



**Australian  
Competition &  
Consumer  
Commission**

# **Determination**

## **Applications for Authorisation A30220, A30221, A30222, A90862 and A90863**

**Acquisition by Qantas Airways Limited of ordinary  
shares in Air New Zealand Limited and cooperative  
arrangements between Qantas, Air New Zealand and Air  
Pacific Limited**

**Date: 9 September 2003**

**Authorisation No:**

A30220  
A30221  
A30222  
A90862  
A90863

**Commissioners:**

Samuel  
Martin  
Bhojani  
Willett  
McNeill

**Public Register:**

C2002/1775

## Executive Summary

On 9 December 2002, Qantas Airways Limited (“Qantas”) and Air New Zealand Limited (“Air NZ”) made applications for authorisation to the Australian Competition and Consumer Commission (“the Commission”) for conduct which may constitute an exclusionary provision within the meaning of the *Trade Practices Act 1974* (“the Act”), conduct which may substantially lessen competition, and for the acquisition of shares.

The applications specifically 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.

On 20 December 2002 the Commission received further applications for authorisation from the Applicants in respect of a “Cooperation Agreement” with Air Pacific Limited (“Air Pacific”) for conduct which may constitute an exclusionary provision within the meaning of the Act and conduct which may substantially lessen competition.

In assessing applications for authorisation, the Commission is required to apply certain tests set out in the Act. Essentially, these tests require that the Commission only grant authorisation if it is satisfied that, in all circumstances, the arrangements are likely to result in a benefit to the public and that the benefit would outweigh the detriment to the public constituted by any lessening of competition that results from the arrangements.

The Act also sets out specific criteria that the Commission must have regard to when undertaking its assessment of proposed acquisitions such as the Applicants’ Equity Proposal.

### *The Applicants’ submission*

The Applicants submitted that the Proposed Arrangements are likely to result in a net benefit to the public. Their submission relied heavily on econometric modelling to support this proposition and the net benefit to Australia was estimated to be in the range of \$680 million over five years. The majority of this benefit flowed from claims of increased tourism to Australia and cost efficiencies.

Other sources of public benefit claimed by the Applicants included scheduling efficiencies, improved freight operations, increased international competitiveness of Australia’s aviation industry, preservation of a commercially viable full service Australasian airline and furtherance of the national interest.

The Applicants submitted that, while there is some scope for the Proposed Arrangements to result in some limited anti-competitive detriment, the arrangements would result in substantial net benefits overall.

#### *Submissions from third parties*

The Commission sought comment from interested parties and received submissions from individuals and organisations including airline operators, trade associations, and Commonwealth and state government departments.

#### *Draft Determination*

On 10 April 2003 the Commission issued a Draft Determination proposing to deny authorisation to applications A30220, A30221, A30222 A90862 and A90863. The Commission considered that the highly anti-competitive effects of the Proposed Arrangements would significantly outweigh the low public benefits flowing from the Proposed Arrangements. Undertakings proposed by the Applicants were regarded as being unlikely to impact the outcome.

In response to the Draft Determination the Applicants submitted material in support of their assertion that the Commission's conclusions were incorrect and also offered revised undertakings directed towards the Commission's concerns about new entry and anti-competitive effects. A small number of submissions were received from interested parties with only one effectively questioning the Commission's Draft Determination.

#### *The Commission's view on anti-competitive detriment*

The Commission has formed the view that the Proposed Arrangements between Qantas and Air NZ are 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.

The trans-Tasman route passenger market, where the Applicants currently have a joint share of around 90 per cent, would be particularly vulnerable to the Proposed Arrangements. The Commission acknowledges that Virgin Blue has now been confirmed as entering the trans-Tasman market in the near future. However, the extent to which Virgin Blue might be able to be regarded as a competitive constraint to the Applicants under the Proposed Arrangements will depend on the scale and timing of its entry and expansion, the routes on which it operates, and the market's response to its entry.

Regardless of Virgin Blue's entry, the Proposed Arrangements will substantially reduce competition between network carriers on the trans-Tasman route and will impact on choice and price for travellers preferring or requiring network carrier service such as long haul international travellers and business travellers. The Commission does not believe that, at this stage, fifth freedom carriers such as Emirates, can be regarded as a permanent feature of the trans-Tasman market (they can leave the market as quickly as they enter it) or have the same flexibility in competition as an incumbent operator.

The Commission also considers that the Proposed Arrangements would be significantly anti-competitive in the trans-Tasman freight market. In an environment of reducing freight capacity, the Proposed Arrangements would exacerbate pressure on freight rates to the detriment of Australian exporters, importers and consumers.

The Proposed Arrangements would also give rise to substantial anti-competitive detriment in the Australian domestic air transport passenger market by enhancing the market power of Qantas and acting as a barrier to entry to new entrant airlines.

The Commission would note that its assessment of anti-competitive detriment has been made at a time when the aviation industry and individual markets are subject to rapid change and development. The Commission recognises that if this rate of change was to continue it is possible that the Commission could, on a later occasion, reach a different conclusion as to the level of anti-competitive detriment in a market such as the trans-Tasman. The Commission also recognises that changing circumstances may also mean that the Commission could, at some point in the future, come to a conclusion in relation to public benefit that differs from that discussed below.

