.41. The Commission similarly finds difficulty with the approach used by NECG to model the impact on the economy generally of capacity reductions, for example:

- NECG does not explore the matter of import leakages associated with costs Qantas incurs overseas and relies on the Monash Model welfare multipliers to account for those costs;

- neither the costs overseas of Qantas or the costs of foreign carriers in Australia appear to have been recognised in welfare multipliers used in the Monash Model;

- no account has been taken of the potential for Qantas to recover a large proportion of export revenue shortfalls on JSA routes by reallocating Qantas aircraft on alternate routes, or to dispose of surplus aircraft overseas or to defer aircraft imports;

- the model used by NECG is designed to capture total changes in macroeconomic aggregates but fails to assess the concurrent economic costs involved with changes in real GDP levels, meaning that NECG appears to have estimated a change in gross economic production not net economic welfare.

Additional employment

Views of the Applicants and interested parties

11.42. The Applicants claimed that additional employment is an important benefit that arises from the JSA with the additional flying permitted by the JSA supporting over 950 jobs.

11.43. The *NSW Govt* submitted that continuation of the arrangement will help to moderate the adverse impact on employment in Qantas in the continuing uncertain market.

11.44. *DTRS* submitted that in the absence of the JSA the presence of Qantas on the Kangaroo Route may be reduced which may lead to some loss of employment.

The Commission's views on additional employment

11.45. As stated earlier the Commission does not believe that there would necessarily be a reduction in capacity in schedules operated under the counterfactual. Under these circumstances it is unlikely that the JSA would lead to additional employment.

Increased tourism

Views of the Applicants and interested parties

11.46. The *Applicants* claimed that the loss of Qantas and British Airways services on the Kangaroo route if the JSA is not authorised would be significant for Australian tourism. They further claimed that the JSA supports tourism through a combination of enhanced capacity, lower fares, better quality of services and higher promotional expenditure in Europe.

11.47. The Applicants cited estimates from the NECG Report that the capacity and promotional effects of loosing the JSA would translate into a reduction, on average, of between 3,800 and 10,200 tourists visiting Australia each year over the next five years. NECG estimated that the impact on the Australian economy in terms of loss of national income from falls in tourism levels if the JSA is not authorised would amount to between $58 million and $353 million in real terms over five years.

11.48. *AFTA* submitted that whilst it would not comment on the quantification prepared by NECG of the possible lost tourism if the JSA is not authorised it does agree with the Applicants that the operation by Qantas of JSA routes means that tourist visits to Australia are likely to be higher with the JSA than without it.

11.49. *DITR* submitted that the Applicants claims with regard to the capacity and promotional effects of losing the JSA seem overstated. DITR stated that the worst case scenario estimated by NECG represents only 0.2% of short term arrivals in 2002 and would be difficult to distinguish from the broader effects of economic cycles and other impacts affecting inbound markets. DITR considered that nevertheless the impact of the JSA on tourism is likely to be positive as a result of network benefits and synergies between the international and domestic networks of Qantas and BA.

11.50. The *NSW Govt* submitted that the JSA enhances tourism opportunities in Australia from a wider international market.

11.51. The *Qld Govt* noted that authorisation of the JSA will ensure that Australia continues to benefit from hub and spoke efficiencies, and the significant brand and marketing presence of BA in the UK and European markets. This has the effect of potentially drawing large traffic volumes from a range of European destinations to Australia on Qantas and BA services. Absent the JSA this traffic drawing capacity from the UK and Europe is potentially diminished and at risk.

11.52. *Virgin Blue* submitted that it does not accept that the JSA results in an increase in tourism to Australia:

- if the JSA routes as competitive and barrier to entry are as low as the Applicants claim there will not be a reduction in capacity on JSA routes should the JSA not continue;
- rather than there being a reduction in the promotion expenditure by Qantas if the JSA were removed Virgin Blue suspects there will be an increase in activity by both BA and Qantas as they seek to consolidate their positions as the two largest suppliers on the JSA route; and
- the Australian Tourism Commission would increase its promotional spending in the event of decreased spending by the Applicants.

11.53. The *WA Govt* submitted that it supported the contention that tourist numbers to Australia are higher with the JSA than without it. The WA Govt believed that Qantas would simply not be able to maintain the current levels of frequency and capacity on the key UK and European routes which are so vital to Australian tourism.

11.54. *DTRS* submitted that the substantial marketing of Australia as a destination for European travellers undertaken by Qantas may decline should reauthorisation be denied, as Qantas has indicated that would rationalise its European services. DTRS submitted that it is unlikely that foreign competitors would increase spending to market Australia, leading to a possible decline in tourism growth.

The Commission's view on increased tourism

11.55. In its previous authorisations of the JSA the Commission concluded that while tourism was clearly of benefit to Australia it remained unconvinced that there were substantial tourism benefits arising from the JSA. The Commission noted that there was a wide range of factors which influenced tourism demand which were more significant than the JSA including general purchasing power in source countries, the relative cost of other destinations, the total cost of visiting Australia (land as well as air component) and the perceived quality of Australia as a destination.

11.56. The Commission also commented that no material had been advanced by the Applicants to suggest the relative contribution any benefits flowing from the JSA may make to tourism. This Application has been accompanied by a supporting submission from NECG which attempts to quantify tourism benefits flowing from the JSA and is the primary material offered by the Applicants in support of their increased tourism claim.

11.57. The Commission notes that NECG originally claimed increased tourism benefits ranging from $58 million to $353 million over a five year period. This estimate was subsequently revised upwards to between $58 million and $414 million to account for NECG errors and then revised down to between $33 million and $318 million following the withdrawal of Qantas' Rome services. No further estimates have been provided taking into account Qantas' withdrawal of its Paris services.

11.58. The estimate at the *high* end of the range of benefits claimed by NECG relate to a scenario whereby capacity reductions claimed to occur under the counterfactual advanced by the Applicants are not replaced by foreign airlines.

11.59. As stated earlier the Commission does not accept that there would necessarily be capacity reductions under the counterfactual. Moreover the Commission does not believe that it is realistic to assume that foreign airlines would not replace any capacity reductions given the level of competition in the markets concerned. The Commission has noted earlier the strong competition between airlines for leisure market travellers on JSA routes. The Commission is also aware that following its withdrawal from the Rome and Paris routes Qantas immediately entered into code share arrangements with Cathay Pacific and Air France respectively to enable it to service those routes.

11.60. The proposition that foreign airlines would not replace any capacity reductions by the Applicants is particularly inconsistent with their views on competition as expressed in their supporting submission:

> *"5.34 Overall price and product competition in JSA Passenger Air Services markets has been characterised by sustained and intense competition that will continue. Despite the concerns expressed by the Commission in the 2000 Determination that competition from mid-point carriers might be transitory, this has been shown not to be the case. Rather, due to underlying economic advantages, mid-point carriers appear likely to continue to grow and ensure that competition on JSA routes remains intense."*

11.61. The estimate at the *low* end of the range of benefits claimed by NECG relates to a scenario whereby capacity reductions claimed to occur under the counterfactual advanced by the Applicants are replaced by foreign airlines. However NECG claims that there would be a reduction in promotion of Australia affecting tourism as Qantas would reduce promotional expenditure and foreign airlines are unlikely to promote Australia to the same degree as Qantas. Such a proposition seems inconsistent with the submission made by DITR which notes that while Qantas is normally the primary marketing partner of the Australian Tourism Commission in overseas markets, Singapore Airlines has negotiated this role in the UK.

11.62. Assumptions made by NECG aside, the Commission also has concerns with a number of aspects of the estimation process used by NECG. However the Commission sees little merit in articulating those concerns in light of its comments above and the DITR observation that the worst case scenario advanced by NECG represents only 0.2% of short term arrival in 2002 and would be difficult to distinguish from the broader effects of economic cycles and other impacts affecting inbound markets.

11.63. The Applicants have stated that the JSA supports tourism through a combination of enhanced capacity, lower fares, better quality of services and higher promotional expenditures in Europe. The Commission has addressed enhanced capacity and promotional expenditure above and lower fares and quality of service benefits in other areas of its benefit analysis.

