



INDEPENDENT CONSUMER & COMPETITION COMMISSION

DRAFT
DETERMINATION AND SUMMARY OF
REASONS

on

application for authorisation of Code-share Agreement

between

Air Niugini Limited and Qantas Airways Limited

for the Port Moresby/Cairns Route

Application Lodgement Date : 17 November 2010

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1. Introduction

- 1.1. This is the draft determination and summary of reasons on the application for authorisation, lodged on 17 November 2010, in respect of a proposed Code-share Agreement between Air Niugini Limited ('Air Niugini') and Qantas Airways Limited ('Qantas') as required under s.70 of the *Independent Consumer and Competition Commission Act 2002* ('ICCC Act').
- 1.2. The authorisation process under the ICCC Act requires amongst other things, the Commission to issue a draft determination, and then a determination. A determination will be issued after stakeholders and persons having interest in the application have been given the benefit of perusing the draft determination and providing comments to the Commission before a determination is made.
- 1.3. This draft determination takes into account views expressed by stakeholders during the initial consultation process, including views expressed on the Issues Paper which the Commission issued on 5 April 2011. Confidential submissions to the Commission by submitters, for which confidentiality was granted, have also been taken into account. All confidential information is maintained in the Commission's confidential files.
- 1.4. As the authorisation process involves wide and extensive stakeholder participation, the Commission consulted widely with all stakeholders. Following release of an Issues Paper on this matter for further comments from stakeholders, Airlines of PNG made the first request for extension, followed by the applicant, then its shareholder on at least 3 different occasions in total. These requests for extensions were granted. Those seeking extensions said the requests for extension was to enable them undertake research and provide comments to the issues raised by the Commission. A last request was made by the applicant's lawyers for an extension to be granted to 16 June 2011 for them to provide comments on behalf of their client Air Niugini. A number of public notices and letters on different occasions were sent out to stakeholders advising them of the various extensions.
- 1.5. As a consequence of these various requests for extensions the draft determination of the Commission has had to be delayed until now.
- 1.6. At the outset, it is relevant to mention that, simultaneously with this application, the applicant lodged another application for authorisation of a proposed code-sharing arrangement with Philippine Airlines on the Port Moresby/Manila route ('the other application'). In this draft determination, there is some reference to the other application because they are highly relevant to scale, scope and network economies, which influence the ability to compete on other international routes. Those references, therefore, should be seen in that light. The two applications, however, stand separate, each in its own circumstances relating to competition and public benefit issues considered in the respective draft determinations.

2. The Parties

Air Niugini Limited (Air Niugini)

- 2.1. Air Niugini is Papua New Guinea's largest airline, solely owned by the Government of Papua New Guinea. Its core business is the provision of domestic and international passenger and airfreight services.
- 2.2. Air Niugini has a domestic network that spans a substantial proportion of the geographic area of the national territory and serves 21 domestic airports. It also serves 10 international airports, including, Singapore; Hong Kong; Tokyo; Sydney; Brisbane; Cairns and Manila (Nino Aquino International Airport) in the Republic of the Philippines.
- 2.3. Air Niugini's domestic and international fleet consists of nineteen aircraft, 2 x B767 aircraft, 1 x B757, 6 x Fokker F-100 jets, 2 x Dash-8 Q400 modern turbo prop aircraft and 8 Dash-8 turboprop aircraft.

- 2.4. The PNG Government's audited equity capital in the airline as at 31 December 2007 was K236, 623,000. There are no audited accounts published by Air Niugini for more recent years.
- 2.5. Air Niugini has existed since November 1973 having been first established with capital subscribed as follows: Papua New Guinea Government holding 60% of the shares, Ansett (16%), Qantas (12%) and Trans Australia Airlines (TAA) (12%). Since 1980, following the progressive exit of the other shareholders, Air Niugini has been wholly-owned by the Independent State of Papua New Guinea; falling within the responsibility of the Minister for Public Enterprise, but having its own board of directors and management. The Independent Public Business Corporation has broad supervisory responsibility for the operations of Air Niugini.
- 2.6. Air Niugini's capital, therefore, has been provided by the Government of PNG, with subsequent injections of additional capital and effective loans, in the form of Government guarantees for loans sourced elsewhere as well as direct loans, as described in greater detail later in the determination.
- 2.7. Relevant to this application, Air Niugini operates services on the Port Moresby/Brisbane and Port Moresby/Sydney routes with a code-sharing agreement with Qantas, under which the former is the operating carrier while the latter is the marketing carrier. The agreement has been authorised by the Commission (file no.A2009/09) for a period of two and a half years expiring on 30 June 2012.

Qantas Airways Limited (Qantas)

- 2.8. Qantas is a large international airline, which is also a significant competitor on the domestic Australian routes. It is also the wholly-owned parent of JetStar, a discount operator, formed to compete with discount operators on international and domestic routes.
- 2.9. Qantas was originally owned by the Australian Government, but was privatised, first partially, and then wholly, some years ago. It is now entirely a private sector company and is listed on the Australian Securities Exchange.
- 2.10. In common with the private sector, Qantas has to service its capital and raise debt at prevailing market rates for capital and debt raisings from time to time.
- 2.11. The Qantas fleet of domestic and international operations consists of Airbus A380s, A330s and A320s, Boeing 747s, 767s, 737s and 717s, Bombardier Dash-8s, Bombardier Q400s and British Aerospace 146s. In addition to its airline operations, the Qantas Group operates a portfolio of airline related businesses including airport operations, freight, engineering, catering and travel and accommodation booking businesses.
- 2.12. Of some relevance to this application, in the context of scale, scope and network economies enjoyed by the applicant, is a code-sharing agreement between Qantas and Air Niugini, under which the latter is the operating carrier for services on the Port Moresby/Brisbane and Port Moresby/Sydney routes, with Qantas as the marketing carrier. That agreement has been authorised by the Commission (file no.A2009/09) for a period of two and a half years expiring on 30 June 2012.

3. Remaining competitor on the route

Airlines of PNG Limited (Airlines PNG)

- 3.1. Airlines PNG is a locally incorporated airline. It has been listed on the Port Moresby stock exchange since 2008 by its previous owners John Wild, and his family who currently maintain a 47.09% shareholding in the airline. The balance of the shareholding is held by some 2,300 other shareholders including PNG institutional investors such as NASFUND, Teachers Savings and Loans, Credit Corporation, other local landowner groups and companies, and individual PNG nationals.

- 3.2. Airlines PNG has an issued share capital of 223,000,000 ordinary fully paid shares as at 31 December 2009. The airlines' share price as at 5 July 2011 was K0.50 per share which equates the issued share capital to K111, 555,000.
- 3.3. Airlines PNG does not receive any Government subsidy; has raised capital and debt on the market, at the prevailing market rates for capital and debt raisings from time to time; is required to service its debt at rates of interest prevailing from time to time; and generate returns on equity that are sufficient to provide an acceptable dividend and/or capital appreciation to its shareholders, or risk a diminution in its capitalised value.
- 3.4. The airline services a number of domestic airports and Cairns on the PNG/Australia route at the moment using its fleet of 20 aircraft consisting of De Havilland Dash-8, De Havilland Twin Otter. Airlines PNG is also a code-share partner with Pacific Blue, which is the operating carrier, on the Port Moresby/Brisbane route. That code-sharing agreement was authorised by the Commission on 11 November 2008, (file no.A2008/07) for a period of three years.

4. Application for authorisation and interim authorisation

- 4.1 On 17 November 2010 Air Niugini sought authorisation from the Commission under section 70 of the ICCC Act to enter into and give effect to a proposed code-share agreement with Qantas. The code-share agreement relates to the purchasing of 5 seats by Air Niugini on all the QantasLink services between Port Moresby and Cairns.
- 4.2 The Commission is required under section 77(2) of the ICCC Act to make a determination on whether to permit Air Niugini and Qantas to enter into and to give effect to this agreement.
- 4.3 After lodging this application, the applicant caused to be published a 'summer schedule' of services, which included the proposed additional services to Manila, the subject of the other application, intended to be introduced only if, and after, the proposed code-share agreement with Philippine Airlines was authorised by the Commission. It also sought interim authorisation of the proposed code-share agreement with Philippine Airlines from the Commission, pending a final determination, as the implementation date of the new schedule had arrived. The Commission declined to grant interim authorisation on the basis that the evidence before it showed that the rights of a third party were involved and could not be lightly disregarded and that it was not certain that, under the Act, the Commission had the power to grant such 'interim authorisation'.
- 4.4 The applicant then approached the Civil Aeronautics Board of the Philippines Government and secured landing rights for the additional services. The applicant appears to be able to bypass established bilateral protocols between the two sovereign states, which usually require their respective departments and agencies responsible for foreign affairs and international air transport, to negotiate these rights.

5. Elements of an authorisation

- 5.1. Section 77(6) of the ICCC Act provides that the "*Commission shall not make a determination granting an authorisation pursuant to an application under Section 70(1), (2), (3) or (4) unless it is satisfied that:*
 - a) *The entering into the contract or the arrangement or the arriving at the understanding;*
or
 - b) *The giving effect of the provision of the contract, arrangement or understanding;* or
 - c) *The giving or the requiring of the giving of the covenant; or*
 - d) *The carrying out of enforcing of the terms of the covenant,*

as the case may be, to which the application relates, will in the circumstances result, or be likely to result, in a benefit to the public which would outweigh the lessening in competition that would result, or would be likely to result or is deemed to result, from it.”

- 5.2. The Commission’s determination to grant or decline the grant of authorisation for Air Niugini’s application to code-share with Qantas will be governed by the test outlined above.