#### *The Commission's view on public benefit*

The Commission has substantial reservations about the extent of public benefit claimed to arise from cost efficiency savings. Any such savings are more likely to accrue to shareholders (with around 50 per cent of Qantas' equity foreign owned) than consumers in an environment of reduced competition. While there may be some public benefits to consumers from scheduling changes, these are likely to be minor.

The Commission also has substantial doubts over the benefits of proposed new direct services if they could not be introduced absent the Proposed Arrangements, given their questionable viability and given the limited frequencies involved. An undertaking offered by the Applicants to commit to the new services for one year was conditional on load factors and yields being achieved at levels satisfactory to the Applicants.

The Commission is not satisfied that the Proposed Arrangements will lead to increased tourism given that they are expected to result in higher prices and reduced capacity. The Commission therefore does not recognise more than a marginal public benefit from increased tourism.

The Commission does not find a public benefit flowing from the Proposed Arrangements to the extent that they propose dedicated freight only services. The Commission does not believe these services are viable at current freight rates (otherwise they would be offered absent the Proposed Arrangements).

Given the already strong position of Qantas relative to other international airlines and taking into account the little that Air NZ brings to the Proposed Arrangements, the Commission believes the Proposed Arrangements would only result in a benefit of marginally increased global competitiveness for Qantas. The Commission is similarly not satisfied that there is a national interest benefit associated with the Proposed Arrangements proceeding.

After taking into account all claims, considering all submissions and following careful analysis, the Commission does not find that the Proposed Arrangements give rise to public benefits of significance.

*Balance of anti-competitive detriment and public benefit*

Having regard to the foregoing the Commission considers that the highly anti-competitive effects of the Proposed Arrangements identified by the Commission would substantially outweigh the low public benefits accepted by the Commission as flowing from the Proposed Arrangements.

The Commission has carefully considered undertakings offered by the Applicants in relation to access to facilities and a capacity ceiling. Given that Virgin Blue is entering the trans-Tasman market such undertakings are now directed more towards the rate of entry of Virgin Blue than the possibility of entry. The Commission considers that the scale of anti-competitive detriment would not be significantly reduced if the undertakings resulted in a faster rate of entry by Virgin Blue.

Undertakings intended to reduce anti-competitive detriment associated with reduced competition by using capacity ceilings and price caps to protect consumers from higher prices are considered by the Commission to be largely ineffective and to not reduce detriment. Undertakings in relation to public benefits, such as commitments to new services, were taken into account by the Commission when assessing public benefit.

In summary the Commission is of the view that the gap between anti-competitive detriment and public benefits likely to flow from the Proposed Arrangements is substantial and would not be significantly reduced by the undertakings offered by the Applicants.

The Commission therefore denies authorisation to applications A30220, A30221, A30222, A90862 and A90863.

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## Glossary<sup>1</sup>

A30202	Commission determination in respect of the RJSA between Qantas and BA, 10 May 2000
A90408	Commission determination in respect of the IATA Passenger Agency Program, 13 November 2002
A90565	Commission determination in respect of the JSA between Qantas and BA, 12 May 1995
A90649 and A90655	Commission determination in respect of Ansett Australia, Ansett International, Air NZ and Singapore Airlines, 22 July 1998
AAA	Australian Airports Associated Limited
ABTA	Australasian Business Travel Association
ACA	Australian Consumers Association
Act	<i>Trade Practices Act 1974 (Cth)</i>
ACTU	Australian Council of Trade Unions
AFCQ	Air Freight Council of Queensland
AFIF	Australia Federation of International Forwarders Ltd
AIPA	Australian and International Pilots Association
Air NZ	Air New Zealand Limited
Air Pacific	Air Pacific Limited
alliance	An agreement between airlines to cooperate in the provision or operation of some of their services on a route, or on a regional or global basis
Alliance	The conduct encompassed by the Strategic Alliance Proposal, the Cooperation Agreement and the Equity Proposal
AMWU	Australian Manufacturing Workers' Union
Ansett	Ansett Holdings Limited
Ansett International	Ansett International Limited
Applicants	Qantas Airways Limited and Air New Zealand Limited

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<sup>1</sup> A number of the following definitions have been sourced from Productivity Commission (1998), *International Air Services: Inquiry Report*, Commonwealth of Australia: Canberra.

Applications	Applications for authorisation A30220, A30221, A30222, A90862 and A90863
ASX	Australian Stock Exchange
ATC	Australian Tourist Commission
ATEC	Australian Tourism Export Council
available seat kilometres	The total number of seats offered multiplied by the distance flown, used as a measure of air transport passenger capacity
BA	British Airways Plc
BAC	Brisbane Airport Corporation Ltd
belly hold	The cargo hold underneath an aircraft
blocked space agreement	The purchase by one carrier of a block of seats from another carrier for resale to passengers directly
Bodas	The New Zealand Commerce Commission Decision No.278 in respect of a business acquisition proposal involving Air NZ, Ansett and Bodas Pty Ltd, 3 April 1996
Brierley	Brierley Investments Limited
BVM	Bon Voyage Marketing Ltd
cabotage	Provision of commercial domestic air services within a country. Cabotage rights are classified as either consecutive cabotage (the right of foreign-owned airline(s) to fly a domestic flight stage within the host country as a continuation of an international service) or standalone cabotage (the unrestricted right of foreign-owned airline(s) to provide domestic air services in the host country)
CGE	Computable general equilibrium
city pair	An air route between two cities
code sharing	The assignment of one airline's designator code (for example, QF for Qantas) to a flight operated by another airline
Combined Submission	Submission lodged on behalf of six separate interested parties: Gullivers Pacific Group; Infratil Limited; Major Accommodation Providers; Ms Kerry Prendergast; Talley Fisheries; and Wellington International Airport
Commission	Australian Competition and Consumer Commission
Cooperation Agreement	The conduct referred to in applications for authorisation A90862 and A90863