11.64. On the basis of the material put before it the Commission is not able to conclude that there would significantly increased tourism or tourism benefits of substance arising from authorisation of the JSA.

Product and service benefits

The views of the Applicants and interested parties

11.65. The *Applicants* claimed that the JSA will continue to give rise to a number of customer service benefits that, while difficult to quantify, are nonetheless real benefit to consumers. These benefits were claimed to include:

- broader availability of schedule options for passengers, including more one stop services to more destinations;
- greater availability of discount fares; and
- provision of higher quality 'seamless' travel services, especially in places where Qantas does not have its own offices.

11.66. *AFTA* submitted that the JSA has allowed the Applicants to offer a broader choice of schedules, more flexible fares, a greater range of product (fare types) and higher levels of consumer support.

11.67. *DITR* submitted that the JSA allows greater coordination of flight scheduling, baggage handling, catering, ground services, frequent flyer programs and airport lounges. DITR submitted that these aspects promote a more seamless travel experience to customers, which is becoming increasingly important to travellers. DITR also noted that the number of connections able to be made at the Applicants' mid-points between JSA services has increased from 68 in 1995 to 158 currently and that there has been substantial product innovation in terms of in-flight entertainment and comfort offered by carriers.

11.68. *Virgin Blue* submitted that the JSA does not result in higher quality products and services. Virgin Blue suggested that if the JSA routes are as competitive as the Applicants claim, it is unlikely that there will be a reduction in capacity on JSA routes or a decrease in the quality of those services.

11.69. *DTRS* submitted that quality of service is difficult to define, relying on a number of factors including, but not limited to, cabin service and configuration, airport handling facilities, service frequency, flight duration and range of destinations available. DTRS agreed with the Applicants' contention that the synergies between Qantas and BA allowed by the JSA have led to decreased delays and improved connections. DTRS also noted that any consideration of service levels must also take account of ticket price.

The Commission's view on product and service benefits

Availability of schedule options for passengers

11.70. The Applicants claimed that the number of through services offered by them has increased from 35 to 55 under the JSA and that at the time of application they offered 123 one stop alternatives each week for travel between ports in Australia and Europe.

11.71. The Commission notes that the growth in through services (60%) over the period of the JSA is merely consistent with growth in Australia – Europe demand (+60%) and less than growth in Australia – UK demand (+70%).

11.72. The Commission also notes that BA no longer makes a unique contribution to the JSA route in terms of the one stop services it provides to Europe. At various stages BA has been the only provider of certain services for the JSA alliance, eg through Malaysia and providing the Perth – Singapore hubbing leg. All its services on JSA routes are now duplicated by Qantas.

11.73. The number of one stop alternatives to Europe provided by the Applicants has fallen by 30 per week following the withdrawal of Qantas' services to Rome and Paris.

11.74. The Applicants claimed that without the JSA Qantas passengers would no longer have preferred access to intra-Europe connecting flights on BA flights into and out of London. They claimed that absent the JSA BA would have little financial incentive to carry Qantas passengers at current rates.

11.75. The Commission believes that if BA is currently receiving an incentive in the form of a share of Qantas long haul revenue under the JSA that incentive could just as easily be provided outside the JSA through code share charging.

11.76. The Commission is also being asked to believe that BA is currently giving up sales to high yielding local passengers to accommodate Qantas low yielding leisure passengers (presumably Qantas premium fare passengers would still be attractive to BA on a pro rate basis).

11.77. The extent of any benefit accruing to Qantas passengers being able to access BA services to points beyond London is probably lower now than at any time since the inception of the JSA. As noted by DTRS, recent years have seen not only an expansion of the range of ports in Europe available on a one stop basis through mid-point carriers, but European carriers are increasingly providing access to ports in Europe using interline agreements at intermediate points. Carriers engaging in such activities include Finnair, Air France, Lufthansa, Swiss International Airlines and KLM. Passengers are now also able to access low cost carriers for intra Europe travel.

11.78. The Applicants also claimed that the JSA provides passengers with the ability to mix and match Qantas and BA flights noting that during 2002 a substantial number of passengers changed airlines at Singapore.

11.79. The Commission believes that a certain amount of airline changing at Singapore would happen inevitably as a product of the hubbing process. Given BA only operates to Sydney and Melbourne, passengers on BA flights wishing to travel to other Australian destinations would have no choice but to change airlines at Singapore.

11.80. In A30202 the Commission accepted that the JSA was an important factor in the development and expansion of integrated services. The Commission acknowledges that there are still benefits to consumers from the integrated services provided by the Applicants but also notes that in recent times there has been a contraction in JSA routes and that there are now more options for consumers to access Europe via mid-point carriers, interlining arrangements at mid-points and through low cost carriers. Under these circumstances it would be expected that the benefits to arise from schedule options arising from the JSA in the medium term would be less than those recognised by the Commission in previous determinations.

Provision of high quality 'seamless' travel services

11.81. The Applicants claimed that the JSA allows them to offer truly seamless service to their customers. Whilst acknowledging that some of these benefits such as reciprocal frequent flyer benefits and access to each other lounges would occur absent the JSA as result of **one**world, the Applicants claimed that the JSA provides a range of service benefits beyond **one**world.

11.82. The Applicants identified in particular benefits arising from the storage of passenger information and itineraries on the same system. The Applicants claimed that if Qantas passengers need to change their travel plans whilst in any part of the world and are closer to a BA service than a Qantas office, BA staff are able to access the passengers' records and amend or fix any problem as if the passengers were in a Qantas office.

11.83. The Commission agrees that there would be some benefits from the joint system described by the Applicants but suggests that the number of passengers who benefit from such facilities is likely to be very small and so therefore would be the benefit.

Greater availability of discount fares

11.84. The Applicants claimed that coordinated yield management combined with the financial incentives arising from the JSA benefit sharing arrangements optimises the availability of seats in different fare classes across the combined Qantas and BA JSA route services. This process ensures that a higher proportion of consumers are able to travel on discounted seats.

11.85. NECG submitted that managing yields jointly allows the number of seats held back for late booking high yielding passengers to be minimised thereby allowing additional discount fares and reducing the number of empty seats.

11.86. In A30202 the Commission stated that yield management is a valuable supply management tool which can and probably has brought benefits to both consumers and the Applicants under the JSA.

11.87. In accepting arguments of benefit from additional discount fares the Commission would note that such an outcome is likely to be dependent on the levels of competition in the market concerned. In a highly contested market, for example, the fares of competitors will have an impact on the setting of discounted fare levels. However in a market where there is an excess of demand integrated yield management will probably provide less benefits in the form of discounted seats. Mr Robert Gurney, Head of Sales and Distribution in Qantas, recently described[48] the aim of yield management as:

> *"……to maximise the airline's revenue in respect of each flight by selling the maximum number of seats to passengers, each of whom is paying the maximum amount they are prepared to pay for the seat."*

11.88. The Commission appreciates how integrated yield management might assist making more discounted seats available by minimising the number of seats held over for late passengers. However from another perspective such conduct is restraining supply for late passengers, who are more likely to be business passenger than leisure passengers, and thereby reducing competition for such passengers in markets where the Commission has already stated it has competition concerns.

11.89. Overall the Commission accepts that in strongly contested markets there is likely to be a public benefit from integrated yield management systems.

International competitiveness and the national interest

Views of the Applicants and interested parties

11.90. The *Applicants* claimed that it is in the national interest that Qantas remain a successful and internationally competitive airline. They also submitted that increased international competitiveness of Australian industry is recognised as a public benefit by the Commission.

11.91. *DITR* submitted that there are economy wide benefits from having strong and competitive Australian based airlines. DITR believes that the JSA would strengthen Qantas and assist its long run sustainability in what is a very difficult international trading environment characterised by low yields, increasing competition, high costs and demand volatility.

11.92. The *NSW Govt* submitted that there is a need to ensure a viable international airline service to enhance opportunities in both business and tourism. It submitted that the sustainability and profitability of international airlines is clearly threatened and against this is the need to balance the dependence of the Australian tourism industry and business generally on access to reliable

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[48] Statement of 7 March 2004 to the Australian Competition Tribunal, File No 5 of 2003.

air transport services. The NSW Govt submitted that the JSA appears to meet this objective.