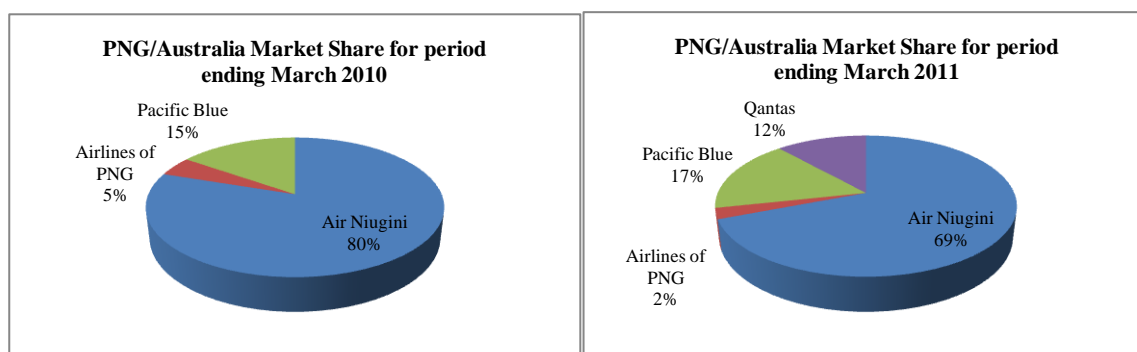
6. Submissions by stakeholders and the public

- 6.1 As part of the authorisation process under the ICCC Act, the Commission is required to consult widely with the applicant and persons having an interest in the application, including industry players and wider general public; to assist it make an informed decision on this matter.
- 6.2 The first such consultation commenced immediately following the receipt and registration of Air Niugini’s authorisation application. Stakeholders that provided their comments then were; Airlines of PNG, Department of Transport (Air Transport Division), Civil Aviation and Safety Authority of Papua New Guinea, Department of Treasury, Minister for Treasury and Finance, Minister for Public Enterprises, Department of Commerce and Industry, Tourism Promotion Authority, Mr. David W.Olley and the PNG Ambassador to the Philippines. The Department of Treasury and the National Research Institute provided submissions on the eve of the release of the Issues Paper and mention was made therein that those submissions would be taken into account in the preparation of the draft determination. That was done.
- 6.3 From the above consultations, the Commission identified a number of significant competition and public benefit issues relevant to the application and consequently issued an Issues Paper. The purpose of that paper was to outline the issues on which the Commission specifically sought submissions to inform its determination of the application. Airlines PNG and Mr David W. Olley, who declared his interest as a shareholder in Airlines PNG, Air Niugini; Independent Public Business Corporation; the Department of Treasury provided comments on the Issues Paper.
- 6.4 Where relevant, specific submissions by interested parties are mentioned in this draft determination. Comments made by stakeholders were considered and given appropriate weight in the Commission’s draft determination. All those submissions (excluding submissions made in confidence, or parts thereof, and granted confidentiality by the Commission) can be accessed from the Commission’s public register and on its website.

7. Characteristics of the market

Australia-PNG traffic sharesⁱ

- 7.1 The pie chart below shows the shares of the players for the entire PNG/Australia traffic for the years ending March 2010 and March 2011.



- 7.2 In its earlier determination authorising code-sharing arrangements between Qantas and Air Niugini (file no. A2009/09), the Commission noted that Air Niugini and Qantas have between them an aggregate of around 80% of the PNG/Australia air passenger traffic total. Current estimates shows that there has been very little change in the parties combined share of the bilateral traffic. For the year ending March 2011, the shares of the players are as follows –

Qantas (12%), Air Niugini (69%), Pacific Blue (17%), and Airlines PNG (2%). Airlines PNG's share of the total PNG/Australia traffic declined, while Pacific Blue Airlines increased its share, noting that it only operates on the Port Moresby/Brisbane route, compared to its partner Airlines PNG; and Qantas and Air Niugini.

- 7.3 Since the entry by Qantas into the Port Moresby/Cairns route in July 2010, it has progressively increased its market share. On the other hand, Airlines PNG's market share has declined substantially. It carried, on average, some 68% less passengers than the prior year.

Traffic growth and seat utilisationⁱⁱ

- 7.4 Information before the Commission shows that traffic growth rate between PNG and Australia peaked in 2007, but declined substantially in 2008. The substantial decline in growth rate is owed largely to the global financial crisis which dampened international travel demand worldwide. Traffic growth rate has since picked up and on an upward trend post 2008.
- 7.5 Traffic composition on the PNG/Australia route continues to consist predominantly of business travellers, followed by holiday-makers, those visiting friends and relatives (VFR) and the 'other' categories. There continues to be consistent increases in the number of business and holiday passengers since 2003, reflecting solid organic growth on the route. VFR travel remains somewhat stable with a very small proportion constituting travel for 'other' purposes.
- 7.6 The Port Moresby/Cairns route has experienced significant growth over the last 7 years since 2003, contributed to by fare reductions consequent upon the entry of Airlines PNG since 2005. Year on year growth on the Port Moresby/Cairns route has been mixed. Following a peak in 2007 it declined in 2008 and steadily picked up, reaching growth of 16% in 2010. Growth rate over the last 7 years has been well over 10%. Since 2009, traffic has been growing by some 40% average compared to the corresponding month of the previous year.
- 7.7 Most travel on the route appears to be business and holiday with very little for VFR and 'other' purposes. The Commission therefore concludes that travel between PNG and Australia will continue to be largely for business, followed by holiday travel, with a small proportion for VFR and 'other' travel purposes.
- 7.8 For recent periods, the Commission undertook some estimation of traffic growth and seat utilisation (revenue traffic) on the Port Moresby/Cairns route on the basis of publicly available data released by the Bureau of Infrastructure, Transport and Regional Economics (BITRE) up to March 2011. For the year ending March 2010 total traffic volume on the route was some 75,000; compared to year ending March 2011 where traffic volume was some 98,000, an increase of some 32%.
- 7.9 In terms of traffic volume by direction, the Commission observed from BITRE data that there is only a slight imbalance between inbound and outbound traffic between Port Moresby and Cairns; although with high monthly variations, especially during December and January. Traffic into PNG from Cairns seems to be slightly less (around 5%) than in the reverse direction, for the year ending March 2010 and 2011.
- 7.10 In regard to passenger load, the Commission estimates this from seat utilisation¹ (Revenue Passenger Load) information publicly available for the overall PNG/Australia air passenger market since there is no route-specific data available for the Port Moresby/Cairns route. Estimates for the 2nd, 3rd and 4th Quarter of 2010 and also the 1st Quarter of 2011, on total PNG/Australia traffic was undertaken to examine the pre and post-entry effect of Qantas on seat utilisation for all the airlines operating on the Port Moresby/Australia route network. This information is shown in the table overleaf.

¹ The statistics noted cover revenue traffic carried by the operators of scheduled regular public international air transport services only and do not include charter traffic.

Quarter	Seat Utilisation			
	Air Niugini	Qantas	Airlines PNG	Pacific Blue
2 nd Qtr 2010 (pre entry)	60.3	...	59.4	60.0
3 rd Qtr 2010 (post entry)	63.3	46.6	51.1	67.6
4 th Qtr 2010 (post entry)	57.6	58.0	48.6	62.6
1 st Qtr 2011 (post entry)	53.5	46.4	40.1	56.3

Source: ICCC calculation from publicly available data sourced from the BITRE website

- 7.11 The Commission observes that the quarterly seat utilisation on the PNG/Australia routes has been mixed. Prior to entry by Qantas in its own right on the Port Moresby/Cairns route, the Air Niugini/Qantas alliance enjoyed an aggregate of 60.3% average seat utilisation on the PNG/Australia routes. Post entry, Air Niugini's average seat utilisation declined to 57.6%. Airlines PNG's seat utilisation declined significantly from 59.4% to 40.1% as of the 1st Quarter of 2011. The information shows that since Qantas' independent entry as a carrier using its own airplanes on the Port Moresby/Cairns route, Airlines of PNG's revenue traffic declined significantly; while Air Niugini experienced some decline, which stabilised above 50%, across the entire PNG/Australia route network.
- 7.12 The impact of entry by Qantas on the Port Moresby/Cairns route on Airlines PNG's operations on the route is much more dramatic than suggested by the consolidated load factors for the participants provided above on all routes between the two countries; the volume of seats captured by Airlines PNG has been reduced substantially as its flight frequency has substantially reduced— from 7 services per week, to two services per week.

Airfares and yield

- 7.13 Confidential data provided by Qantas and Air Niugini to the Commission, when it assessed the code-share agreement between them that was granted authorisation in 2007, demonstrated that the carriers obtain relatively high passenger revenue yields on the PNG/Australia network routes. This is driven by the unusually high proportion of business traffic on the route, known to exhibit relatively less price elasticity in demand.
- 7.14 The Commission also notes from recent confidential data that business class yields on the Port Moresby/Cairns route remains unabated by competition from Airlines PNG, which only offers economy class seats on this route, due to the type of aircraft it operates; indeed this class showed an upward trend between 2009 and 2010. Yields on the economy seats however declined significantly between the period 2005 and 2010 since Airlines PNG entered the Cairns and Brisbane sectors.
- 7.15 A further consideration arises – the effect on other routes between PNG and Australia, specifically Port Moresby/Brisbane and Port Moresby/Sydney. Notwithstanding the difficulty of obtaining historical airfares for rigorous assessment of how airfares have changed over a given period, the Commission noted yield information for Port Moresby/Brisbane and Port Moresby/Sydney routes which demonstrates a significant drop in airfares following the entry of Airlines PNG on the Port Moresby/Cairns route, and Port Moresby/Brisbane route in code-share with Pacific Blue in late 2009.
- 7.16 The applicant said that there was a slight increase in average yields between 2009 and 2010 across each of the routes, including on the Cairns route when the previous Cairns Code-share came to an end on 1 July 2010. The Commission however notes that despite this claimed increase, data provided by Air Niugini at the time of its application to the Commission, shows that yields are still low compared against pre-Airlines PNG entry on the Port Moresby/Cairns route, despite it trending upwards as the applicant has alluded to.
- 7.17 The yield movement on those routes demonstrates that with the entry of Airlines PNG on the Port Moresby/Cairns route, fares on the other two PNG/Australia routes have reduced significantly as well, adjusting for other factors. Indeed, in its recent submission, the applicant said the entry of Airlines PNG into the market in late 2005 coincided with a marked decrease in average yields. A similar effect is observed in the other two PNG/Australia routes as

discussed above. This is not surprising, as domestic competition within Australia, in conjunction with a lower-cost Port Moresby/Cairns fare, offers ‘substitutable’ services which are price competitive. The consequences for competition in other markets, therefore, are relevant considerations in respect of this code-share application.