CRS or computer reservation system	A computerised system which provides information to subscribers (usually travel agents) on airline schedules, fares and seat availability. It is used to make reservations and issue tickets for passengers
Danzas	Danzas AEI Pty Limited
dedicated freight aircraft	An aircraft set up to transport freight only
DHL	DHL International (Aust) Pty/Ltd
Draft Determination	Draft determination issued by the Commission in respect of applications for authorisation A30220, A30221, A30222, A90862 and A90863, 10 April 2003
DITR	Department of Industry, Tourism and Resources
DTRS	Department of Transport and Regional Services
EBIT	Earnings before interest and tax
Equity Proposal	The conduct referred to in application for authorisation A30222
Feeder traffic	The carriage of passengers on domestic journeys linked to international travel (also referred to as “domestic on-carriage”)
fifth freedom	The right of an airline of one country to carry traffic between two other countries providing the flight originates or terminates in its own country
flag carrier	A country’s national airline. Countries with only a government airline often identify the airline as the national or flag carrier
fourth freedom	The right of an airline of one country to carry traffic from another country to its own country
Frontier Economics	Economic consultants engaged by Virgin Blue to undertake a critique of the NECG Report
FSA	Full service airline
GDS	Global distribution system
GPG	Gullivers Pacific Group
grandfather rights	The allocation of airport landing and take-off slots based on past and/or current allocation
hub and spoke network	A network of routes operating through a central hub point
IASC	International Air Services Commission

IATA	International Air Transport Association
IINZ	Importers Institute of New Zealand
interlining	Carriage of passengers and/or freight by one airline on behalf of another airline, based on a formal arrangement (an interline agreement) between the airlines which involves the coordination of baggage checks, carriage or air cargo, for example, and the honouring of tickets between airlines. The identity of each carrier is maintained
JAL	Japan Airlines
JAO Network	All Air NZ flights and all Qantas flights into, within and departing from New Zealand
JSA	Joint Services Agreement between Qantas and BA – authorised by the Commission in 1995
Kiwi Shareholder	The New Zealand Government
load factor	The number of passengers carried as a percentage of the number of seats available
Melbourne Airport	Australia Pacific Airports (Melbourne) Pty Ltd
NECG	Network Economics Consulting Group Pty Ltd
NECG Model	The econometric model upon which the report prepared by NECG is based
NECG Report	The report prepared by NECG, lodged by the Applicants in support of the Applications
NT Airports	Northern Territory Airports Pty Ltd
NTTC	Northern Territory Tourist Commission
NZCC	New Zealand Commerce Commission
open skies agreement	An agreement between two countries to remove restrictions on the ability of their designated airlines to operate services between two countries
Origin Pacific	Origin Pacific Airways Pty Limited
Proposed Arrangements	The conduct referred to in authorisation applications A30220, A30221, A30222, A90862 and A90863
Proposed Undertakings	Enforceable undertakings proposed by the Applicants in their submission to the Commission dated 24 January 2003
PwC	PricewaterhouseCoopers

Qantas	Qantas Airways Limited
QCMA	Re Queensland Co-op Milling Association Ltd and Defiance Holdings Ltd (1976) ATPR ¶ 40-012
Response	The Applicants' response to submissions lodged by third parties in relation to this matter
Rex	Regional Express
RJSA	Restated Joint Services Agreement between Qantas and BA – authorised by the Commission in 2000
RPK or revenue passenger kilometres	The number of paying passengers on an aircraft multiplied by the number of kilometres flown, used as a measure of air passenger travel
SA Govt	South Australian Government
SACL	Sydney Airports Corporation Limited
SAM or single aviation market	Single Aviation Market agreed between the Governments of Australia and New Zealand which removes restrictions on the designated airlines of each country providing services between, beyond and within the countries.
Seventh freedom	The right of an airline of one country to operate flights between two other countries without the flight originating or terminating in its own country
sixth freedom	The right of an airline of one country to carry traffic between two other countries via its own country
Strategic Alliance Proposal	The conduct referred to in applications for authorisation A30220 and A30221
Submission	The Applicants' supporting submission lodged with the Commission on 9 December 2002
TFI	Tourism Futures International
Thai Airways	Thai Airways International
third freedom	The right of an airline of one country to carry traffic from its own country to another country
TIANZ	Tourism Industry Association New Zealand
TTF	Tourism Task Force
United	United Airlines



VBA

Value based airline

Yield

Airline revenue per unit of traffic. Passenger yield is airline revenue per passenger kilometre

## 1. Introduction

- 1.1. The Australian Competition and Consumer Commission (“the Commission”) is the Commonwealth agency responsible for administering the *Trade Practices Act 1974* (“the Act”). 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.
- 1.2. The Act recognises that competition may not always be consistent with the most efficient social outcome. It therefore allows the Commission to grant immunity from the Act for anti-competitive arrangements or 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 their reasons.
- 1.6. The Act requires that the Commission 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 takes into account any submissions received from interested parties.
- 1.7. The Commission issued a Draft Determination in relation to applications for authorisation A30220, A30221, A30222, A90862 and A90863 on 10 April 2003.
- 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 also invites 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.
- 1.10. This document is the final Determination in relation to applications for authorisation A30220, A30221, A30222, A90862 and A90863 lodged with

the Commission by Qantas Airways Limited (“Qantas”) and Air New Zealand Limited (“Air NZ”).