11.93. The *WA Govt* submitted that continued shocks to the aviation industry in recent times have reinforced the need to have a strong and competitive Qantas. The JSA was cited as being recognised as the difference between Qantas being able to achieve profits on the Europe route or incurring significant losses.

11.94. *DTRS* submitted that the Government believes that there is a substantial public benefit in having a strong Australian based aviation industry that is able to compete in the international market and that Australia's interests are served by having one or more viable Australian based international carriers.

11.95. DTRS further submitted that the JSA reflects the current trend towards cooperation between airlines in order to rationalise and improve services through interline agreements and airline alliances and facilitates the ability of Qantas and BA to strongly compete in the developing global aviation market.

11.96. While it acknowledged the shocks experienced by the international aviation industry in recent years and losses incurred by many international airlines, DTRS observed that Qantas remains one of the few major international carriers to remain consistently profitable during the downturn.

The Commission's view on international competitiveness and the national interest

11.97. In A30202 the Commission stated that it considered that there is a public benefit from having a strong viable international airline such as Qantas and that alliances can contribute to attaining that position.

11.98. Ultimately however there has to be balance between pursuing the viability and competitiveness of national airlines and maintaining competition. This balance, and the importance of competition, has been implicitly recognised by the Government in its international aviation policy. DTRS submitted:

> *"A key element of the policy has been the trading of 'fifth freedom' intermediate and beyond rights, which allow foreign carriers access to markets between and beyond Australia to stimulate competition on routes from key tourism sources for Australia.*

11.99. If the Government was exclusively interested in the viability of Qantas it would not have pursued such rights.

11.100. From the Commission's perspective then public benefits associated with assisting national airline viability are likely to be larger when associated with removing doubt or uncertainty over the viability and competitiveness of a national carrier than when maximising those aspects of a carrier which is already viable and competitive.

11.101. There have been considerable changes in aviation markets since the Commission issued A30202. The Applicants at that time, for example, sought authorisation to counterbalance the impact of the alliance between Singapore Airlines, Ansett and Air NZ. With the failure of Ansett that alliance is no longer in effect. Not only did the failure of Ansett remove a major competing alliance it also impeded access to feeder traffic for competing international carriers (particularly those in the Star Alliance) to the benefit of Qantas, and immediately handed Qantas the majority of the Australian domestic market.

11.102. As a result of the above developments Qantas traded profitably through the recent downturn. More recently Qantas has announced record profits, and a resurgence in international travel is generally acknowledged as having commenced. Under these circumstances the Commission could hardly regard the JSA as being a primary factor in keeping Qantas viable and competitive overall in the medium term. Certainly there is no sense even in the counterfactual submitted by the Applicants that failure to obtain authorisation of the JSA would threaten the viability of Qantas.

11.103. At best the JSA could be said to result in an improvement in the competitiveness and profitability of Qantas on JSA routes to the UK and Europe which account for around 7% of Qantas' international business. Such an outcome is hardly unexpected when two major players on a route join forces.

11.104. While the Commission will recognise international competitiveness and national interest benefits associated with the JSA it does not believe that they are benefits of substance.

Evaluation of public benefits

11.105. The Commission accepts that there are significant cost savings arising from the JSA. The strong competition on most JSA routes should see some of those savings continue to be passed on to consumers, especially leisure passengers. Business passengers are less likely to benefit from the savings.

11.106. While there have been reductions in fares for many travellers, especially those on discount economy fares, over the period of the JSA, the Commission believes that the lower fares are a product of competition on JSA routes rather than the JSA. While it is true that the Applicants have probably offered lower fares in the market in response to the competition, those lower fares have been facilitated by cost savings already acknowledged above as benefits.

11.107. The Commission does not accept the counterfactual proposition advanced by the Applicants that there would necessarily be capacity reductions if the JSA was not authorised. The Commission accordingly does not accept public benefits associated with that counterfactual claimed by the Applicants in the form of increased net exports and additional employment.

11.108. As in its previous determinations the Commission believes that any tourism benefit arising from the JSA is not likely to be of substance. In particular the Commission notes the comment of DITR that the most optimal benefit estimated by NECG, is of such a level as to be indistinguishable from the broader effects of economic cycles and other factors impacting inbound markets.

11.109. While the Commission does believe that there are public benefits from the schedule options available to passengers under the JSA, the Commission also believes that the level of those benefits has diminished over the period of the JSA as a result of the withdrawal of the Applicants from continental Europe and other routes, increased passenger access to European destinations from intermediate points by using mid-point and European carriers, and the availability of low cost carrier options within Europe.

11.110. The Commission considers that any 'seamless' service travel benefits arising from the JSA are at best marginal given that the most significant of those services are already available outside the JSA through the **one**world alliance.

11.111. The Commission accepts that there is a public benefit from the greater number of discount economy seats available as a result of integrated yield management under the JSA, but notes that some of this benefit may be offset by resultant reduced competition for late booking passengers to the extent there is competition for such passengers.

11.112. The Commission recognises international competitiveness and national interest benefits arising from the JSA but given the strength of Qantas relative to other airlines around the world does not believe that they are benefits of substance.

12. Commission assessment – whether public benefits outweigh anti-competitive effects

Anti-competitive detriment and public benefit

12.1. In Determination A30202 the Commission expressed the view that the determination was finely balanced and stated that given that the agreement had operated without apparent detriment to date and there had been no opposing submissions it was not disposed towards refusing authorisation. The Commission indicated however that it needed to recognise the potential for anti-competitive detriment, especially in a relatively volatile environment.

12.2. The Commission again sees the assessment of the JSA as finely balanced though with some variation from previous assessments of the arrangement. On this occasion there have been opposing submissions to the Application. Additionally for the first time the Commission has identified separate markets for leisure and business passengers. Following its assessment the Commission believes that the JSA gives rise to anti-competitive detriment in the business passenger market between Australia and the UK. At the same time the Commission believes there is greater certainty attached to competitive constraints able to be exercised by sixth freedom carriers as is evident in the dynamics of leisure passenger markets on JSA routes.

12.3. From the Commission's perspective the primary public benefits flowing from the JSA are associated with cost and efficiency savings and schedule options. The greater competition experienced in most markets has given greater certainty to the passing on of cost and efficiency savings to consumers and reinforced this particular benefit. On the other hand the Commission believes that there has been some erosion of the public benefit associated with the JSA as a result of the contraction of JSA services and the expansion of the range of routes and connections offered by other carriers.

12.4. The Commission again finds an overall small net public benefit even in the face of the determined detriment. In attaching weight to this detriment the Commission was influenced by the small number of business travellers disadvantaged by the JSA relative to the large number of leisure passengers who either benefited from, or were not disadvantaged by, the agreement.

12.5. However the Commission recognises the contribution that high yielding business passengers can make to the viability of individual airline routes, as is evidenced by Qantas' recent withdrawal from the Paris route because it was primarily a leisure passenger route. The Commission will be alert for developments occurring in markets involving the UK which could see the Commission giving greater weight to the detriment associated with the UK business passenger market.

Conditions

12.6. Virgin Atlantic submitted that any determination by the Commission to reauthorise the JSA should include conditions to re-establish effective competition in relevant markets.

12.7. The Commission normally considers the inclusion of conditions in an authorisation in circumstances where there is some uncertainty as to the level of competition that might occur or the public benefits that might accrue under the conduct concerned. The Commission does not see a need to include conditions on this occasion.

Period of authorisation

12.8. In its previous determinations on the JSA the Commission provided authorisation for periods of five years and approximately three years and two months respectively. The latter period was imposed in order to synchronise the timing of assessments of the JSA and the alliance between Ansett Australia, Singapore Airlines and Air New Zealand. As the latter alliance has lapsed it is no longer a factor in determining a period for authorisation of the JSA.

12.9. The Applicants have sought authorisation of unlimited duration or in the alternative a term of authorisation of not less than ten years. The Applicants have stated that such terms are justifiable on the basis of the performance of the JSA to date, with little evidence of competitive detriment while delivering substantial public benefits. They claim the longer terms will remove uncertainty as to the continuing relationship between Qantas and BA and enable them to plan for the future with confidence particularly with respect to major investments in aircraft and IT systems.