- 7.18 Total average yields on the Cairns to Port Moresby direction of the route continue to be higher than the reverse. While this has, historically, appeared to be consistent with the pattern of traffic on the route, in recent periods, as noted above, there seems to be a bit more southbound traffic than northbound in the aggregate. The higher average yield northbound under such circumstance may be interpreted as capitalising on the higher income and buying power of Australians travelling between Port Moresby and Cairns (most likely business related travel) than in the reverse direction, although that appears to be counterintuitive, given the expected incentive to equalise traffic levels and capacity utilisation. Such observed inconsistencies, however, are not infrequent in some network-based markets, as they are complex.
- 7.19 The historical pattern of airfares on this route shows that fares were substantially higher prior to the entry of Airlines PNG on this route, than they have been since. This pattern was evident despite the steep rise in fuel prices. The pre-Airlines PNG entry era co-incided with the Air Niugini/Qantas code-sharing arrangements on this route. For reasons discussed elsewhere, Airlines PNG could not economically survive the sudden and significant increase in route capacity with the entry of Qantas without restructuring its operations on the route. Its share of revenue passengers carried declined which can be attributed to the reduction in its operating capacity on the route. If the two largest operators were to be allowed to collaborate, they would be able to reduce costs by rationalisation and cut fares below Airlines PNG’s ability to respond, thereby securing its exit and creating the conditions for a reversion to the pre-Airlines PNG entry era level of air fares. This issue is discussed in greater detail under the heading of ‘Assessment of effect on competition’ later in this draft determination.
- 7.20 The applicant itself, in its most recent submission, acknowledges “The entry of Airlines of PNG into the market in late 2005 co-incided with a marked decrease in average yields”.
- 7.21 A further aspect, already alluded to above, but worth reinforcing, in terms of anti-competitive effects on markets other than the one the subject of this application, is that fares on the Port Moresby/Brisbane and Port Moresby/Sydney routes also followed the Port Moresby/Cairns fares downward with the entry of Airlines PNG on the Cairns route because of competitive domestic air services within Australia i.e. between Cairns, Brisbane and Sydney. The applicant acknowledges this in its latest submission (see paragraph 4.2).

Government equity and subsidy

- 7.22 As a state entity, Air Niugini has benefited from Government subsidies and equity injection on various occasions. Government subsidy into Air Niugini has been in the form of bank guarantees and direct equity injections into the airline. There were two direct equity injections into the airline that occurred in 2006 and 2007 for re-fleeting purposes.
- 7.23 The Commission noted in Air Niugini’s 2002 audited financial report the airline stated that “...the one off costs for the early return of the lease of the A310...and the entry into a new lease for B767-300 was K53.7million. Funding of K24 million from BSP was facilitated by a PNG Government Guarantee of K42million to cover new and existing borrowings.”
- 7.24 In Air Niugini’s 2004 audited financial report, the airline stated that “in early 2005, the airline paid back a bond of K10 million to POSF...the airline is now free of all bank and financial institutions debt...” It also said that “BSP has returned the guarantee of K42 million to the PNG Government.”
- 7.25 The Commission also noted that in December 2006 and August 2007, the Government of PNG injected K30 million and K40 million respectively into the airline. The funds injected in 2006 were used to purchase two F100 aircraft to replace the F28 - 4000 fleet. The funds injected into the airline in 2008 were set aside to fund the purchase of the B787 aircraft.

- 7.26 Air Niugini has never declared a dividend to the Government. Independent Public Business Corporation, the statutory shareholder in the SoEs, submitted, in effect, that there is no obligation to declare a dividend and corporations can re-invest in the business. Further, as an SoE, Air Niugini is unable to list on the stock exchange and raise capital on the market in the way Airlines PNG can.
- 7.27 The Commission accepts that Air Niugini is not obliged to declare dividends. The matter needs to be considered, however, in the context of Air Niugini’s claims of its ability to declare dividends as a public benefit. Such claims cannot be accepted without testing.
- 7.28 It is, moreover, relevant, that access to Government capital or loans without incurring a market cost of capital or debt, reduces the ‘risk’ element of the business by the implicit assurance of access to such funds when needed and, indeed, an implicit ‘guarantee’ by the Government, which virtually eliminates the perception of ‘counterparty risk’ for suppliers. Market-based operators such as Airlines PNG do not enjoy such benefits. There could also be a perception of an SoE as ‘an arm of Government’ – the earlier reference to Air Niugini’s ability to secure additional landing rights without the involvement of the usual sovereign authorities in bi-lateral negotiations, is an example in point. While the weight to be given to such factors remains to be assessed, clearly, they cannot be completely ignored.
- 7.29 In its 2006 report, the Airline’s Chairman Sir James Tjeong, CBE said *“the vision for the last five years was to bring the airline into profitability and restore its financial independence. This has been very successfully achieved by the Board and Management. The vision for the next five years into the future will be to explore growth opportunities presented in the environment and expand the route network to be a more effective airline in the region”*.
- 7.30 In its submission to the Commission dated 20 December 2010, Air Niugini said that *“no funding is provided by the Government in 2010. K100 million has been returned to Department of Treasury to acquire the Falcon aircraft. Therefore, most of the re-fleeting has been carried out from the internally generated funds and external borrowings through leasing programs”*. It is not clear, however, whether the repayment includes an interest component.
- 7.31 Air Niugini submitted that the strategic direction for the airline in 2011 and beyond is to *“provide safer, reliable, competitive, affordable and sustainable air service to the travelling public. To achieve these key strategic goals, airline has its objectives and plans on routes, aircraft fleet, fares types, systems, assets and human resources. Code-share arrangements are also part of this strategic direction.”*
- 7.32 The Commission also noted that Air Niugini’s audited financials for the years ending 2008, 2009 and 2010 were unavailable as they are yet to be audited by the Auditor General. This has affected Air Niugini’s ability to be able to make the information available for disclosure to the public. Air Niugini has also sought and was granted an extension of time from the Registrar of Companies to 30 June 2011 to furnish the financial reports for each of these years to the Investment Promotion Authority.
- 7.33 Consequently, only audited financial figures that are publicly available are shown in the table below.

Year	Net Profit/Loss For the Year	Total Equity (inclusive of Revaluations, Retained earnings)	Return On Equity	Share Capital (Year End)
2002	(38,935,000)	1,858,000	-2096%	58,910,000
2003	51,215,000	52,422,000	98%	58,910,000
2004	31,293,000	78,845,000	40%	58,910,000
2005	17,955,000	98,417,000	18%	58,910,000
2006	37,143,000	176,950,000	21%	88,910,000
2007	12,454,000	236,623,000	5%	128,910,000

Source: Data extracted from Air Niugini’s publicly available Audited Annual Financial Reports for various years

- 7.34 The lack of publicly available financial data for the periods 2008 – 2010 inclusive means that the Commission is unable to analyse the financial performance of Air Niugini, in relation to the current competition landscape and its impact on the airline’s profitability, with a degree of

confidence that is generated by audited accounts. What can be drawn from the publicly available information and from the unaudited accounting information provided to the Commission in confidence is that Air Niugini has turned around its loss making operations to profitability.

- 7.35 As discussed in the issues paper, Air Niugini has been generating a positive return on equity overall. Return on equity (RoE) reveals how much profit a company earned in comparison to the total amount of shareholder equity found on the balance sheet. In the private sector, RoEs represent a measure of the efficiency and profitability of the enterprise and influence share prices. It is noted that the equity provided by the Government shareholder of Air Niugini increased in 2006 and 2007 by a factor of 219% based on share capital figures in the table directly above.
- 7.36 Although Air Niugini's combined financials shows a strong balance sheet and profitability since 2002, its profitability continues to remain volatile. This volatility is not unusual, largely because of the volatile nature of the business, mainly due to fluctuations in cost factors such as fuel, aircraft lease and maintenance, and technical crew that comprises much of the operating costs of any airline, which causes earnings and profits to fluctuate depending on the market conditions prevailing from time to time. Air Niugini is no exception as its operating costs (fuel, aircraft lease, maintenance and technical crew) comprise a substantial proportion of its overall total operating cost. As discussed above, audited financial information for the past three years is unavailable to make any comparable and meaningful assessment of Air Niugini's financial performance in relation to recent years, however unaudited information indicates the performance of the airline to date as discussed below.
- 7.37 Ordinarily, if Air Niugini had had its financials audited in the same time frame as a private sector company, much more recent figures would have been available for publication. It has claimed confidentiality for its unaudited figures, as they have not been released publicly, hence they cannot be reproduced. However, that does not prevent the Commission from commenting broadly on them. While audited accounts are more reliable than unaudited financials, to the extent that the latter can be indicative of performance, they show that Air Niugini's financial performance has fluctuated markedly, but has not improved above its long term average for the period in respect of which audited figures are available.

Designation & capacity allocation

- 7.38 Designation of, and capacity allocations to, airlines seeking to operate international airline services from Papua New Guinea, is administered by the PNG Department of Transport ('DOT') and hence for the purposes of allocation of routes and capacity on routes to PNG based airlines, DOT is the "regulator". In its review, the Commission received information from DOT showing that PNG has air services agreements (ASAs) with 13 countries - Australia, New Zealand, Solomon Islands, Fiji, Vanuatu, Singapore, Malaysia, Japan, Philippines, Indonesia, Palau, Micronesia and Hong Kong.² The Commission notes that very recently, a new ASA was entered into between PNG and South Korea, bringing the total number of ASAs to 14.
- 7.39 According to DOT, each party to the air services agreement designates its own airlines to operate international air services on the specified routes in the agreement. Each party has the right to designate as many airlines as it wishes to conduct international air transportation in accordance with the agreements. Such designation is transmitted to the other party in writing through diplomatic channels."³ Moreover, DOT said that designation for international airline operation is a prerequisite to operating international air services between PNG and the territory of the other sovereign party to the ASA agreement".⁴ For PNG airlines conducting international operations, the Minister for Transport has the authority to designate and approve the International air service licensee.

² Department of Transport letter dated 12 January 2011.