## 2. The Applications

- 2.1. On 9 December 2002, Qantas and Air NZ (together, “the Applicants”) made applications for authorisation to the Commission pursuant to sections 88(1) and 88(9) of the Act for conduct which may constitute an exclusionary provision within the meaning of the Act, conduct which may substantially lessen competition and for the acquisition of shares.
- 2.2. The applications specifically sought authorisation for:
- collaborative arrangements between the Applicants (“the Strategic Alliance Proposal”) (A30220 and A30221); and
  - the acquisition by Qantas of ordinary shares comprising up to a 22.5 per cent voting equity interest in Air NZ (“the Equity Proposal”) (A30222).
- 2.3. On 20 December 2002 the Commission received further applications for authorisation (A90862 and A90863) from the Applicants in respect of a “Cooperation Agreement” between Qantas, Air NZ and Air Pacific Limited (“Air Pacific”) which is ancillary to the above Strategic Alliance Proposal. The applications were made pursuant to subsection 88(1) of the Act for conduct which may constitute an exclusionary provision within the meaning of the Act and conduct which may substantially lessen competition.

### The Applicants

#### *Qantas*<sup>2</sup>

- 2.4. Qantas was incorporated in Queensland in 1920 and operates airline passenger and freight services internationally and domestically. Qantas operates a domestic and international fleet of 194 aircraft and services 142 destinations in 32 countries. It operates, on average, 5,300 domestic and 540 international flights per week and employs approximately 33,000 people. On the basis of revenue passenger kilometres (“RPKs”), Qantas is ranked as the 12<sup>th</sup> largest airline worldwide and is one of Australia’s largest 30 companies.
- 2.5. Qantas also operates Australian Airlines and a number of Qantas subsidiaries 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.
- 2.6. 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.

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<sup>2</sup> Air New Zealand Limited and Qantas Airways Limited, *Submission to the Australian Competition and Consumer Commission in support of the application for authorisation*, 9 December 2002 (paragraphs 2.17 – 2.23).

- 2.7. Qantas Holidays Limited operates holiday, tour and travel businesses.
- 2.8. Qantas holds 46.32 per cent of the shares in Air Pacific.
- 2.9. In March 1993, British Airways Plc (“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 offer and Qantas listed on the Australian Stock Exchange (“ASX”) 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.
- 2.10. Qantas has entered into a Joint Services Agreement (“JSA”) with BA which provides for the coordination of various aspects of their airline services between Australia and Europe, Australia and South East Asia, and South East Asia and Europe. In 1995, the (then) Trade Practices Commission granted authorisation. This authorisation expired on 11 May 2000.
- 2.11. In 2000, the Commission granted authorisation to an authorisation application lodged by Qantas and BA in respect of a Restated JSA (“RJSA”). The RJSA provided for similar coordination of airline services and prices between Qantas and BA as the original JSA. The RJSA also contemplated that Qantas and BA may extend this coordination and profit sharing to any part of their networks. The RJSA authorisation expires in July 2003. A further application for authorisation was lodged in relation to the RJSA on 6 May 2003. Pending the Commission’s assessment of that application, interim authorisation has been granted by the Commission.
- 2.12. Qantas is a member of the **oneworld** marketing alliance. The alliance was formed in September 1998, and **oneworld** members commenced operating the alliance in February 1999. The members of the **oneworld** alliance are Qantas, BA, American Airlines Inc, Cathay Pacific Airways Limited, Aer Lingus, Finnair, Iberia and LanChile.

#### *Air NZ*<sup>3</sup>

- 2.13. Air NZ was incorporated in New Zealand in 1940 and is New Zealand’s only international and principal domestic airline. It operates air passenger and cargo transport services throughout New Zealand and the South West Pacific, and to Australia, the United States and the United Kingdom. Air NZ operates a fleet of 83 aircraft, linking 48 destinations in 16 countries. Air NZ operates (on average) 1470 domestic flights and 194 international flights per week and employs 9,500 people worldwide. On the basis of RPKs, Air NZ is the world’s 33<sup>rd</sup> largest airline.
- 2.14. Air NZ operates business units providing engineering and ground handling services and subsidiaries extend to travel wholesaling and retailing services.

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<sup>3</sup> Air New Zealand Limited and Qantas Airways Limited, *Submission to the Australian Competition and Consumer Commission in support of the application for authorisation*, 9 December 2002 (paragraphs 2.2 – 2.16) and Freedom Air website, <http://www.freedom.co.nz>.