12.10. *AFTA* submitted that reauthorisation should not be for an indefinite period but for a limited time and suggested that five years would be suitable.

12.11. *DITR* submitted that authorisation should not be of unlimited duration and suggested a term of not less than five years. DITR cited as relevant factors the scope of the JSA, the rapidly changing nature of the global airline industry and the regulatory burden on business.

12.12. The *Qld Govt* submitted that the ACCC should periodically revisit the JSA to ensure that the principles of net public benefits are maintained.

12.13. The *WA Govt* submitted that it did not support any new agreement being for an indefinite period and that any new agreement should be subject to review after a three year period.

12.14. *DTRS* submitted that given the volatility of the global aviation industry re-authorisation should be subject to a fixed period review which would ensure the re-authorisation remained appropriate to contemporary market conditions. DTRS considered a period of five years appropriate.

12.15. The Commission believes that given the volatile nature of the aviation industry especially as it relates to competition between airlines, the nature of the JSA conduct which removes competition between two substantial players and the fine balance the Commission has recognised between competitive detriment and public benefit associated with the JSA a fixed period of authorisation is necessary. The Commission proposes to authorise the JSA for a period of five years.

13. Draft Determination

The Applications

13.1. On 6 May 2003 Qantas and BA lodged applications for authorisation (numbers A30226 and A30227) with the Commission.

13.2. Applications A30226 and A30227 were made pursuant to subsection 88(1) of the Act for an authorisation under that subsection to:

- make a contract or arrangement, or arrive at an understanding, where a provision of the proposed contract arrangement or understanding would be, or might be, an exclusionary provision within the meaning of section 45 of that Act (A30226);

- give effect to a provision of a contract, arrangement or understanding where the provision is, or may be, an exclusionary provision within the meaning of section 45 of the Act (A30226);

- make a contract or arrangement, or arrive at an understanding, a provision of which would have the purpose, or would have or might have the effect, of substantially lessening competition within the meaning of section 45 of the Act (A30227); and

- give effect to a provision of a contract, arrangement or understanding which provision has the purpose, or has or may have the effect, of substantially lessening competition within the meaning of section 45 of the Act (A30227).

13.3. Specifically, the Applications sought authorisation for the Restated Joint Services Agreement (JSA) dated 3 April 2000 (as amended) and related and consequential coordination of schedules and pricing between the Applicants. Pursuant to the JSA, the Applicants have sought authorisation to, from time to time, enter into and/or give effect to contracts, arrangements or understandings that may constitute or include exclusionary provisions, including, but not limited to, in connection with the joint supply or joint acquisition by the Applicants of air transportation services and other goods and services.

The Statutory Test

Application A30226

13.4. For the reasons outlined in Part 12 of this Draft Determination, the Commission is satisfied that, in all the circumstances, the arrangements for which authorisation is sought under subsection 88(1) of the Act in respect of provisions which may be exclusionary provisions would be likely to result in such a benefit to the public that they should be allowed to take place.

Application A30227

13.5. For the reasons outlined in Part 12 of this Draft Determination, the Commission is satisfied that, in all the circumstances, the making of the arrangements and the giving effect to the provisions of the arrangements that might have the purpose or effect of substantially lessening competition and for which authorisation is sought under subsection 88(1) of the Act:

- would be likely to result in a benefit to the public; and
- that benefit would outweigh the detriment to the public constituted by any lessening of competition that would be likely to result from the arrangements.

Draft determination

13.6. The Commission therefore proposes, subject to any pre-determination conference requested pursuant to section 90A of the Act, to grant authorisation to Applications A30226 and A30227 for a period of five years.

APPENDIX A

Summary of submissions on the Application

Australasian Business Travel Association

ABTA submitted that:

- it accepts that the public benefits outlined are beneficial to members of ABTA whilst it is mindful of the need for both airlines to maintain costs and improve efficiencies;
- it has not seen or been advised of any past anti-competitive behaviour or public detriment during the term of the JSA thus far;
- the JSA has been of benefit to ABTA members who undertake extensive international travel to regions where the Applicants' airlines have network coverage as it results in significant savings and convenience; and
- the Commission should maintain continued monitoring of the JSA market power and barriers to entry that may impact on competition in the future.

The ABTA submitted that none of its members commented on the Application.

Australian Federation of Travel Agents Limited

The Australian Federation of Travel Agents Limited (AFTA) submitted that it supports the Applications, subject to certain reservations.

AFTA submitted that:

- it does not believe it to be in the public interest that the JSA be authorised for an indefinite period and that authorisation should be for a fixed period of five years; and
- a review of the authorisation should be implemented in the event that there is a significant reduction in the number of economy seats or frequency of flights on the Kangaroo Route, or if there is a reduction in the number of city pairs services on the route by the Applicants.

In relation to the public benefits claimed by the Applicants, AFTA submitted that it:

- agrees with the Applicants' claims in relation to the challenges facing end point carriers on the Kangaroo Route and that advantages that geography grants to sixth freedom carriers;
- believes that the JSA has allowed the Applicants to offer a broader choice of schedules, more flexible fares, a greater range of product (fare types) and higher levels of consumer support; and

- agrees with the Applicants' submission in relation to the greater availability of discount fares as a result of higher levels of capacity.

While AFTA did not comment on the quantification of the public benefit in relation to tourism, it did agree that the operation by Qantas of the JSA results in more tourist visits to Australia than without the JSA.

In relation to the anti-competitive detriment associated with the Proposed Arrangements, AFTA submitted that it is relevant for the Commission to consider the market for travel agency services. AFTA submitted that, while it formed the view that the JSA does not lessen competition in this market, it would be concerned should the Applicants attempt to reduce commissions payable to travel agents under the guise of the JSA.

AFTA submitted that there is a likelihood that competition in the market for travel agency services would be lessened in the event that Qantas and BA combined their commission programs on JSA Routes.

In relation to the Applicants' submission that the Proposed Arrangements do not lessen competition in the market of the provision of domestic travel services, AFTA submitted that the Applicants' assertion that the success of Virgin Blue is evidence that this is incorrect and that, in its view, Virgin Blue has benefited from the demise of Ansett and its business plan to position the airline as a low cost (VBA) carrier. Nonetheless, AFTA submitted that the JSA does not lessen competition in the provision of domestic air travel services.

AFTA submitted that there is not a single market for air passenger services. AFTA submitted that there are separate markets for different classes of travel or passenger types. AFTA submitted that while there has been a downward trend in the price of economy travel on the relevant routes during the term of the JSA, the cost of premium class tickets has risen considerably in both dollar and real terms.

AFTA submitted that, in relation to barriers to entry, it agrees with the comments of the Applicants and NECG and that there is unlikely to be any material constraint on further expansion by mid-point carriers.

In relation to market power, AFTA submitted that, while Qantas and BA have an advantage over fifth and sixth freedom carriers, this does not translate into a significant degree of market power. AFTA submitted that reauthorisation of the JSA would not significantly increase the Applicants' market power.

Department of Industry, Tourism and Resources

The Department of Industry, Tourism and Resources (DITR) made a submission specific to the issues most relevant to the tourism sector.

DITR submitted that it supports the reauthorisation of the JSA. DITR submitted that there does not appear to have been any significant lessening of competition on the JSA routes since the JSA was last authorised and that it does not believe that there are any major competition concerns over the short to medium term.

DITR submitted that, on balance, the benefits for tourism are likely to be positive and there are wider community benefits from supporting the competitive position and sustainability of Qantas.

DITR submitted that, due to uncertainties in the aviation market and potential longer term competitive pressures, the Proposed Arrangements should not be authorised for an unlimited period and should instead be limited to a period of not less than five years.

In relation to the anti-competitive detriment associated with the JSA, DITR submitted that it largely agrees with the Applicants' submission that the JSA has been pro-competitive and that competition in markets for air travel between Australia and Europe and South East Asia has been intense.

DITR submitted that competition is expected to increase over time.