³ Ibid

⁴ Ibid

- 7.40 The designated airline can apply to relevant authorities of the other country for “*operating authorisations and technical permissions relating to operation and navigation of aircraft and the other party grants appropriate authorisations...*”⁵; including meeting conditions of airline being incorporated and [having] its principal place of business in the territory of the party designating the airline; and conforming to other international aviation requirements to which PNG is a signatory to as well as domestic CAA requirements.
- 7.41 DOT advised the Commission that capacity entitlements are negotiated based on demand normally at the request of designated airlines when they anticipate improved market conditions and, thus, the need for increased capacity. It said that capacity allocation is made under a pooled arrangement for the total entitlement of each country where designated airlines of each country are at liberty to utilize its existing capacity based on commercial considerations. Unused capacity is left in the pool for future use.⁶ Capacity not utilized by an airline which has been allocated capacity by its home country, can be re-allocated to another designated carrier of that country.
- 7.42 DOT also said that code-sharing is allowed for in all PNG’s bilateral air services agreements. Moreover, it said “*PNG has adopted a phased approach towards liberalisation of international air services by undertaking to gradually lift limitations in traffic rights, capacity and frequency of flights and routes (limited to specified routes as opposed to an open route schedule) taking into account the volatility of market conditions that can support open competition...*”⁷

State of play on designation and capacity for PNG carriers

- 7.43 The Commission notes that Air Niugini is the first airline since independence to be designated to operate international air services to the 13 countries with which PNG has ASAs (and now to South Korea, the 14th country). Air Niugini, is said, therefore, to enjoy automatic designation as a PNG carrier to all countries with which PNG has ASAs and to any additional countries with which PNG may conclude ASAs. Airlines PNG recently launched into international operations. It was initially designated for international operations between PNG and Australia only.
- 7.44 Airlines PNG recently applied for capacity allocation to five countries; but instead, the Minister for Transport designated it to operate services to only three of the five countries for which it had applied for - Singapore, Indonesia and Philippines.⁸ A more recent letter from Airlines PNG to DOT sought designation for Singapore and any other countries with which PNG may have ASAs. Clearly, this was an attempt by Airlines PNG to secure rights equivalent to Air Niugini.
- 7.45 In correspondence with the Commission since the release of the Issues Paper, DOT suggested that Airlines PNG had only applied for designation to the three countries in respect of which it was granted designation. The Commission notes that the correspondence reproduced at page 20 of the Issues Paper shows that this is not correct. Airlines of PNG sought designation ‘for both the Singapore Bi-Laterals and in any future bi-lateral talks with other States.’ Furthermore, documentary evidence obtained from Airlines PNG clearly shows that other reminders and information requests pursued the wider designation requests, including the one letter specifically seeking designation for five countries.
- 7.46 It is not clear what regulatory decision has been made on the request by Airlines PNG for wider designation, but as far as communication of any decision can be relied upon as an indicator of the progress of the decision-making process, the Commission understands that no decision has been made on such requests for wider designation. It is not clear why DOT maintains its position that Airlines PNG’s designation request was limited to the three countries referred to in the decision by the then Minister for Transport. This is a matter for further inquiry by the Commission, which it hopes can be clarified by the time of the final

⁵ Ibid

⁶ This specific advice was relayed to the Commission in an email dated 15 February 2011 from DOT. Advice on similar matter was contained in the letter of 12 February 2011 from DOT.

⁷ Department of Transport letter dated 12 January 2011.

⁸ Airlines PNG letter dated 31 January 2011.

determination. The Commission has drawn the attention of the current Minister for Transport to this situation, copied to the Secretary of DOT, for whatever action he considers appropriate in the circumstances, but no feedback has been received.

- 7.47 A matter of some concern is that evidence of aircraft availability to service a route for which designation and capacity is sought, is required by the regulator, in respect of Airlines of PNG, but not for Air Niugini. Co-incidentally, Air Niugini, in its latest submission, pointed out to the non-availability of an aircraft to Airlines PNG, suitable for the Port Moresby/Manila route.
- 7.48 The requirement to have available an aircraft, to service a route in respect of which designation or capacity is sought, essentially creates a ‘chicken and egg’ situation – regulatory permission is only available after the aircraft intended to operate the route has been organised. However, organising an aircraft in advance of permission is extremely expensive and the uncertainty created by the delay and eventual regulatory decision is a considerable and costly disincentive to entry, because having an aircraft standing on the tarmac, or in a hangar, awaiting a decision, the timing of which is unpredictable, is an extremely expensive exercise, the costs and risks of which few, if any, intending entrants would be prepared to undertake.
- 7.49 In combination, the above discriminatory requirement for aircraft availability and discriminatory grant of capacity, create an almost insuperable regulatory barrier to entry.⁹
- 7.50 Apart from its request for official designation as a PNG designated airline for purposes of conducting its international aviation services with countries PNG as ASA’s with in future, Airlines PNG also applied for passenger and freight capacity allocations as shown in table below.

Route	Capacity Type	Capacity Amount Requested	Application Date
Singapore	Freight	40 tonnes each direction weekly	27 Nov 2009
Philippines	Freight	60 tonnes each direction weekly	27 Nov 2009
Singapore	Passenger	422 seats each direction weekly	17 Sept 2009
Hong Kong	Passenger	211 seats each direction weekly	17 Sept 2009
Philippines (Manila)	Passenger	422 seats each direction weekly	17 Sept 2009
Indonesia (Jakarta)	Passenger	422 seats each direction weekly	17 Sept 2009
Solomon Islands (Honiara)	Passenger	422 seats each direction weekly	17 Sept 2009

Source: Letters from Airlines PNG

Capacity between PNG and Australia

- 7.51 The Commission understands from the Department of Transport’s submission that whilst Ministerial approval is required for designation for any PNG Airlines wishing to operate international airline services, capacity allocation is the prerogative of the Secretary of the PNG Department of Transport who makes decisions on such matters.

⁹ Eminent authorities on competition issues such as the so-called ‘Chicago School’ economists (Professors Robert Bork; George Armentano; Richard Posner and Milton Friedman); and a noted US aviation industry regulator, Mr Alfred Kahn, have decried the anti-competitive effects of regulation and its practical implementation. Clearly, this is an example. Furthermore, as part of its ongoing efforts to liberalise markets and remove non tariff barriers to trade, PNG has participated in a number of APEC initiatives, of which the current one being implemented is to Strengthen Implementation of Good Regulatory Practices which embody the principles of competition, transparency, non discrimination, accountability, public consultation and cost/benefit assessment. Presumably DOT is unaware of this initiative.

- 7.52 The Commission notes that current capacity allocation between PNG and Australia as at April 2010 is as follows: Passenger Capacity – 3,520 seats per week in each direction; Freight Capacity - 130 tonnes per week in each direction.
- 7.53 It is not clear what national interest objective is served by limiting freight capacity, which directly influences the level of trade between the two countries. By contrast, no such limitation applies to seaborne trade. In an era of trade liberalization, the rationale for such a constraint appears questionable.
- 7.54 The table below shows the return weekly passenger seat capacity operated by respective airlines on the different routes.

Scheduled Airline or Alliance	<i>Passenger Seat Capacity</i>			Total
	Port Moresby/Cairns	Port Moresby/Brisbane	Port Moresby/Sydney	
Airlines PNG/Pacific Blue	72 ¹⁰	384 ¹¹	0	456
Air Niugini/Qantas	948	1,913 ¹²	180 ¹³	3,041
TOTAL				3,497

Source: ICCC estimates from information submitted by Air Niugini

- 7.55 The Commission also understands that PNG designated airlines such as Air Niugini and Airlines PNG can use their allocated capacity to offer services jointly with other designated airlines of Australia on the route. A similar arrangement is understood to be also available for any Australian carrier, subject to obtaining prior approval from the regulator – the International Air Services Commission of Australia (IASC).
- 7.56 According to Air Niugini, it provides a total of 3,041 seats on the PNG/Australia route in each direction. Of this, Qantas had taken up 887 seats for sale on the Port Moresby/Brisbane-Sydney route (via the current code-share agreement on that route); while Air Niugini sells the balance of 2,154 seats.
- 7.57 Of the 2,154, only 948 seats are available for sale by Air Niugini on the Port Moresby/Cairns route in each direction. Airlines PNG offers a total of 72 seats weekly for its Port Moresby/Cairns services while 384 seats are provided in code-share with Pacific Blue on its Port Moresby/ Brisbane services. Altogether, PNG designated carriers provide total of 2,226 (2,154+72) seats available southbound and slightly less northbound.
- 7.58 Based on the above estimates, it appears that there is an unused capacity of 910 (3,520-2,610) seats per week in each direction between PNG and Australia. As outlined earlier, any unused capacity allocated to PNG airlines operating international routes can be reallocated to another designated carrier if it wishes to use such available capacity, on any route between the two countries, subject to meeting technical criteria.
- 7.59 From the above information and the block space uptake by Air Niugini under the proposed code-share arrangement, it appears that there would still be an underutilisation of PNG's total passenger seat capacity allocation under the ASA with Australia, although no issue arises at this stage, no carrier apparently having sought the allocation of unused capacity.

¹⁰ Utilised and operated by Airlines PNG.

¹¹ Operated by Pacific Blue and utilisation shared by Pacific Blue and Airlines PNG under a code-sharing agreement authorised by the Commission.

¹² Operated by Air Niugini and utilised by Qantas and Air Niugini under a code-sharing agreement authorised by the Commission.

¹³ Operated by Air Niugini and utilised by Qantas and Air Niugini under a code-sharing agreement authorised by the Commission.

Current air services

- 7.60 At the time the Commission released its Issues Paper, the current level of regular passenger air transport services between Port Moresby and Cairns is noted as shown in the table below. There appears to be very little material change from these services noted since then.

WEEKLY SERVICES BETWEEN PORT MORESBY AND CAIRNS			
SCHEDULED OPERATOR	AIRCRAFT TYPE	NO OF WEEKLY RETURN SERVICES	NO OF SEATS AVAILABLE
Air Niugini	Dash 8 Q400 (74 seater)	2	296
	Fokker F-100 (100 seater)	8	1600
Qantas	Dash 8 Q400 (74 seater)	12	1776
Airlines of PNG	DHC-8-100 (36 seater)	2	144
TOTAL		24	3816

Source: ICCC, calculations based on respective airline schedules dated Dec 2010

- 7.61 The Port Moresby/Cairns route is serviced by a mixture of F100's, Dash-8 Q400 and Bombardier Dash-8's by the above airlines. All these aircraft are narrow bodied and do not have sufficient belly-holds to carry significant cargo, other than mail and passenger baggage.
- 7.62 Qantas has been operating 12 return weekly services since 1 July 2010. Air Niugini operates 2 Dash-8 Q400 weekly services and 8 F-100 weekly services. The current Dash-8 services represent a 50% reduction of Dash-8 services on the Port Moresby/Cairns route or 296 seats. Airlines PNG currently operate two weekly services, down from seven services pre-July 2010, representing a 71% reduction of services or 360 seats in each direction on the route.
- 7.63 Air Niugini said that although some minor adjustments to its current schedules and operations may occur, there are no plans to reduce its services on the Port Moresby/Cairns route if the code-share agreement is authorised.
- 7.64 The airlines also compete on the Port Moresby/Brisbane route through their respective current code-sharing agreements – Qantas/Air Niugini alliance and Pacific Blue/Airlines PNG alliance using the B767 and B757 aircrafts respectively. Both code-sharing agreements have been authorised by the Commission until 30 June 2012 and 31 March 2012 respectively.
- 7.65 Air Niugini and Qantas also operate services between Port Moresby and Sydney under their code-sharing agreement, authorised by the Commission until 30 June 2012.

8. Assessment of effect on competition

Market definition

- 8.1 The first step in assessing the effect on competition of conduct under consideration is to define the market. For the purposes of the ICCC Act, the market is defined under Section 45(2) as:

'A reference in this Part to the term "market" is a reference to a market in the whole of Papua New Guinea for goods and services as well as other goods and services that, as a matter of fact and commercial common sense, are substitutable for them, including imports.'