- 2.15. Freedom Air is a wholly owned subsidiary of Air NZ. Freedom Air began services across the Tasman in December 1995 and operates on a value based airline (“VBA”) model. In December 2000, Freedom Air announced its expansion into New Zealand’s domestic market, but it has since ceased its domestic New Zealand services. Freedom Air currently operates 54 services per week across the Tasman and has a fleet of four 737 aircraft.
- 2.16. In 1996, Air NZ acquired 50 per cent of Ansett Australia Limited (“Ansett”) and (indirectly) 24.5 per cent of Ansett International Limited (“Ansett International”). In 2000, Air NZ acquired the remaining 50 per cent of Ansett and thereby a further 24.5 per cent of Ansett International. However, as a result of unsustainable operational losses, Ansett was placed into voluntary administration on 12 September 2001.
- 2.17. Air NZ holds 1.97 per cent of the shares in Air Pacific.
- 2.18. Air NZ was wholly owned by the New Zealand Government until April 1989, when it was privatised and listed on the New Zealand Stock Exchange. At the time of privatisation, Air NZ had two separate classes of shares. “A Ordinary Shares” could be held only by New Zealand nationals and “B Ordinary Shares” could be held by New Zealand nationals or other persons. In addition, the New Zealand Government retained one fully paid special rights convertible share of NZ\$1.00 (“the Kiwi Share”). Only the Government could hold the Kiwi Share. While the Kiwi Share did not carry any general voting rights, the consent of the Government as holder was required for certain prescribed actions by Air NZ or its directors. In addition, there are a number of provisions in Air NZ’s Constitution (generally those provisions that were concerned with capital structure, ownership and composition of the Board) that may not be varied without the consent of the Government. The Kiwi Share carried no dividend entitlements.
- 2.19. Initial investors in Air NZ were Brierley Investments Limited (“Brierley”) (35 per cent), Qantas (20 per cent), Japan Airlines (7.5 per cent), American Airlines (7.5 per cent) and New Zealand public institutional investors (30 per cent). In 1994, American Airlines and Japan Airlines sold their shares in Air NZ. In 1997, Qantas sold its shareholding to institutional investors. By May 1999, Brierley’s shareholding had increased to just over 47 per cent.
- 2.20. In April 2000, Singapore Airways purchased 8.3 per cent of Air NZ and in August of that year purchased most of Brierley’s B Ordinary Shares to increase its shareholding to 25 per cent. Brierley continued to hold 30 per cent of the shares in Air NZ.
- 2.21. Following the placing of Ansett in voluntary administration, Air NZ was recapitalised in January 2002 to secure its ongoing viability. The New Zealand Government advanced Air NZ a loan of NZ\$300 million in October 2001. Following shareholder approval in December 2001, the second stage of the recapitalisation was completed on 18 January 2002. This involved the repayment of the NZ\$300 million loan plus accrued interest through the issue of 1,279,866,438 unlisted convertible preference shares to the Government. These shares carry a cumulative five per cent dividend and full voting rights.

They convert to ordinary shares in Air NZ on a one-for-one basis on 31 January 2005, or such earlier date as the Government elects.

- 2.22. At the same time, further ordinary shares were issued to the Government by Air NZ, resulting in additional proceeds of NZ\$585 million. The issue of shares to the New Zealand Government diluted the shareholdings of existing owners, and post-recapitalisation, the Government became the largest shareholder in Air NZ, owning 82 per cent of the voting stock in Air NZ. Brierley's and Singapore Airline's shareholdings were reduced to 5.5 and 4.5 per cent respectively.
- 2.23. The proceeds from the issue of ordinary shares were used to repay all outstanding unsecured borrowings of Air NZ (totalling approximately NZ\$600 million).
- 2.24. In 1999, Air NZ became a member of the marketing alliance known as Star Alliance. The members of the Star Alliance network are Air Canada, Air NZ, All Nippon Airways, Austrian Airlines, British Midland, Lauda Air, Lufthansa, Mexicana, SAS, Singapore Airlines, Thai Airways International, Tyrolean Airways, United Airlines and Varig.

#### *Air Pacific*

- 2.25. Air Pacific is 46.32 per cent owned by Qantas and is currently the only direct operator between Australia and Fiji. Qantas code shares on Air Pacific services between Australia and Fiji. The other shareholders are Air NZ with 1.97 per cent and Air Pacific with 51 per cent.

#### **The Conduct<sup>4</sup>**

- 2.26. The Applicants are seeking authorisation for a Strategic Alliance Proposal, an Equity Proposal and a Cooperation Agreement with any authorisation not limited with respect to time.
- 2.27. The Applicants have confirmed that *"no aspect of this conduct will be implemented independently"* and that the Commission should *"use the entirety of the supporting submissions in respect of the applications and any future submissions...for the purposes of applying the respective tests for authorisation to each of the five applications"*.<sup>5</sup>

#### *The Strategic Alliance Proposal*

- 2.28. The Strategic Alliance Proposal creates a Joint Airline Operation Network ("the JAO Network") which will be commercially managed by Air NZ, with day-to-day flying operations the responsibility of each respective airline.
- 2.29. The JAO Network extends to all Air NZ flights and all Qantas flights into, within and departing from New Zealand.

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<sup>4</sup> Air New Zealand Limited and Qantas Airways Limited, *Submission to the Australian Competition and Consumer Commission in support of the application for authorisation*, 9 December 2002.

<sup>5</sup> Letter from the Applicants to the Commission, 18 February 2003.