DITR also submitted that it does not share the Applicants' view that regulatory barriers are not a constraint on further expansion by mid-point carriers. DITR submitted that, for example, under the current Australia-United Arab Emirates air services arrangements, Emirates are constrained from further expansion into Sydney and Melbourne.

DITR submitted that further liberalisation of air services agreements is a prerequisite for ensuring that third country international carriers can enter the Australia-Europe market to maintain competition over the longer term and promote tourism growth.

DITR submitted that the JSA assists the Applicants' long term competitive position on the Kangaroo Route and overcomes the difficulties associated with operating two long sector services from end points. DITR submitted that it is likely that the JSA results in more flights than would occur without the JSA.

DITR submitted that, while it is difficult to know how airfares would have moved in the absence of the JSA, it does not appear to have provided any degree of market power to the Applicants in order to significantly influence prices in the fare categories of relevance to tourism. DITR submitted that, on the whole, it believes that Qantas' airfares have been significantly influenced by its competitors on JSA routes. DITR also submitted that the JSA has provided Qantas and BA additional flexibility in pricing and capacity to meet consumer demand and appears to have provided a greater range of travel products.

DITR noted additional consumer benefits as a result of the JSA including greater coordination of flight scheduling, collocation at airports, baggage handling, catering, ground services, frequent flyer programs and airport lounges which help promote a more seamless travel experience.

DITR submitted that the Applicants' claims with regard to the capacity and promotional effects of losing the JSA seem overstated. DITR submitted that the "worst case" reduction in tourist numbers claimed by the Applicants without the JSA represents only 0.2 per cent of the short term arrivals in 2002. DITR submitted that such a reduction in tourism would be difficult to distinguish from the broader effects of economic cycles and other impacts affecting inbound markets. DITR, however, acknowledged the network benefits that the JSA provides as well as the synergies between Qantas and BA's international and domestic networks and submitted that the impact of the JSA on tourism is likely to be positive.

DITR submitted that it does not believe that the Applicants have provided sufficient justification for authorisation of an unlimited duration. DITR submitted that reauthorisation for a period of not less than five years would be appropriate and noted that the Commission has the power to review the authorisation at any time.

DITR submitted that, while it does not see any need for conditions to be attached to the re-authorisation, it would be useful if the Applicants would continue to collect and calculate benchmark airfare data.

Department of Transport and Regional Services

The Department of Transport and Regional Services (DTRS) submitted that the aviation sector has faced considerable upheaval since the JSA was initially authorised in 1995.

DTRS submitted that many international airlines have suffered substantial losses and have rationalised services and that several airlines have faced bankruptcy or severe losses.

DTRS noted that, while the United States' Government has provided direct support of $3.46 billion to its six largest airlines since 11 September 2001, the Australian Government does not provide financial support to Australian international airlines.

DTRS submitted that the Australian domestic aviation industry has also been reshaped with the collapse of Ansett. DTRS submitted that Ansett's collapse has impeded access to feeder traffic for competing international carriers, in particular, the Star Alliance. DTRS also noted that Virgin Blue has entered the Australian domestic market.

DTRS noted that Qantas has not been immune to disruptions in the aviation market with downgraded profit forecasts and staff reductions; however, it said that Qantas remains one of the few international carriers to remain consistently profitable in the current downturn.

DTRS submitted that consolidation of the airline industry and the expansion of airline alliances has been a feature of the industry since the late 1980s. DTRS submitted that it is likely that the trend of holding equity in partner airlines is likely to continue as part of the continuing globalisation of the world economy and as pressure on the aviation sector continues.

DTRS submitted that the Australian Government's international aviation policy aims to increase competitive pressure on international routes in order to provide reasonably priced access to major trading partners and to avoid potential monopolies exploiting dominant positions on crucial international routes. DTRS submitted that a key element of the policy has been the trading of fifth freedom intermediate and beyond rights. DTRS submitted that the policy is primarily being implemented through liberalisation of the bilateral system and, where possible, pursuing a liberalised agenda in multilateral fora such as the Asia-Pacific Economic Cooperation (APEC), the International Civil Aviation Organisation (ICAO), the Organisation for Economic Cooperation and Development (OECD) and the General Agreement on Trade in Services (GATS). DTRS submitted that Australia also seeks liberalised outcomes with bilateral partners through open skies agreements. DTRS noted that currently Australia's only open skies agreement is with New Zealand.

DTRS submitted that there are currently nine carriers flying the Kangaroo Route. DTRS submitted that, apart from Qantas, BA and Lauda Air, these carriers are based in intermediate points (in the Middle East or Asia). DTRS submitted that, over the last decade, most European carriers have departed the route (Alitalia, Lufthansa, KLM, Olympic and Air France/AOM have ceased operating services to Australia).

DTRS submitted that over 30 airlines service the Kangaroo Route, with the majority of those serving the route using interline agreements with other airlines operating services to Australia from Asian collection and distribution points such as Singapore, Hong Kong, Bangkok and Kuala Lumpur.

DTRS submitted that the Australian Government believes that there is a substantial public benefit in having a strong Australian based aviation industry which is able to compete in the international market.

DTRS submitted that the Australian Government encourages the entry of new carriers to the Australian market and has reduced foreign ownership restrictions for Australian based international airlines. DTRS submitted that ownership restrictions for domestic airlines have been significantly liberalised.

DTRS submitted that it accepts that the JSA enables Qantas and BA to provide an increased level of services to their customers. DTRS submitted that the JSA helps facilitate access from a broad range of European ports through BA's European network; however, it noted that the presence of third country carriers in Asia and the Middle East as well as routes via Africa and the Pacific provides alternative access to a wide range of ports in Europe.

DTRS submitted that the JSA will continue to create cost savings and efficiencies which enable capital, personnel and equipment to be transferred to other markets or for other purposes. DTRS submitted that competition on the Kangaroo Route from other carriers provides downward pressure on fares, encouraging savings to be passed on to consumers.

DTRS submitted that anecdotal evidence suggests that prices have consistently reduced in real terms over the last 30 years and that technological improvements, reduced regulation and competition have played a role in this. DTRS said that it difficult to attribute lower fares to specific factors such as the JSA. DTRS submitted that, in the absence of the JSA, it is likely that competition would continue downward pressure on ticket prices.

DTRS submitted that, in the absence of the Commission identifying significant alternative economic benefits, a decision not to renew the JSA would have a negative impact on net exports and employment.

DTRS submitted that marketing of Australia as a destination for European travellers undertaken by Qantas may decline should reauthorisation of the JSA be denied and that it is unlikely that foreign competitors would increase spending market Australia. DTRS submitted that this may lead to a decline in tourism growth.

DTRS submitted that it is of the view that unutilised capacity under existing bilateral agreements and expansion by foreign carriers offers scope for continued and, possibly, growing competition.

In relation to barriers to entry, DTRS submitted that the JSA enables the Australia's existing bilateral agreements provide significant opportunities for airlines from third countries to enter the Australia market and that a substantial amount of available capacity on the Kangaroo Route remains unutilised. DTRS also submitted that there is no barrier to new or existing market participants developing arrangements similar to the JSA (subject to Commission approval).

DTRS submitted that despite the level of market share enjoyed by the JSA partners, their position is not dominant and their total market share remains at less than 50 per cent.

DTRS submitted that it agrees with the Applicants' contention that the synergies between Qantas and BA as a result of the JSA have led to decreased delays and improved connections. DTRS submitted that it is not clear to what extent competitors would pick up any reduction in services by the Applicants should the JSA not be reauthorised.

DTRS submitted that it may be appropriate for the Commission to consider the implications of the lack of competition in the domestic business class market segment for international business class travel.

DTRS submitted that there is little evidence to suggest that the renewal of the JSA would significantly extend Qantas and BA's market power.