- 8.2 Bearing in mind the statutory provision on the definition of the market, the Commission would need to identify the relevant market for the purpose of establishing actual and/or potential competition effects in the market(s). Identification of markets is the first essential step in any competition analysis. It begins with a consideration of the products or services of the firms under consideration and then proceeds to consider substitution possibilities in both the demand and supply sides.

- 8.3 The ‘product’¹⁴ under consideration here is the provision of air travel between Port Moresby and Cairns. There is no economically viable substitution possibility for air services between those two airports. Air services between those two airports, therefore, represent both the ‘product’ and ‘geographic’ dimensions of the market.
- 8.4 In terms of customers, the Commission considers that people travelling on the route fall into one of the four categories:
- a. Government/Business travel purposes;
 - b. Visiting Friends and Relatives travel purposes;
 - c. Holiday Travel purposes;
 - d. Other travels.
- 8.5 These groups of travellers are considered to have different demand elasticities to the price-product-quality package combination of the services that are being offered. Persons travelling for government or business related purposes are considered to be less price sensitive, meaning they would not be affected as much as those travelling for other purposes as in VFR, Holiday and ‘Other’ travel related purposes by price increases. Thus any significant non-transitory increase in the fares in this market would not impact on their choice to travel by air.
- 8.6 The Commission noted from information supplied to it that trips between PNG and Australia are predominantly business, followed by holiday travel, with a small proportion for VFR and ‘other’ travel purposes. Consequently, the code-share can be looked at in terms of its impact on the different categories of travel on the route.
- 8.7 It may also be relevant to examine the ‘knock-on’ consequences of the proposed arrangements on any other market. The code-share agreement would also impact on competition in the PNG domestic route, as Australian traffic is channelled into Port Moresby from their port of origin, in this case, from Cairns, and then through the domestic networks of Air Niugini and Airlines PNG for domestic destinations. Therefore, the Commission considers that given the significance of ‘networks’ in the airline industry, the PNG domestic aviation market is also a relevant market for consideration.
- 8.8 A further consideration arises – the effect on other routes between PNG and Australia, specifically Port Moresby/Brisbane and Port Moresby/Sydney. The Commission noted in IPBC’s submission wherein it quoted a parliamentary presentation by the Minister for Public Enterprises, Hon. Arthur Somare. IPBC alluded to that statement that Air Niugini’s international services has also improved with international passenger numbers growing in the four years to May 2010 and airfares dropping by 20% to 40% in some sectors.
- 8.9 Notwithstanding the difficulty of obtaining historical airfares for rigorous assessment of how airfares have changed over a certain period, the Commission noted yield information for Port Moresby/Brisbane and Port Moresby/Sydney route which demonstrates a significant drop in airfares following the entry of Airlines PNG on the Port Moresby/Cairns route, and Port Moresby/Brisbane route in code-share with Pacific Blue in late 2009.
- 8.10 The relevance of the effects on competition in markets other than the one the subject of the proposed code-share agreement and the effect of Airlines PNG’s entry on fare levels and yields on the Port Moresby/Brisbane and Port Moresby/Sydney routes have been discussed above and also in the other application. One view is that the presence of the code-share operations between Airlines PNG and Pacific Blue on the Port Moresby/Brisbane route should maintain a price constraint on that route and the Port Moresby/Sydney route.
- 8.11 Nevertheless, the appropriateness for consideration of those routes as markets relevant to consideration of this application remains, because of the uncertainty surrounding regulatory decision-making by DOT in relation to international aviation designation and capacity allocation. Arguably, if Airlines PNG is forced to exit the Port Moresby/Cairns route, as a consequence of the code-share authorisation being granted, it ceases to operate as a PNG international carrier between PNG and Australia and its designation under that bi-lateral

¹⁴ in this case, actually, a ‘service’ - traditionally, competition literature appears to restrict the description to ‘product’, despite the subject-matter in some circumstances consisting of a service.

agreement could be withdrawn, thus making it problematical for it to participate in the Port Moresby/Brisbane code-share arrangement with Pacific Blue and throwing the economics of that arrangement into doubt, and consequently, the presence of a competing service to the collaborative Air Niugini/Qantas service, which has been authorised by the Commission, with predictable effects on competition on the latter route and the Port Moresby/Sydney route as well as on domestic civil aviation markets and Airlines PNG's competitiveness for through traffic to domestic destinations other than Port Moresby.

Applicant's submissions on competition

Air Niugini's submission to the Commission on competition can be succinctly summarised in the following manner.

- 8.12 Air Niugini submitted that under this hard-block code-share arrangement, each seat, on each code-share service sold by it, effectively has a marginal cost of zero Kina. Unsold hard-block seats therefore represent an absolute loss to Air Niugini. It therefore has the strongest possible incentive to market its seats on code-share services aggressively in competition with Qantas.
- 8.13 In addition, it submitted that under the code-share arrangement each of the parties would sell and market fares on code-share services independently, in full competition with the other. Each carrier, independently from the other, would set its own price; determine its own fare classes and rules; operate its own independent yield management systems; and sell its products through its respective independent sales networks.
- 8.14 It also submitted that this code-share agreement does not constrain capacity. Capacity has clearly exceeded current demand following the entry of Qantas independently in July 2010 on the route with 12 services in each direction per week on a 74 Seater Dash-8 Q400 aircraft. There is no commitment, however, by the prospective parties that frequency and/or capacity will not be reduced – merely that there is 'no intention' to do so, other than minor adjustments.
- 8.15 It submitted that although Airlines PNG is a small competitor, it has the ability to vigorously constrain the conduct of a much larger competitor; as described by the Australian Competition Tribunal (ACT) when approving the proposed Trans-Tasman alliance between Qantas and Air New Zealand.
- 8.16 Air Niugini submitted that the parties are constrained due to a number of factors such as the ability of major customers to impose price pressure by threatening to or actually chartering or operating their own services between Papua New Guinea and Australia. In addition to being constrained by their existing competition, the parties are at all times constrained in their conduct by the fact that barriers to entry to the Australian Air Passenger Services Market are low. If Air Niugini or Qantas were to raise prices or reduce service levels, it would be easy for a new entrant to take advantage of this to enter the market.
- 8.17 It submitted that although Air Niugini has responded to competition from Airlines PNG, it has been careful not to engage in conduct that may be considered predatory. Air Niugini has introduced new discounted fares prior to Airlines PNG and Qantas Link entry to the market and continues to compete with the discounts offered by Airlines PNG and QantasLink. These discounted fares, however, respond to prices offered by Airlines PNG and Qantas rather than attempting to force prices down further. Air Niugini has tended to offer fares above Airlines PNG because Air Niugini offers a full service in-flight product. Air Niugini has not engaged in conduct aimed at forcing Airlines PNG to withdraw from the market or behave in a less competitive way.

Market concentration

- 8.18 In its submission to the Commission, Air Niugini argues that high market share is not indicative of market power. It quoted the ACT's decision on a similar matter submitting that when approving the proposed Trans-Tasman alliance between Qantas and Air New Zealand, the ACT summarized the ability of a small but vigorous competitor to constrain the conduct of a much larger competitor as follows:

“Although market share can be a significant factor in determining the extent of competition in a market, we believe that prime attention must be paid to market conduct. A structuralism approach that focuses heavily on an increase of market power by using market shares as a proxy to assess market power fails to assess the whole picture...”

It went on to quote another section that *“[m]arket shares, by themselves, in the absence of barriers to entry or expansion, do not guarantee that the firms holding such market positions will be able to act to the detriment of the competitive process. A high market share indicates only that at a point of time the firm in question has been able to command the patronage of many customers in the market. Such patronage may be due to the fact that the firm has been able to offer the right “price-product-service package” to customers...”*

It also quoted another paragraph as follows; *“...When entry barriers are low or non-existent, in the sense that there exist no impediment to competitively significant entry – entry that will serve to constrain the firm in question – then if the firm currently enjoys a high share of the market, this will not of itself signal that the firm can be expected in the future to behave in an anti-competitive manner.”*

- 8.19 The Commission noted an alternative argument by Airlines PNG to Air Niugini’s claim. Airlines PNG said that *“[t]he references summarize the ability of a small but vigorous competitor to constrain the conduct of a much larger competitor. We would distinguish the current circumstances on the basis that the Trans-Tasman market has open skies arrangements vis-à-vis Australian and New Zealand owned carriers and a number of fifth freedom carriers have access to that market as well. Those circumstances simply do not exist under the bilateral air service arrangements between Australia and PNG.”*

Airlines PNG also stated that, *“...for the record... the Qantas/Air New Zealand alliance was actually abandoned after failing to secure approval from the New Zealand Commerce Commission.”*

- 8.20 The Commission noted a media release of the New Zealand Commerce Commission stating that *“[a]lthough Virgin Blue’s entry on Tasman and New Zealand main routes, and the presence of other international airlines on the Tasman route, have some impact on the relevant markets, the competition provided by these carriers is not sufficient to allay all of the Commission’s concerns.”¹⁵*

- 8.21 In its most recent submission, Air Niugini argued that the above analysis fails to take account of dynamic factors. Such factors, including barriers to entry and expansion; and other dynamic factors are discussed extensively in this draft determination. It is necessary, however, to consider concentration, because that is a *necessary* condition, albeit not a *sufficient* condition for the exercise of unilateral or co-ordinated market power. This approach accepts and supports the applicant’s position that concentration of itself is not probative of market power or substantially anti-competitive effects, or the likelihood thereof. It is a starting point, from which other factors need to be taken into account, most significantly, for reasons enunciated later, the height of barriers to entry and expansion.

Motivation for the proposed code-share agreement

- 8.22 In 2008, Air Niugini made its submission on the Airlines PNG/Pacific Blue code-share alliance¹⁶ stating that:

‘The proposed code-share’s key objectives and motivation should be the generation of new traffic not solving the participating airline’s financial or capacity problems. The presentations by the parties lack attention to this issue rather than attempting to solve the airline’s problems.’

- 8.23 That submission appears to suggest that only a new route should form the basis of a code-share application.¹⁷ It appears from Air Niugini’s submission that the motivation for its code-

¹⁵ New Zealand Commerce Commission Media Release, 23 October 2003 “Air New Zealand and Qantas: Commission rejects proposed Alliance as not in the interest of New Zealanders”.

¹⁶ Air Niugini’s submission to the Commission dated 28th October 2008.

share agreement with Qantas is to enable Air Niugini to take advantage of the additional flight frequency and timings offered by QantasLink services to its customers. If so, this appears contrary to the intent of the claims made by Air Niugini on the application for authorisation of the code-share agreement between Airlines PNG and Pacific Blue. Furthermore, the existing code-share between Air Niugini and Qantas emerged from the withdrawal by the latter from PNG, rather than the creation of a new route. In the case of the Airlines PNG/Pacific Blue code-share, at that time, Airlines PNG did not have available aircraft to provide services on the route; but through the arrangement, it enabled new entry into the market – of a joint Airlines PNG and Pacific Blue service into the Port Moresby/Brisbane route, which was previously serviced exclusively by Qantas/Air Niugini alliance in a code sharing arrangement.