2.30. In respect of the JAO Networks, the Applicants propose to coordinate the following:

- pricing and remuneration, including setting passenger fares and freight rates, the level of rebates, incentives, promotions or discounts offered to customers, development of new fare products, the level of services fees, holiday package airfares and joint tendering for corporate and government accounts;
- the exchange of information relating to JAO Networks and sectors operated by Freedom Air, including schedules, financial information, pricing, yields, seat availability, freight capacity availability, sales and other information;
- scheduling, capacity planning, routings, frequencies, aircraft types, connection requirements and a range of times for services provided by the Applicants;
- reciprocal rights for code sharing on each other's services;
- a special pro rate agreement;
- Qantas Holidays maximising the provision of new tourism products which utilise the JAO Networks as part of itineraries offered by Qantas Holidays, including the promotion of New Zealand and Australia as a joint holiday destination;
- freight operations;
- sales and marketing functions including operating joint offices and joint retail sales outlets, co-locating certain facilities and staff, appointing common general sales agents in countries outside Australia and New Zealand, conducting joint promotions, offering coordinated incentive programs, providing access to each other's customer lounges, ground services and freight handling services and providing each other with equivalent customer services;
- entering into a frequent flyer program agreement whilst retaining separate and autonomous frequent flyer programs; and
- giving priority to each other in the display of each other's flights in their respective reservation systems.

2.31. The Proposed Arrangements also encompass coordination on non-JAO Networks where the Applicants are of the view that it is effective and efficient for them to do so. Coordination of "non-JAO" activities includes:

- implementing further arrangements and structures designed to deliver additional benefits to each other's customers and frequent flyers;
- cooperation in developing the "in-flight experience" for passengers;



- identifying, developing and providing new consumer benefits, products, services and pricing strategies for different markets;
- liaising with regard to fleet planning and flight operations strategies, including coordinating individual fleet acquisitions, identifying future fleet requirements, leasing arrangements and sharing knowledge in respect of fleet planning, etc.;
- coordinating aspects of information technology systems and requirements;
- developing and implementing safety and security policies and procedures and coordinating on flight disruption and emergency planning procedures;
- exploring joint purchasing opportunities and negotiating with suppliers on behalf of each other;
- pursuing joint human resource activities to contribute to staff training, service standards, cost reductions and increased productivity;
- operating joint airport lounges, check-in and customer service centres at agreed airports and ensure that each other's eligible passengers have access to such airport lounges;
- liaising and cooperating with respect to representations made to the Australian and New Zealand governments or, as appropriate, other governments or aviation regulators relating to the Strategic Alliance; and
- cooperating on further commercial opportunities to be agreed on from time to time.

2.32. A Strategic Alliance Agreement also contains restrictive covenants whereby the Applicants will not compete with each other. Specifically, Air NZ, its affiliates and Freedom Air must not operate on any non-trans-Tasman sectors which depart from or arrive at an Australian airport (except that Air NZ is permitted to continue operating its Sydney-Los Angeles sector).<sup>6</sup> Similarly, Qantas and its affiliates must not operate on any sectors which depart from and/or arrive at an airport in New Zealand (other than by flying as part of the JAO Network).

2.33. The Alliance Agreement is for a term of not less than five years.

2.34. A "Strategic Alliance Advisory Group" comprises three representatives appointed by each airline and will support Air NZ's management of the JAO Networks. The decisions of this group are required to be unanimous – that is, a recommendation of the Strategic Alliance Advisory Group will only result

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<sup>6</sup> The Commission notes that on 10 February 2003, Air NZ announced the suspension of its direct flights from Sydney-Los Angeles effective 28 April 2003.

in a change in management direction when both Air NZ and Qantas agree that such a change should take place.

- 2.35. The Strategic Alliance Proposal also allocates benefits accruing to Qantas and Air NZ under the Proposed Arrangements.

*The Equity Proposal*

- 2.36. The Applicants propose that Qantas will subscribe for redeemable convertible notes equivalent to 4.99 per cent of the equity in Air NZ on receipt of Kiwi Shareholder approval. On receipt of authorisation by the NZCC and the Commission and with the consent of Air NZ shareholders, the convertible notes will convert to ordinary shares and Qantas will subscribe for ordinary shares that will result in Qantas holding 15 per cent of the equity in Air NZ. In addition, Qantas will then, or at the end of a three year period, subscribe for Air NZ equity securities that would result in Qantas holding 22.5 per cent of the voting equity in Air NZ. Qantas will be entitled to maintain this level of shareholding pursuant to “top up” arrangements with Air NZ.
- 2.37. Associated with the Equity Proposal is the right for Qantas to have up to two directors on the Board of Air NZ, and for Air NZ to have one director on the Board of Qantas.

*The Cooperation Agreement*

- 2.38. The Cooperation Agreement between Qantas, Air NZ and Air Pacific allows the parties to cooperate with respect to aspects of passenger and freight services, including with respect to pricing and scheduling.
- 2.39. The Cooperation Agreement will cease immediately should the Strategic Alliance Agreement be terminated.