Hobart International Airport Pty Ltd

Hobart International Airport Pty Ltd (Hobart Airport) submitted that, in its consideration of the Applications, the Commission should consider the following points:

- the lower the fares available for international outbound travel, the greater the possibility that discretionary travel expenditure will be attracted away from domestic markets, at least inbound tourism in respect of Tasmania;

- a greater number of international destinations and broader schedule choices, if proven, may have a similar effect;

- on the other hand, the lower the fares available for international inbound travel, the greater the possibility that discretionary travel will be drawn to Australia. However, the benefit in this for Tasmania and Hobart depends on there being a domestic flow-on to Tasmania and Qantas is in a position to assist with such a flow-on;

- cost savings and efficiencies imply flow-on effects of those savings and efficiencies – there is the opportunity for some of those savings and efficiencies to be distributed to the Applicants' supply to Tasmania and Hobart;

- Tasmania and Hobart's experience of the downturn in competition and supply with the demise of Ansett demonstrated how important these two aspects of connection to the mainland are, however, Hobart Airport is not in a position to comment on whether, or how, domestic competition would be affected by the approval of the Applications;

- the Applicants' submission referred to increased promotional expenditure on tourism – this will only be of value to Tasmania and Hobart to the extent that such expenditure is applied effectively in respect of Hobart and Tasmania;

- Hobart Airport would be interested to ensure that the Applicants' proposal does not make any negative change in travellers' ability to make discretionary choices about how they travel to and from Tasmania and Hobart; and

- the Applicants' submission is silent on whether or nor resources will be redistributed away from other markets to achieve the outcomes in the Applications. It would be of concern to Tasmania and Hobart if they were, particularly for the possible suppression of prospects to grow supply if and when required.

New South Wales' Premier's Department

The New South Wales Premier's Department made a submission on behalf of the New South Wales Government (NSW Govt).

The NSW Govt submitted that it supports reauthorisation of the JSA.

The NSW Govt submitted that the Australia-UK route is a key route for Australia and NSW, that Qantas and BA are sound airlines and that the JSA guarantees continued service for the nation. The NSW Govt submitted that the JSA strengthens the two main carriers and guarantees a high quality reliable service.

The NSW Govt submitted that, while there are competition arguments for discontinuing the JSA, these are outweighed by the argument that it is important for Australian business, tourism and general travellers to have access to reliable and financially sound air services to the UK and Europe.

The NSW Govt submitted that continuation of the JSA will help to moderate adverse employment impacts in Qantas in the uncertain aviation market.

The NSW Govt submitted that tourism is a major economic activity in Australia and that the JSA enhances tourism opportunities in Australia from a wider international market. The NSW Govt submitted that the JSA supports the critical mass of the airlines to enable them to compete in a broader international market to the benefit of business and tourism for Australia.

The NSW Govt submitted that the sustainability and profitability of international airlines is threatened in the current aviation market and that the JSA appears to achieve access to a reliable air transport service. The NSW Govt submitted that there is no clear evidence that the termination of the JSA will improve competition or meet appropriate air transport needs.

Queensland Government Aviation Steering Committee

The Queensland Government Aviation Steering Committee (Qld Govt) submitted that the JSA will *prima facie* continue to deliver net public benefits on the Kangaroo Route.

The Qld Govt submitted that the JSA effectively assists in mitigating the competitive disadvantages that the Applicants face by improving hub economies at mid-points.

The Qld Govt submitted that, given that there are 13 airlines that provide services on the Kangaroo Route (and a further 13 that operate on code share arrangements) and that the benchmark economy fare is lower today than it was in May 1995, it appears that the JSA is not having any detrimental impact on competition on the Kangaroo Route.

The Qld Govt submitted that its support is predicated on the fact that UK and European markets are significant generators of visitation and economic benefits to Australia representing 22 per cent of total visitor arrivals.

The Qld Govt also submitted that it supports the continued increase of airline services and increased presence from a range of mid-point carriers on the Kangaroo Route but wished to note that the authorisation of the JSA will ensure that Australia continues to benefit from the hub and spoke efficiencies and significant brand and marketing presence of BA in the UK and European markets. The Qld Govt submitted that this has the effect of drawing large traffic volumes from a range of European destinations to Australia on Qantas and BA services.

The Qld Govt submitted that there are sub-national consequences of reauthorisation of the JSA and that the ‘public’ should be considered as an aggregate of these sub-national areas as well as the nation as a whole.

The Qld Govt submitted that, should the JSA not be reauthorised, there is likely to be a reduction in the frequency and/or capacity of daily services to Brisbane and that such a reduction will have an adverse impact on tourism and economic development in Queensland.

The Qld Govt submitted that the Applicants should provide an analysis detailing the quantum of regulatory costs they would potentially incur should renewal of the JSA be of a shorter term.

The Qld Govt submitted that, while the Applicants seek an indefinite term for the authorisation of the JSA, the Commission should periodically revisit this issue to ensure that public benefits are maintained.

Skywest Airlines Pty Ltd

Skywest Airlines Pty Ltd (Skywest) is a regional airline in Western Australia and participates in the Qantas Frequent Flyer Program and offers through-check arrangements with Qantas.

Skywest submitted that it strongly supports reauthorisation of the JSA on the following grounds:

- Skywest customers benefit from the continued provision of high quality international air services with convenient links to the global networks of both Qantas and BA through BA's code share arrangements on Qantas JSA services to Perth;

- without the JSA, rationalisation of secondary JSA routes would appear likely, with Perth services a prime candidate for rationalisation. Skywest customers and the broader Western Australian economy would suffer as a result; and

- as a result of frequent flyer and through-check arrangements, Skywest customers benefit from its affiliation with Qantas and, to the extent that continuation of the JSA will ensure a strong, viable future for the Qantas group, Skywest customers will continue to enjoy these benefits into the future.

Tourism Tasmania

Tourism Tasmania submitted that it supports the renewal of the JSA given the importance of the UK and Europe as source markets for visitors to Tasmania and on the basis that greater levels of passenger capacity, schedule flexibility and airline choice linking Europe to Australia engender increased price competition and greater consumer choice.

VIP Logistics Pty Ltd

VIP Logistics Pty Ltd (VIP Logistics) submitted that, since 1996, the international aviation industry has suffered three major setbacks: the terrorist attacks on 11 September 2001; the Iraq war; and SARS. VIP Logistics submitted that the markets relevant to the JSA have been affected by these setbacks.

VIP Logistics submitted that, despite the downturn in the aviation industry, competition on the Australia-Europe route remains active.

VIP Logistics submitted that it supports reauthorisation of the JSA.

Virgin Atlantic

Virgin Atlantic expressed concerns in relation to the JSA as it effectively acts as a barrier to entry to the Europe-Australia, Europe-South East Asia and South East Asia-Australia markets for carriers such as Virgin Atlantic.

Virgin Atlantic submitted that the anti-competitive effects of the JSA are not outweighed by the public benefits and that, as such, the application for authorisation should be rejected by the Commission.

In particular, Virgin Atlantic submitted that:

- its preference is to operate services to Australia as extensions of the existing UK-Hong Kong service, however, the current UK-Hong Kong ASA prevents UK carriers from flying passengers to Australia via Hong Kong; and
- even if the UK-Hong Kong ASA is amended to enable Virgin Atlantic to continue its Hong Kong services to Australia, the only way it will be able to mount a viable operation is if either the JSA is not re-authorised by the Commission or if terms and conditions are attached to its re-authorisation in order to re-establish effective competition.

Relevant markets

Virgin Atlantic submitted that the markets that are affected by the JSA are Europe-Australia markets, Europe-South East Asia markets and South East Asia-Australia markets. Virgin Atlantic submitted that within each of these geographic areas are markets which are differentiated according to origin and destination and purpose of travel.

Virgin Atlantic submitted that every origin and destination pair constitutes an economically distinct product and that travellers are generally not prepared to substitute another destination when faced with an increase in price. Further, Virgin Atlantic submitted that a distinction has to be made between different types of passengers – for example, time sensitive passengers.

Virgin Atlantic further submitted that Heathrow is a separate market, particularly for time sensitive passengers, and that Heathrow is also preferred by many non-time sensitive passengers due to the large number of services provided to many destinations by many competing carriers.