- 8.24 The code-share agreement now proposed by Air Niugini suggests that there is unused capacity available from Qantas and by accessing that capacity, Air Niugini would be able to expand its offerings in the Port Moresby/Cairns market. As for Qantas, the agreement would appear to work to its advantage by solving its overcapacity problem and enable it to earn revenue from seats that would otherwise not be sold by itself. The issue of ‘overcapacity’ is explored further below. On any view, the previous submission by Air Niugini, on the Airlines PNG/Pacific Blue code-share is inconsistent with the arguments put forward in respect of this application.

Competitor relationships, collaboration and effect on competition

- 8.25 At the outset of this discussion, the Commission notes that code-share agreements that operate within different market environments produce different market outcomes. Some produce serious anti-competitive outcomes and detriments to the public. Others produce public benefits that outweigh their anti-competitive detrimentsⁱⁱⁱ. The impact of code-share agreements operating within the context of other associated arrangements, such as the Frequent Flyer Programs (FFPs) between partner airlines, where travellers earn points and/or redeem points for travelling on the alliances or code-share partner’s services, collectively produce stronger anti-competitive outcomes. Membership of alliances also bound up with code sharing, in practice, bring in a degree of ‘exclusivity’ to code-share agreements, even when this is not specified in the agreement itself^{iv}. The usual overall impact of such arrangements is to produce stronger anti-competitive effects. Competition effects of a code-share agreement, therefore, will depend on, amongst other things, the economic circumstances and the behaviour of the parties and their rivals within the market.
- 8.26 The Commission notes that Air Niugini will take up 5 of 74 seats available per flight as hard-block seat uptake under the proposed code-share agreement. The price of these seats will be set by Qantas. Consequently, Air Niugini’s ability to price below the agreed seat charge is limited, and it would run counter to rational economic decision-making to do so on other than a very short term basis. Therefore, the pro-competitive outcome of this arrangement, in terms of pricing, would be minimal. The Commission, however, does not discount the fact that unsold seats would remain a loss to Air Niugini and therefore creates an incentive to sell all those seats to recover the fixed cost of the seats. In spite this fact, there is no evidence available to demonstrate that the fare charged by Air Niugini would be below the cost of seats set by Qantas to the former - indeed, as stated above, it would be irrational to sell below cost on a sustained basis. Hence, the ‘margin’ for competition would be limited to the differential between the ‘wholesale price’ set by Qantas and the latter’s retail price. Such a margin is not expected to be substantial until the competitive pressure of the independent competitor on the route, Airlines PNG, is eliminated by its exit from the market.
- 8.27 It is also unlikely that the hard-block seats to be sold to Air Niugini would impact Qantas’s decision to reduce the current fares it offers relative to Air Niugini, notwithstanding the annual growth rate of some 16% that the market is recording between Port Moresby and Cairns. On the contrary, the marginal revenue derived from the seats sold to Air Niugini enhances its profitability as it is commonly accepted in the industry that ‘an unsold seat on an aircraft about to take off is the most perishable product in the world’. It would appear, in a small but significant way, to reduce the incentive of Qantas to compete on fare offerings to

¹⁷ No other interpretation appears to offer itself.

travellers in this market. Code-share agreements between the airlines that have high market shares act as a shield from competitive pressure that would otherwise be mutually exerted.

- 8.28 While Air Niugini has submitted that it has no plans to reduce services, there is no guarantee that it would not do so if the code-share agreement is authorised. Current overcapacity on the route strongly suggests that if traffic does not increase soon, substantially and sustainably, profitability criteria would dictate some reduction of services. The code-share agreement would be likely to mute the competitive vigour between the parties and allow them to ‘rationalise’ services without detrimentally affecting profits.
- 8.29 While, in ordinary circumstances, the third competitor would be able to compete vigorously for market share, if prices rose following the code-share agreement, the factors discussed earlier, namely Airlines PNG’s ‘market-financed’ operation, in contradistinction to Air Niugini’s Government financial assistance, means that it could not sustain a lengthy ‘price war’. Qantas, of course, is a large international and Australian domestic airline conglomerate and could sustain less profitable operations on the route for a considerable time. Alternatively, once it has achieved a satisfactory share of the market, it could trim its operations to sustain its share of a market in which it previously had no independent share.
- 8.30 The code-share agreement, if authorised, would provide an advantage to the two sharing parties and enhance their ability to ‘discipline’ new entry and expansion, by reducing prices such that it is below their rival’s costs thus making its operation unprofitable. Indeed, that is exactly what has happened with Airlines PNG, whose operations have been substantially reduced as a consequence of the sudden increase in capacity on the route.
- 8.31 Air Niugini argues that such ‘predatory conduct’ can be addressed by other provisions of the Act – presumably section 58, relating to the ‘taking advantage of market power’. Such an approach ignores a fundamental point of competition law. One of the legs of the authorisation test relates to ‘any lessening of competition’ that *would, or would be likely to* arise from the arrangement proposed. That is a forward-looking, preventive approach which is intended to avoid the likelihood of ANY type of conduct which substantially lessens competition, *or is likely to do so*, including overt or tacit collusion or predatory conduct, whether or not specific prohibitions of the Act allow such conduct to be addressed through litigation to enforce the prohibition.
- 8.32 While it is unnecessary to go further on this point, tacit collusion or authorised collaboration, which could result in prices being set at cost, would have the same effect of driving Airlines PNG out of the market but would be extremely difficult, if at all possible, to be made to fit the prohibition and meet the evidentiary standards, usually applied in jurisdictions around the world, in relation to ‘taking advantage of market power’ – such cases are notoriously difficult to prove. In Australia, for instance, the Commission understands that there has been only two such cases proven to the satisfaction of the Court, over a period of some 37 years of enforcement of competition law.
- 8.33 There is a further anti-competitive dimension to the Cairns code-sharing proposal. Where both carriers are operating as carriers on the route, the sale price of block-booked seats offers the opportunity of ‘price signalling’, whether for predatory purposes or to raise prices after the exit of the only other competitor. Price signalling is now causing increasing concern among regulators, as in large enterprises, forming a significant segment of the relevant national economy, sophisticated methods are emerging, catalysing calls for specific regulation of price signalling.

The nature of the competitive process and its benefits

- 8.34 In Air Niugini’s submission, it said that “ *it is possible that the no authorisation of the new Code-share Agreement could result in the carriers chasing sales to cover extra operating costs and may lead to a less efficient and ultimately, less competitive market structure than the authorisation of the new Code-share Agreement.*” It also stated that “*Without the code-share agreement, Air Niugini expects that there would more likely be a capacity and price battle as carriers strive to sustain a viable and sustainable service.*” It elaborated further by saying that “*...the argument is made that the previous Code-share arrangement on the Cairns*

route enabled high frequency services to Cairns. If due to price and capacity battles Air Niugini is forced to withdraw its services due to lack of profitability, then this would result in Air Niugini offering fewer services and frequencies to its customers making the Air Niugini presence in the market less viable and less competitive.”^v Air Niugini contended that it is more vulnerable to a price and capacity battle which could lead to a loss making situation than Qantas and that this would be detrimental to overall efficiency of the route. Furthermore, it said that “authorisation of the Code-share would enable both carriers to compete and give Air Niugini much greater frequency than is currently the case without the operational cost burden of adding additional service.”

- 8.35 In regards to these claims, the Commission noted, in the Queensland Wire Industries case^{vi}, that Justice Mason C J and others said that “[c]ompetition by its very nature is deliberate and ruthless. Competitors jockey for sales, the more effective competitors injuring the less effective by taking sales away. Competitors almost always try to “injure” each other in this way.” The Commission considers that chasing sales and other usual competitive conduct described by Air Niugini in its submission is the very sort of conduct that the competition law is intended to produce, with the outcome being lower prices, innovative and improved products and services which benefit consumers. Such an outcome is attributable to the fact that competition is the best and most efficient way of allocating economic resources to achieve the highest standard of living for all the citizens of the nation.
- 8.36 Therefore it is highly unlikely that, without an authorisation of the proposed code-share agreement, taking into account other market conditions currently and likely to prevail into the foreseeable future, such vigorous competition, of itself, would lead to a less efficient market, as claimed by the applicant. It is likely to impact positively on the parties’ behaviour to offer competitive product offerings at lower prices in the market to the benefit of the public. This is what the PNG competition law aims to protect, preserve and promote. Thus, airlines operating competitively on the route are more likely to achieve more efficient operations to earn sufficient profits to make their operations viable. The converse arguments based on the above propositions are also true.
- 8.37 The competition law requires that public benefits must be shown to outweigh anti-competitive detriments because the public benefits of competition are well accepted and understood and, ordinarily, competition needs to be safeguarded to ensure those benefits are realised. It is only in the case where public benefits, which are demonstrated to outweigh the anti-competitive effects of proposed arrangements, can lawfully justify the grant of authorisation.

Traffic shares and complementarity of networks

- 8.38 The pie charts above show that the parties’ combined share of total passenger traffic between PNG and Australia is around 80%. It is, arguably, significantly higher, in operating capacity terms, on the Port Moresby/Cairns city pair route¹⁸. A code sharing agreement therefore, will, in effect, create a dominant collaborative two-firm presence on that route, whose market share would be difficult to erode by the current competitor, Airlines PNG, or any potential entrant; and would likely deter new entry and/or force out the only other existing competitor. Withdrawal of Airlines PNG on this route is, therefore, a distinct consequence of the code-share arrangement proceeding.
- 8.39 In the PNG domestic aviation market the code-share agreement will most likely limit competitive access to important international traffic to the domestic network of PNG domiciled competitors such as Airlines PNG, and thereby impact on feed-through traffic into the domestic market and detrimentally affect competition within the domestic market. The reverse is also true for traffic flow from domestic to international routes – the ‘channelling’ or ‘funneling’ effect is a significant trait of airline networks, including code-shared services and alliances, which significantly affect their economics.
- 8.40 Customers would prefer to make ‘through’ booking on the code sharing airlines’ network for connections due to the advantages of the network economies enjoyed by the parties in the international, and respective domestic markets, partly due to convenience and partly due to

¹⁸ This is deduced from capacity and frequency of services offered by the carriers on the route.

the loyalty incentives discussed below, which not only apply to flights, but to credit card and purchase ‘points’ benefits, now proliferating. The Commission stresses that such business acumen is to be lauded, but when collaboration is sought to be authorised, the anti-competitive effects of such incentives, which operate as barriers to entry and expansion must be taken into account. This also tends to affect the booking behaviour of travel agents using central reservation systems, which are often pre-programmed, in relation to connection options, in favour of code-share partners or alliances. Customers themselves, due to the benefits of connections and the benefits of the frequent flyer programmes as will be discussed further below, also tend to ‘stick with’ affiliated carriers. Such economic circumstances create significant barriers for any new entrant or current player to sustain and make viable their international operations, considering the need to incur sunk costs - such as marketing and establishing networks, and overcoming customer’s switching costs for loyalty programs.