**Chronology**

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

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

<b>Date</b>	<b>Description</b>
9 December 2002	Applications lodged in respect of A30220, A30221 and A30221
10 December 2002	Letter to Applicants regarding confidentiality in respect of certain aspects of the Strategic Alliance Agreement and Appendix D of the NECG Report
17 December 2002	Applicants withdraw claim for confidentiality of key elements of the Strategic Alliance Agreement and certain aspects of Appendix F to the NECG Report
19 December 2002	Letter to interested parties inviting submissions in respect of A30220, A30221 and A30222
20 December 2002	Applications lodged in respect of A90862 and A90863
6 January 2003	Letter to the Applicants requesting additional information
7 January 2003	Letter to interested parties inviting submissions in respect of A90862 and A90863
16 January 2003	Confidential NECG models supplied to the Commission by the Applicants
22 January 2003	Letter to the Applicants requesting further information
24 January 2003	Paper on proposed undertakings lodged by the Applicants
28 January 2003	Letter to interested parties inviting submissions on the proposed undertakings
29 January 2003	Letter to the Applicants requesting additional information
3 February 2003	Meeting between the Commission and representatives of the Applicants and NECG to discuss the NECG Model
4 February 2003	Response to the Commission's letter of 22 January advising when the Commission's requests for further information would be fulfilled
4 February 2003	PricewaterhouseCoopers report supplied by the Applicants to the Commission
5 February 2003	Initial deadline for submissions from interested parties

5 February 2003	Tourism Futures International report supplied by the Applicants to the Commission
6 February 2003	Letter to interested parties inviting comment on the Tourism Futures International report
10 February 2003	Letter to the Applicants requesting additional information
19 February 2003	Extended deadline for submissions from interested parties
3 March 2003	Response to the Commission's letters of 6 January, 29 January and 10 February 2003
5 March 2003	Revised confidential NECG models and summary of net benefits supplied by the Applicants
7 March 2003	Further information provided by the Applicants
14 March 2003	Response to "Third party submissions" lodged by the Applicants and NECG on behalf of the Applicants
14 March 2003	"Update" of the Tourism Futures International report lodged by the Applicants
14 March 2003	Copy of answers to questions lodged by the NZCC forwarded to the Commission by the Applicants
17 March 2003	"Updated" Executive Summary lodged by the Applicants
10 April 2003	Draft Determination issued
9 May 2003	Final date to lodge submissions in response to the Commission's Draft Determination
9 May 2003	Submission from Applicants responding to Draft Determination
4 June 2003	Commission writes to the Applicants requesting an extension to the period within which it must make a determination in respect of Application A30222
6 June 2003	The Applicants agree to extend the Commission's consideration of A30222 until 30 September 2003
17 July 2003	Meeting between the Applicants and the Commission
1 August 2003	Applicants confirm further submission to be filed by 30 August 2003

6 August 2003	Commission agrees to take into account submission lodged by 30 August 2003
1 September 2003	Further submission lodged by the Applicants
9 September 2003	Final Determination issued

### 3. Background to the Applications

#### **Changes in international and domestic aviation policy**

##### *Australian aviation policy*

- 3.1. 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.
- 3.2. Prior to 1988, Commonwealth Government policy segregated the international and domestic aviation markets. The domestic trunk route market was divided almost equally between Ansett and Australian Airlines under a two airline policy. On the international side there was a policy of single designation and Qantas was the sole Australian carrier.
- 3.3. In 1987, the Commonwealth Government announced that it would commence deregulation of the domestic aviation industry and it withdrew from regulating areas such as fare setting, aircraft imports, capacity controls and route entry.
- 3.4. Deregulation of the international market followed shortly thereafter. In the early 1990s a major international aviation reform program was initiated which saw a policy of multiple designation of international carriers introduced and actively pursued in negotiations on air service agreements with other countries. Air services agreements are bilateral agreements between countries which specify the level and style of airline activity which may take place between the two countries by their designated carriers. Air services agreements typically require a designated carrier to be under the substantial ownership and control of the country designating the carrier.
- 3.5. In 1992, as part of the multiple designation initiative, the Commonwealth Government created a separate authority, the International Air Services Commission ("IASC"), whose primary role was to allocate, in the public interest, capacity negotiated in air service agreements amongst Australian designated carriers. Pre-existing international capacity was grandfathered under legislation, effectively to Qantas.
- 3.6. In the same period as these changes were occurring, the Government also decided to merge Qantas (the national international carrier) and Australian Airlines (the national domestic carrier) and to privatise the merged entity. 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.

##### *Recent policy developments*

- 3.7. For some time the Commonwealth Government has 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 was not constrained by bilateral capacity limitations.

3.8. In June 1999, the Commonwealth 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.<sup>7</sup> Included in the response 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 to include unlimited capacity, code share and own stopover rights);
- Australia would reform foreign ownership rules for Australian airlines, to make sure 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 airlines;
- 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 Australian airlines.

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<sup>7</sup> Productivity Commission (1998), *International Air Services: Inquiry Report*, Commonwealth of Australia: Canberra.

- 3.9. Currently, New Zealand is the only country with which Australia has an “open skies” policy.
- 3.10. In its submission to the Commission in relation to this matter (detailed at **Appendix A** to this Determination), the Department of Transport and Regional Services (“DTRS”) stated that current Australian international airline policy is characterised by:
- the pursuit of liberalisation with bilateral partners either through open skies agreements or, where open skies is not an option, negotiating the most liberalised outcome possible;
  - ensuring a continuation of competitive pressure on international routes to ensure reasonably priced access and to avoid potential monopolies exploiting dominant positions to the detriment of the national interest; and
  - ensuring that the present barriers to entry for other foreign carriers are removed to ensure that credible threat of entry remains.

### **Developments in aviation markets**

#### *International aviation*

- 3.11. This part examines passenger and freight movements between Australia and other countries over recent years.
- 3.12. It should be noted that during 2001/02, Gemini Air Cargo commenced services to and from Australia. Ansett International, Evergreen International, Gulf Air and Sri Lankan Airlines ceased services to and from Australia during this period.