Barriers to entry

<u>ASA restrictions</u>

Virgin Blue claimed that, in addition to restrictions imposed on it by way of the current form of the UK-Hong Kong ASA, market entry is also restricted by a number of other ASAs including:

- the UK-Japan ASA and UK-People's Republic of China (PRC) ASA prevent UK carriers from carrying passengers between Japan and Australia and the PRC and Australia; and

- the UK-Singapore ASA restricts the number of people that UK carriers can pick up in Singapore and fly to Australia and BA is currently using almost all of the rights pertaining to the carriage of such passengers.

While the UK-Thailand ASA allows UK carriers to fly between Thailand and Australia and pick up passengers in Thailand (BA is not currently using all of the rights pertaining to such passengers) and, similarly, the UK-Malaysia ASA allows UK carriers to fly between Malaysia and Australia and pick up passengers in Malaysia (no UK airline is currently providing services between Malaysia and Australia or between the UK and Australia), Virgin Atlantic is currently not operating services to/from Bangkok or Kuala Lumpur and would need to commence services to these destinations from London (and, in particular, Heathrow).

Airport capacity constraints

Virgin Atlantic submitted that Heathrow is effectively full due to runway constraints that exist at almost all times of the day. Virgin Atlantic submitted that this means that incumbents and new entrants cannot significantly increase their provision of services to and from Heathrow by scheduling new services and providing any additional services to one destination almost invariably involves reducing services to another.

Contribution of time sensitive passengers to route viability

Virgin Atlantic submitted that securing a substantial proportion of time sensitive passengers is crucial to the commercial success of a carrier's operations as it ensures that the substantial fixed costs inherent in the provision of services are recovered over the course of economic cycles given that these passengers are higher yield.

Virgin Atlantic submitted that Qantas and BA carry the most passengers travelling for business purposes between London and Australia and are also the largest carrier of such passengers in all business markets, with the exception of the London-Perth market.

Flight frequency

Virgin Atlantic submitted that the frequency of flights in a market provided by a carrier itself or via code-sharing on services operated by other carriers is important to time sensitive passengers in particular when choosing a carrier as it guarantees flexibility.

Virgin Atlantic submitted that Qantas and BA offer the most frequent service between London and Australia and that Qantas and BA offer the most frequent service in all London-Australia city pair markets with the exception of the London-Brisbane market.

Airport presence

Virgin Atlantic submitted that the larger a carrier's slot holding (and hence airport presence), the greater the level of market power it enjoys in markets where this airport is an endpoint due to greater operational flexibility, greater financial flexibility and increased attractiveness of loyalty programs.

Virgin Atlantic submitted that in August 2001, BA held 30 per cent of slots at Heathrow, with 2.5 times the number of slots held by the next largest slot holder (bmi British Midland) and ten times the number of slots held by the third largest slot holders (Aer Lingus and Lufthansa). Virgin Atlantic submitted that it held just over two per cent of slots. Virgin Atlantic submitted that the **one**world alliance (of which Qantas and BA are members) held 47.4 per cent of all slots.

Loyalty programs

Virgin Atlantic submitted that several studies have examined the link between frequent flyer programs and market power and found that both membership of a carrier's frequent flyer program and increased airport presence increased an employee's valuation of that carrier's services.

Virgin Atlantic submitted that Qantas operates Australia's largest frequent flyer program and that BA operates Europe's largest frequent flyer program. Virgin Atlantic submitted that these programs encourage corporations to enter into corporate deals with Qantas and BA as they are attractive to employees. Virgin Atlantic further submitted that being able to attract the business of corporations is crucial to the success of a carrier's operations in the type of city pair markets in which Qantas, BA and Virgin Atlantic operate, given that these firms purchase the majority of higher yield tickets.

Virgin Atlantic also submitted that carriers are able to encourage loyalty via the computer reservation systems travel agents use to find out fare, route and departure time information and to make bookings. Virgin Atlantic submitted that US studies have indicated that, for any city pair market, the majority of bookings are made from the first screen of the display and that a substantial proportion of these bookings are made on flights listed on the first few lines of the first screen.

Feed traffic

Virgin Atlantic submitted that, where the volume of direct traffic alone will not make operations commercially viable, improved feed increases a carrier's market power by increasing the commercial viability of a route through increased loads and revenue and, where greater loads permit more frequent service, average yield earned on the route will increase due to the existence of the "s-curve effect".

Virgin Atlantic submitted that, given that Virgin Blue essentially does not interline, Qantas is the only potential provider of domestic feed in Australia.

Abuse of a dominant position

Virgin Atlantic submitted that, where a carrier is in a dominant position, it can use its operational and financial flexibility, loyalty programs and interline agreements to compete unfairly. Virgin Atlantic submitted that carriers may do this by engaging in predatory behaviour (such as capacity dumping) or by using financial flexibility to price below cost. Virgin Atlantic submitted that Qantas and BA currently use their operational and financial flexibility to compete unfairly in the Europe-Australia, Europe-South East Asia and South East Asia-Australia markets.

Virgin Atlantic submitted that by "tying" the reward received for directing business to it in markets in which it faces little or no competition to markets in which it faces substantial competition, a carrier in a dominant position is able to compete unfairly in the latter markets. Virgin Atlantic submitted that it can do this by either explicitly tying different geographic markets together or by tying the reward received to total spend across its route network and raising qualifying threshold levels beyond the level of business undertaken in the markets in which the carrier faces substantial competition. Virgin Atlantic submitted that in 1999 the European Commission found that BA had acted in this manner in its dealings with travel agents.

Virgin Atlantic submitted that Qantas and BA are also currently able to use their loyalty programs to compete unfairly in Europe-Australia, Europe-South East Asia and South East Asia-Australia by leveraging the dominant position they enjoy in many UK domestic, other European and Australian domestic markets.

Public benefits

Virgin Atlantic submitted that it is extremely unlikely that there are substantial cost savings associated with the JSA and that JSA reduces competition and affords Qantas and BA substantial market power in the relevant markets.

No returns to scale

Virgin Atlantic submitted that studies have shown that there are constant returns to scale in the provision of air transport services and that there are no reductions in unit costs associated with getting bigger.

No reductions in overheads

Virgin Atlantic submitted that, given that both Qantas and BA's management has been retained, it is difficult to see how the JSA has reduced overhead costs.

Reduced competition

Virgin Atlantic also submitted that it is difficult to see how the JSA has produced benefits such as lower fares and increased tourism given that it reduces competition in the relevant markets.

Virgin Atlantic submitted that, given that not re-authorising the JSA will increase competition and lower prices, increase output and improve service quality in the relevant markets, not re-authorising the JSA should not result in a reduction in foreign nationals carried by Qantas or a loss of export earnings as claimed by the Applicants.

Similarly, it is difficult to see why not re-authorising the JSA would lead to a net loss of jobs by Australians.

Virgin Atlantic further submitted that it is difficult to see how the JSA has a positive effect on Qantas' international competitiveness as protecting airlines does not enhance competitiveness.

Appropriate conditions

Virgin Atlantic submitted that, should the Commission be minded to grant authorisation for the JSA, appropriate conditions may include:

- conditions relating to airport access, particularly at Heathrow Airport, Sydney's Kingsford Smith Airport, Melbourne (Tullamarine) Airport, Brisbane Airport and Perth Airport, together with access to facilities such as terminal space, check-in desks, gates and aircraft parking areas;
- conditions relating to frequent flyer programs, such as a commitment to grant full access to Qantas' and BA's frequent flyer programs to any competitor seeking such access, on equal terms to those available to any other participant;
- a condition to ensure that Qantas and BA provide interline fares to competitors at rates no less favourable to those charged to each other;
- conditions relating to computer reservations systems to ensure that Qantas and BA do not bias on screen displays, including by screen padding; and
- conditions relating to travel agent and corporate deals, including that Qantas and BA should agree not to abuse the dominant position they have in the relevant markets by entering into arrangements with travel agents or corporations whereby sales are "tied".

Virgin Atlantic also submitted that any authorisation should be limited with respect to time.

Virgin Atlantic also submitted that it assumes that since re-authorisation of the JSA will require the approval of both the Commission and the UK Office of Fair Trading, a consensus will have to be reached on the remedies to be applied.

Further submissions

The Commission met with Virgin Atlantic on 29 September 2003. Virgin Atlantic made an oral submission to the Commission at that time. Points raised at this meeting are discussed throughout the remainder of this draft determination.