Applicant’s claims that barriers to entry are low

8.41 Air Niugini submitted that barriers to entry into the market are low and its submissions are summarised below.

- a. Firstly, there are low regulatory barriers to entry by new participants. There is more than adequate capacity available under the air services agreement between Papua New Guinea and Australia to allow a new carrier from either country to enter any or all of the code-share routes. Both countries also allow multiple carrier designations. Relevant safety certificates for operation in Australia and Papua New Guinea are available to any carrier that meets the necessary requirements.
- b. Secondly, there are no slot constraints at Port Moresby or Cairns airports that would be likely to hinder the entry of a new carrier on any of the code-share routes.
- c. Third, ground handling facilities and common user terminals are readily available at both Cairns and Port Moresby.
- d. Fourth, there is an active international market for the purchase or lease of appropriate aircraft.
- e. Finally, sunk costs are minimal as aircraft can be easily resold.

8.42 In its recent submission, Air Niugini said amongst other things, that it strongly refutes any suggestion that any alleged difficulty encountered by Airlines PNG in securing designation or capacity on international routes other than the Manila Route (i.e., the Solomon Islands and Hong Kong) has any significant bearing on Airlines PNG’s ability to effectively compete with Air Niugini and Philippine Airlines, or any other potential entrant, on the Manila Route.¹⁹ It said that this is consistent with Airlines PNG’s rapid entry and expansion onto routes between Port Moresby and Australia, notwithstanding that it had not at that time applied for designation on other international routes.

Discussion of barriers to entry

8.43 Barriers to entry can be of various kinds. They can be regulatory; economic or behavioural. Barriers to entry and expansion are important factors to consider in a competition analysis of any market. These barriers can either be structural or strategic, often referred to as economic and behavioural barriers to entry. Structural barriers to entry arise from basic industry characteristics such as technology, costs and demand.

8.44 In *Re: QCMA*, the Australian Trade Practices Tribunal, after listing a number of factors to be taken into account in assessing the competition consequences of a proposed acquisition, said “[o]f all these elements of market structure, no doubt the most important is (2), the condition of entry²⁰”.

8.45 The applicant’s claims that barriers to entry are low, on the basis that equipment can be leased, ignores the following:

¹⁹ Refer to paragraph 3.1 of Air Niugini submission on the Port Moresby/Manila Code-share Issues Paper.

²⁰ Re Queensland Co-operative Milling Association Ltd, Defiance Holdings Ltd. (Proposed Mergers with Barnes Milling Ltd.) (1976) ATPR 40-012, cited from Paclii case download.

- a. Regulatory barriers;
- b. Scale, scope and network economies – including connections to ‘onward’ ports e.g. Cairns from Hong Kong, Cairns from Manila, Hong Kong from Manila; Nadi from Honiara;
- c. Government aid to Air Niugini;
- d. Deterrent effect of discriminatory regulatory decisions.

Some of these barriers have been discussed above and the rest are discussed below.

- 8.46 The regulatory barriers to the entry of Airlines PNG to other international routes have been discussed earlier. Their effect on the ability of Airlines PNG to achieve network, scale and scope economies is significant. Air Niugini’s route network shows ‘onward’ services to Hong Kong from Manila; and to Nadi from Honiara. Whether or not passenger ‘pick-up’ is occurring in Manila or Honiara for such onward flights (and the Commission has no reason to believe that such benefits are being enjoyed by Air Niugini), the addition to network economies, through the ability to pick up passengers from the ultimate destination is a valuable competitive advantage. Again such competitive advantages are denied to the potential entrant on the route due to the regulatory situation, continued and exacerbated by the ‘bypass’ by the applicant, of basic negotiating frameworks, namely, the bi-lateral sovereign negotiating arrangements. It would be almost inconceivable that Airlines PNG would be allowed to so bypass established negotiating arrangements. Hence, discriminatory implementational regulatory behaviour has given rise to a significant economic barrier.
- 8.47 Air Niugini has argued that ‘with or without’ authorisation, the regulatory situation will remain unaffected and should not influence the determination. The applicant appears to be flagging future Government policy as if it were a matter of fact rather than its own opinion of the likely future scenario. Irrespective, the regulatory situation is a clear, present and significant barrier to entry and it is legitimate, indeed incumbent, upon the Commission to take this into account, given that a collaborative arrangement is sought to be superimposed on a market characterised by such a significant barrier. Furthermore, it is not clear that the regulatory outcome will continue to be the same if the Commission determines to decline to grant this authorisation. Without pre-judging the outcome, the PNG international civil aviation regulatory authorities need to urgently review their processes to ensure transparency and accountability, as they affect competition significantly. If the determination is to decline authorisation, the regulator will be strongly incentivised to secure increases in capacity, which, in appropriate circumstances, would be available to a competitor. Finally, if the applicant’s projection of future Government policy is wrong, significant changes may characterise such regulatory decisions in the future.
- 8.48 Furthermore, while aircraft can be leased, there are significant sunk costs associated with setting up lease arrangements, marketing costs, technical and financial arrangements. Such sunk costs are far from insignificant.
- 8.49 In addition, of considerable economic significance as barriers to entry, are the Government intervention and State aid issues discussed below.

Government Intervention in competitive markets

- 8.50 During the Commission assessment of the application by Airlines PNG/Pacific Blue alliance to code-share on the Port Moresby/ Brisbane route (file no.A2008/07); Air Niugini provided a submission^{viii} to the Commission seeking, as a condition of authorisation of that proposed code-share agreement, ‘...a guarantee is provided [presumably by the parties] that passengers who purchase tickets are not stranded in the event of either or both airlines withdrawing from the code-share route of financially failing and being unable to operate their aircraft.’
- 8.51 The point raised by Air Niugini has particular relevance on public policy matters, specifically on government participation in competitive markets and their implication for ‘competition on the merits’ and ‘competitive neutrality’.
- 8.52 In prior determinations relating to Air Niugini’s code-share agreements, it was noted that Air Niugini came close to financial ruin in 2002, and quick government intervention rescued the

airline from becoming liquidated. That comment is not intended to criticise the decision to assist Air Niugini because if it failed at that time (in the absence of government intervention) it would have been devastating for the economy. Air travel and cargo shipments that rely on regular passenger flight schedules, such as the fisheries exports to overseas markets and other industries, including the domestic aviation industry would have suffered significant economic damage. Since Air Niugini was then the only market player serving many domestic routes, and some strategic international routes which provided much-needed economic benefits to the PNG public and the economy. Government intervention in Air Niugini therefore was considered meritorious and served to protect the ‘public interest’.

- 8.53 The market has undergone many changes since that time, in terms of the competition landscape and traffic growth between Port Moresby and other international routes. For instance, at present, two PNG domiciled airlines compete on the PNG’s international aviation sectors, specifically the PNG/Australia routes, against two Australian carriers (Qantas and Pacific Blue – the latter in code-share with Airlines PNG). Whilst the PNG/Australia market has been growing, at some 16% rate per annum; the Port Moresby/Cairns market alone recorded a 32%²¹ growth between period 2010 and 2011; enabling the current market participants to compete to capture and stimulate the growth, through offering competitive fares, services, frequencies and flight timings.
- 8.54 Whether such positive growth the economy is experiencing calls for government intervention to be redirected towards removing barriers to growth of competitive markets, rather than directly supporting its commercial enterprises to compete against an airline that is privately owned by PNG domiciled interests,^{viii} is a public policy question, that is a matter that is entirely one for Government policy, not for the Commission. As a competition authority, however, the Commission considers that it is legitimate for it to express its views on the competitive implications of Government intervention in markets and to take account of the anti-competitive consequences thereof. The Commission, moreover, is obliged to assess the effect on competition of this proposed arrangement in light of circumstances affecting competition in the market – which include any market-distortionary effects of State aid. The relevance of State aid is outlined below.

State aid, subsidy

- 8.55 As noted above under paragraph 7 “Government equity and subsidy” Air Niugini has benefited from Government subsidies and equity injection on various occasions. Government subsidy into Air Niugini has been in the form of bank guarantees and direct equity injections into the airline. There were two direct equity injections into the airline that occurred in 2006 and 2007 for re-fleeting purposes. There was also other Government subsidy to Air Niugini to cover specific loss making international sectors – specifically Port Moresby/Narita route, in 2008²².
- 8.56 The then Minister for Public Enterprise submitted that, *“In some sectors, competition has improved markedly in recent years with benefits flowing to the public...”*. *“In other sectors, State Owned Enterprises continue to provide community service obligations, on behalf of Government, through cross-subsidies paid by the respective State Owned Enterprise concerned, such as Air Niugini in the case of aviation services.”*²³
- 8.57 Relevant to these matters, the European Union has developed strong legislative and administrative regulations governing State aid to national statutory bodies or enterprises, to ensure that State aid or subsidy is appropriate for those circumstances and compatible with various public policy objectives, including its competition policy. Such legislation contains specific provisions concerning ‘exemptions’ in State aid in the EU; and rests exclusively with the European Commission, which possesses strong investigative and decision making powers. It is only after the approval by the Commission that an aid measure can be implemented.^{ix} Such approaches to State aid ensure that they are compatible with existing Government

²¹ From March 2009 to March 2010, traffic volume was 74,632, compared to March 2010 to March 2011 which recorded 98,491.

²² See Air Niugini submission to the issues paper paragraph 2 page 14

²³ Minister for Public Enterprise submission dated 25 February 2011

policies, including promoting and protecting competition on the one hand, and delivering necessary public goods and services on the other hand.