#### Passengers

- 3.13. Table 3.1 shows that demand for international passenger services to and from Australia increased steadily between 1998 and 2001, but decreased significantly in 2001/02. This decrease is, to a large extent, attributable to the events of September 2001, the threat of further terrorist activity and economic factors in Asia.



**Table 3.1 Passengers carried on scheduled air services to and from Australia: 1998 - 2002<sup>8</sup>**

<b>Year ended 30 June</b>	<b>No. of flights</b>	<b>No. of passengers</b>	<b>Percentage change from previous year (PAX carried)</b>
<b>1998</b>	77,600	14,080,113	-
<b>1999</b>	80,372	14,564,061	+ 3.4 %
<b>2000</b>	86,751	14,582,694	+ 7.0 %
<b>2001</b>	93,467	17,126,504	+ 9.9 %
<b>2002</b>	87,346	16,448,978	- 4.0 %

- 3.14. While the latest figures available from DTRS show the lingering effects of the events of September 2001 on international travel, the figures do not reflect the impact of subsequent events which have had a further dampening effect on travel to and from Australia including the Bali bombings in October 2002 and the (then) potential for conflict in Iraq.
- 3.15. In 2001/02, there were 41 international airlines operating passenger services to and/or from Australia.
- 3.16. Table 3.2 below shows the movement in the share of passengers carried by the major carriers into and out of Australia in 1994, 1998 and 2002. Although the share of Qantas has declined, it still retains by far the largest share. Airlines which have notably increased their share over the period include Singapore Airlines, Malaysian Airlines and Thai Airways. Singapore Airlines remains the second largest carrier, ahead of Air NZ. According to DTRS, Air NZ's wholly owned subsidiary, Freedom Air, increased its share from 1.4 per cent to 1.8 per cent over the period 2000/01 to 2001/02.

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<sup>8</sup> Department of Transport and Regional Services, *Air Transport Statistics: International Airlines*, various years.

**Table 3.2 Airline share of passengers carried on scheduled air services to and from Australia: year ended 31 December<sup>9</sup>**

Airline	Share of passengers (%)		
	1994	1998	2002
<b>Qantas</b>	41.6	36.4	33.4
<b>Air NZ</b>	10.8	9.5	9.1
<b>Singapore Airlines</b>	6.4	8.1	12.0
<b>Japan Airlines</b>	4.6	4.1	4.7
<b>United Airlines</b>	4.5	4.1	2.7
<b>Cathay Pacific</b>	4.3	3.7	4.1
<b>British Airways</b>	3.6	4.6	3.4
<b>Malaysian Airlines</b>	3.4	4.6	5.4
<b>Garuda Indonesia</b>	3.2	2.8	2.4
<b>Thai Airways</b>	1.8	2.7	4.2
<b>Ansett International</b>	1.2	4.1	-
<b>Other</b>	14.6	15.3	18.5

### Freight

3.17. The volume of international freight carried on scheduled airline services between Australia and other countries was 635,300 tonnes in the year ended June 2002. This represents a decline of 4.6 per cent compared to 2000-01, and a decline of 7.6 per cent compared to 1999-2000. The majority of the freight is carried on passenger flights. During 2001-02, there were eight dedicated freight only operators. There were also four airlines which operated dedicated freight operations in addition to their regular passenger services. Freight carried on dedicated freighter services accounted for 26.9 per cent of inbound freight to Australia, 13.3 per cent of outbound freight from Australia and 19.5 per cent of total freight. Dedicated freighters accounted for 3.2 per cent of the total flights to and from Australia.

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<sup>9</sup> id.

**Table 3.3 Airline share of freight traffic to/from Australia: year ended<sup>10</sup>**

Airline	Share of freight traffic (%)		
	31 December 1994	31 December 1998	30 June 2002
<b>Qantas</b>	34.2	28.9	23.6
<b>Singapore Airlines</b>	10.9	13.0	15.4
<b>Air NZ</b>	9.5	11.0	7.2
<b>Cathay Pacific</b>	8.5	7.8	7.8
<b>British Airways</b>	3.5	3.5	2.9
<b>Japan Airlines</b>	3.4	3.5	3.2
<b>Malaysia Airlines</b>	2.9	4.9	5.4
<b>United Airlines</b>	2.8	2.7	2.1
<b>Garuda Indonesia</b>	2.6	1.1	1.8
<b>Polar Air Cargo</b>	2.5	1.6	1.0
<b>Thai Airways Int'l</b>	2.4	2.3	4.1
<b>Other</b>	16.9	19.8	22.5

3.18. Table 3.3 above shows that Qantas remains the leading carrier in the freight market but has experienced a decline in share in the period 1994 to 2002. Over the same period Singapore Airlines and Malaysia Airlines increased their shares significantly, while Garuda and Air NZ experienced declines. Federal Express Airlines and Emirates have also moved into the "top ten" freight carriers, with shares in 2002 of 3.6 per cent and 2.6 per cent respectively.<sup>11</sup>

3.19. Table 3.4 below shows international cargo traffic between 1998 and 2002.

**Table 3.4 International freight traffic to and from Australia: 1998 - 2002<sup>12</sup>**

Year ended 30 June	Freight (tonnes)
1998	645,638
1999	645,587
2000	687,247
2001	665,685
2002	635,300

*Domestic aviation*

3.20. 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 early March 2002. Qantas' share of

<sup>10</sup> id.

<sup>11</sup> id.

<sup>12</sup> id.