A record of this meeting is also available on the Commission's public register.

Virgin Atlantic made a second written submission to the Commission on 3 November 2003 in response to the Applicants' Response to Submissions.

A summary of Virgin Atlantic's second written submission follows.

In relation to the Applicants' claims disputing that Heathrow is a distinct market, Virgin Atlantic submitted that:

- the relevant markets for analysis are city pair markets because travellers generally want to travel to a specific destination and will not substitute another destination if price increases;
- the fact that passengers travelling between Europe and Australia have available to them different routeings does not mean that the cities via which they travelled are in the same market as the origin or destination city. Similarly, the fact that passengers originating their journey in Australia visit multiple destinations within Europe does not mean that these destinations are in the same market;
- carriers offering connections from London to other European destinations are not competing in Australia-Europe city pair markets and do not set the terms and conditions of any prorate agreement entered into according to demand in these markets; and
- Heathrow is a separate market for both time sensitive and non-time sensitive passengers and the fact that these flights are extremely long haul does not alter this conclusion.

In relation to barriers to entry, Virgin Atlantic submitted that:

- the JSA has had a profound effect on the entry into and expansion within the relevant markets of Qantas and BA's competitors and hence on competition;
- should Virgin Atlantic be granted the right to fly to Australia via Hong Kong, their chances of success would be greatly improved if the JSA was not reauthorised or if terms and conditions were attached to the JSA such that effective competition is established in the relevant markets. Even then, a level playing field would not exist because, for example, BA enjoys the greatest presence at Heathrow which in turn allows it to induce the loyalty of loyalty programme participants; and
- it is not be the case that barriers to entry apply more to carriers based at the end of routes than at the mid-points – even if a carrier has the rights to provide services in the relevant markets, their entry and expansion in these markets depends on its slot portfolio at Heathrow.

In relation to market share, Virgin Atlantic submitted that:

- the relationships between relative market share and market power and between relative market power and barriers to entry are well understood and have been endorsed by the European Commission;[49] and

- contrary to the assertions by Qantas and BA, the CAA's *Passenger Survey* data is useful because it provides data on what passengers do, rather than the services that airlines provide. MIDT data advocated by Qantas and BA excludes information on tickets not transacted via Global Distribution Systems such as tickets transacted by travel agents or airlines through BA's former booking system or current system or through the booking system that Virgin Atlantic uses. It also excludes tickets purchased over the phone through airlines and other airlines' reservation departments or Internet sites.

In relation to ASA restrictions, Virgin Atlantic submitted that:

- the barriers to entry resulting from ASA restrictions apply more to other carriers than to Qantas and BA; and

- while it hopes that the Hong Kong Government will grant UK carriers the right to operate to Australia via Hong Kong, there is no guarantee that they will do so.

In relation to Qantas and BA's claim that Virgin Atlantic could serve London-Australia markets in conjunction with Virgin Blue, Virgin Atlantic submitted that it and Virgin Blue are entirely separate companies and it therefore has no control over Virgin Blue's actions.

In relation to airport capacity constraints, Virgin Atlantic submitted that:

- the fact that slots are available at other airports in London outside of Heathrow is irrelevant given that Heathrow is a separate market;

- redeploying slots is likely to be easier for Qantas and BA than for other carriers given that they hold 38.4 per cent of slots;

- Qantas and BA's suggestion that other carriers could provide services to Australia via slot redeployment would also reduce competition in the market the slots were formerly used to serve;

- despite the existence of a "grey" market for slots at Heathrow and a willingness by Virgin Atlantic to pay market price for viable slots, it still only has just over two per cent of total slots at Heathrow; and

- historical users of slots such as Qantas and BA have obtained the vast majority of their slot holdings for free and they are able to combine less commercially attractive slots (with a lower price tag) with existing slots to produce more attractive slot combinations.

In relation to loyalty programs, Virgin Atlantic submitted that:

[49] Virgin Atlantic refer to the European Commission (1980), *Xth Report on Competition Policy*.

- BA's comments that loyalty programs do not create barriers to entry differ markedly from BA's submission to the Canadian authorities in connection with the acquisition of Canadian airlines by Air Canada; and

- loyalty programs induce participant loyalty to the largest provider of services at the airport closest to the participant with the required degree of choice because the greater the frequent flyer points, commissions or discounts are offered, the more business will be transacted with a particular carrier.

In relation to the Applicants' submission that Virgin Blue could provide feed for international services to Virgin Atlantic, Virgin Atlantic submitted that:

- Virgin Blue only has interlining agreements with one airline, United Airlines (United);

- interlining between United and Virgin Blue occurs manually and there is no interface between the two carriers' computer systems;

- Virgin Blue will only accept feed where it does not adversely affect its existing operations; and

- Virgin Blue is not able at present to provide the sort of interlining options required by passengers arriving or departing on international services, particularly in relation to those required by time sensitive passengers.

In relation to the Applicants' comments regarding returns from scale and density, Virgin Atlantic submitted that cost savings associated with economies of traffic density will only be passed on to consumers (rather than absorbed by factors of production) if Qantas and BA face effective competition in the relevant markets. Virgin Atlantic submitted that the announcement of substantial cost cutting programs by Qantas recently suggests that any cost savings have been absorbed throughout the existence of the JSA.

In relation to Qantas and BA's submissions regarding reductions in overheads, Virgin Atlantic submitted that it is difficult to see how the JSA has resulted in a reduction in overheads given that both Qantas and BA have maintained individual management and some form of management team must oversee the JSA.

Virgin Blue

Virgin Blue submitted that it is of the view that the analysis provided by the Applicants in relation to the anti-competitive detriment and public benefits of allowing continuation of the JSA is inadequate.

Virgin Blue submitted that the Applicants failed to properly analyse the anti-competitive effects of the JSA in the Australian domestic trunk and regional markets as they have not had regard to the extent to which Qantas takes advantage of its market power in markets for the provision of international air services between

Australia and its position as the only provider of these services who also provides domestic trunk and regional services in order to lessen the ability of its competitors in domestic trunk and regional air services markets to compete.

Virgin Blue submitted that Qantas takes advantage of its position by offering discounts to customers where they acquire their regional, domestic trunk and international air services requirements from Qantas ('bundling'). Virgin Blue submitted that bundling has the practical effect of making it commercially unfeasible for customers to purchase the domestic trunk and regional services of Qantas' competitors. Virgin Blue submitted that the JSA significantly increases Qantas' ability to engage in this conduct which has detrimental effects on the ability of Virgin Blue and Regional Express to compete with Qantas.

Virgin Blue submitted that the majority of public benefits claimed by the Applicants are either private benefits accruing to Qantas and BA (to which less weight should be given) or are greatly overstated.

Virgin Blue submitted that the Applicants have not established a sound basis upon which authorisation could be granted by the Commission.

Virgin Blue submitted that, if the Commission were minded to reauthorise the JSA, it should only do so:

- for a limited period; and
- where Qantas provides undertakings to the Commission that it will refrain from offering any discount or benefit to customers where they acquire their international, regional and domestic trunk air services requirements from Qantas.

Hon Alannah MacTiernan MLA, Minister for Planning and Infrastructure (WA)

The Hon Alannah MacTiernan MLA (WA Minister for Planning and Infrastructure) made a submission to the Commission on behalf of the Western Australian Government (WA Govt).

The WA Govt submitted that, in the interests of stability and airline sustainability, it supports the reauthorisation of the JSA.

The WA Govt submitted that the JSA enables Qantas and BA to maintain a strong working relation which allows them to compete more effectively in the current volatile global aviation environment.

The WA Govt submitted that it advocates arrangements similar to the JSA being viewed favourably by the Commission, should other carriers wish to adopt similar models.

The WA Govt submitted that it is vital that airfares remain affordable and accessible in the major inbound markets of UK/Europe to ensure that strong competition is achieved and that there is currently strong competition to the JSA in all relevant markets through a range of carriers, particularly from South East Asian carriers.

The WA Govt submitted that it does not support reauthorisation of the JSA for an indefinite period and is of the view that any authorisation should be subject to review after a further three year period.