- 8.58 The Commission also notes that in Europe, State aid is not allowed to confer an ‘advantage’ to the recipient against rivals competing in that market. If the beneficiary was firstly entrusted with a clearly defined public service obligation: the parameters for calculating the compensation must be established in advance in an objective and transparent manner: the compensation does not exceed what is necessary to cover all or part of the costs incurred in discharging public service obligations, taking into account the revenue such obligations may generate and the fact that the beneficiary is entitled to make a reasonable profit for discharging these obligations; and, finally, either the undertaking selected to discharge the public service obligation is chosen pursuant to a public tender, or failing this, the level of compensation determined is determined on the basis of what a typical, well run undertaking to discharge these obligations, again taking into account the revenue such obligations it may generate, and the right for the undertaking to make a reasonable profit.^x
- 8.59 It becomes apparent from the above when compared to current practices adopted by the Government to assist Air Niugini that, arguably, aid to Air Niugini fails to meet any one of the above conditions for State aid in competitive markets.
- 8.60 IPBC has argued that capitalisation and loans for SoEs are matters of Government policy, to prepare them for competition. The Commission accepts that proposition, but is bound by its own legislation to assess any lessening of competition against the public benefit claimed for proposals for which authorisation is sought. The Commission is unable to ignore its statutory obligations.
- 8.61 Air Niugini has argued that ‘with or without’ authorisation, the financial involvement of the Government of PNG in Air Niugini will continue. That may well be so and leaving aside the matter that it is somewhat presumptuous of an SoE to forecast future Government policy, it does not prevent the Commission from assessing the situation from the perspective of competition and public benefit. On the one hand, any ‘tilting’ of the playing field is relevant to competition; on the other, the claimed national economic benefits could not only be delivered through competition, but their extent would likely be greater, as competition is generally accepted, by eminent economic authorities world-wide, to be the best and most efficient allocator of economic resources.
- 8.62 Even Air Niugini recognises the significance of the ‘level playing field’ - c.f. its submission on Airlines PNG/Pacific Blue code-share (see paragraph 8.65 below). The concern is also represented by the inclusion by PNG Ports Ltd, another SoE, of a clause in its regulatory contract, which requires consultation by the regulator on matters relating to revenue or capital expenditure if State aid is provided to a competitor with the implicit objective that such ‘Discriminatory Competition’ be factored into any future regulatory decision.²⁴ The clause states as follows; “*PNG Ports and the Regulator must consult in the event that any third party commences the provision of Essential Port Services where the third party receives any financial assistance or guarantee from the Independent State of Papua New Guinea or an agency thereof which is on terms more favourable than those which would be available to PNG Ports in equivalent circumstances as a consequence of the provision on concessional finance, guarantee or political risk insurance terms, concessional tax treatment or exemption from any tax or regulatory requirement (Discriminatory Competition). In this event, PNG Ports may make submissions to the Regulator about the financial effect of the Discriminatory Competition upon revenue and capital expenditure requirements of PNG Ports.*”
- 8.63 Clearly, a small market participant, constituted as a private sector corporation, faced with the requirement to meet shareholders’ expectations on return on investment; market costs of capital and debt, and private sector risk matrix, is bound to be more sensitive about likely losses and therefore, either less likely to enter the market, or forced to exit a route not returning an acceptable rate of return on economic criteria. On the other hand, a State-aided entity, with a larger network, enjoying economies of a large network, scale and scope, can afford to continue in routes not reflecting market rates of return.

²⁴ Clause 4.4 (a), PNG Ports Regulatory Contract for regulatory period 1 February 2010 to 31 December 2014.

- 8.64 The Commission acknowledges, as mentioned earlier, that quantification of the anti-competitive effect of Government assistance in the form of access to capital and debt at lower or no costs, compared to market rates, is difficult. The authorisation process, however, requires a ‘weighing’ process to be conducted as between any lessening of competition and public benefit. That implies an effort to quantify any such State financial benefits. The implicit nature and effect of such financial perceptions in the market are significant. Hence, while precise numbers cannot be attributed, the competitive distortion cannot be assessed as insignificant.
- 8.65 The Commission considers, therefore, that the operation of any code-share agreement between Air Niugini and Qantas, for an airline that has been conferred certain advantages over its rivals within a competitive market would therefore further ‘tilt the playing field’.

Competitive neutrality, competition on the merits

- 8.66 Many stakeholders including the applicant raised concerns about ‘the level playing field’. For instance, Air Niugini made a submission on the Airlines PNG/Pacific Blue Code-share Authorisation stating that “[t]o meet one of the fundamental conditions of sustainable competition there should be a level playing field for all participants and intending entrants”. In addition, the PNG Tourism Promotion Authority also submitted that “[it] is our strongest view that we should not continue to protect the airlines by approving code sharing arrangements...” “We should however create an equal playing field...”²⁵ The Minister for Public Enterprise also submitted that “...introduction of competition and enforcement of fair pricing, where feasible, will encourage State Owned Enterprises to improve their performances.” “...introduction of competition in each sector will need to be guided by strategic reviews that draw on international best practice and past domestic experiences...”²⁶
- 8.67 The above submissions raise matters which the Commission considers relevant for consideration in this application, especially on ‘competitive neutrality’ and its significance for competition. A number of literature have been reviewed on this matter, one of them being the Hilmer Report^{xi}; which was produced for the Australian Government in 1993 on competition policy issues and recommendations to address these issues.
- 8.68 Firstly, competitive neutrality can be understood as a regulatory principle in which all enterprises, public or private, face the same set of rules, and government ownership and involvement does not confer unjustified advantages on any entity. A competitive neutrality policy is “based on the principle that government businesses operating in competitive markets or potentially competitive markets should not enjoy net competitive advantages over the private sector because of their public ownership.” This matter has particular relevance due to the fact that Air Niugini, as a Government owned commercial enterprise, competes with other privately owned airlines, notably Airlines PNG.
- 8.69 As discussed above under “State aid, subsidy”, financial aid to Air Niugini in the absence of clearly quantified community service obligation (CSO) payments distorts competitive markets. Where an SoE, the subject of such State intervention, actively engages in commerce and trade in competition against private firms, the nature, extent and market effects of such intervention, are relevant factors for the Commission to take into account in assessing barriers to entry and the effect on competition of any collaborative arrangements involving the SoE.
- 8.70 The OECD pointed out that where SOE’s operate in a market that private firms also operate in “the potential for anti-competitive effects may be even greater in the case of SOEs due to the various advantages conferred upon them as a result of government control.”^{xii} Accordingly, the Commission considers that the effect of Government policies of financially assisting SOE’s such as Air Niugini, in respect of CSO and providing compensation that is not fully quantified does not promote ‘competition on the merits’ but distorts competition and creates an inefficient market.
- 8.71 IPBC submitted that CSOs are a matter of Government policy and provided examples of

²⁵ Tourism Promotion Authority submission dated 29 November 2010.

²⁶ Minister for Public Enterprise’s submission dated 25 February 2011.

certain specific Government requests that were made on Air Niugini, which it would not have otherwise undertaken, pointing to the disruptive effects on fleet management, of meeting such requests of Government. IPBC also drew analogy with Qantas's evacuation of Australian citizens in Cairo. The Commission accepts the fact of Government policy and specific requests. That, however, does not absolve the Commission from its obligation to quantify such matters where possible and carefully consider the significance of the claimed benefits of such effects in its authorisation process to ensure they are not given more weight than justified.

- 8.72 The Commission sought quantification of CSOs provided by Air Niugini. The information provided shows a preparedness to shut down unprofitable routes unless direct subsidies are received from Government. Some information was provided that indicated that it is being compensated for certain services it claims are uneconomic, that it has been required by Government to provide. IPBC provided some information purporting to quantify the 'uncommercial' component of operations. No cost data was provided, however, which would enable the Commission to assess whether the services claimed to be 'uncommercial' were, in fact, uneconomic to the extent claimed. Hence, the Commission is unable to form a concluded view on whether the payments for the uneconomic services over-compensated; under-compensated; or generally equated with the claimed CSOs.
- 8.73 In light of the discussion of CSOs in the Issues Paper and the limited information provided by the applicant to allow the Commission to quantify CSOs and the level of 'compensation' on various routes, the Commission is restricted in the weight that it can give to the claim. With sophisticated computerised accounting systems available, there would appear to be no reason for Air Niugini to be unable to quantify the claimed CSO. To the extent loss-making routes are claimed to be operated as CSOs, that claim has to be discounted because of the lack of any serious attempt at effective quantification.
- 8.74 Hence, the Commission concludes that Air Niugini is receiving a compensation for claimed CSOs. The relevance of CSOs here is that their claimed costs are significant and should, in effect, be offset against any preferential capital or loan access benefits to which Air Niugini has access. That submission has not been substantiated to the satisfaction of the Commission. Hence, such offsetting effects claimed by uncompensated CSO provision can be given little, if any, weight.
- 8.75 Advantages conferred to Air Niugini, as a Government owned airline through Government sanctioned subsidies; direct participation in Government bilateral talks on ASAs; automatic blanket designation and allocations of capacity as opposed to other PNG based airlines that would be required to apply for the same from the PNG Department of Transport, effectively constrain the ability of private sector market players in their forward business planning and investment decisions. Of greater significance, these discriminatory circumstances inhibit entry and 'chill' competition. It thereby deters new entrants and limits existing players from expansion to realise economies of scale and scope to compete at the international level.
- 8.76 The Commission notes from the OECD that the widest definition of barriers to entry, suggests that barriers to entry arise from product differentiation, absolute cost advantages of incumbents, and economies of scale. Product differentiation creates advantages for incumbents because entrants must overcome the accumulated brand loyalty of existing products. Absolute cost advantages imply that the entrant will enter with higher unit costs at every rate of output. Scale economies, which are discussed further below, restrict the number of firms which can operate at minimum costs in a market of given size. Moreover, competitive neutrality matters, as discussed above, and the regulatory processes associated with capacity allocation all amount to barriers to entry and expansion.
- 8.77 The Commission considers whilst the barriers to entry identified by the applicant may not be too onerous, there are other barriers to entry which are likely to deter current players from expansion, and new entrants from entering the market, as discussed below. There are other barriers to new entry from foreign airlines, and these include, firstly, the ASA that PNG has, including those that other countries, parties to the ASA, also have. In addition, the commercial landing fees collected by regulatory authorities in PNG, the general perception of lawlessness in the country, space restrictions for terminals, check in counters, boarding gates,

etc, do act as barriers to entry; although some, but not all can be overcome relatively easily.

The implications of the interplay between CSO's; State aid/subsidies; competition; and public benefits

- 8.78 A significant part of this draft determination has been occupied by discussion of CSOs and State aid/subsidies in the context of assessing anti-competitive effect and public benefits. The issues can be put simply as follows: two views can be taken of the significance of CSOs and State aid/subsidies in relation to competition on the merits and public benefits.
- 8.79 One view could be that CSOs and State aid/subsidies are of no relevance – both are consequences of Government policies and should be ignored in the context of a ‘market driven’ assessment. The applicant and its statutory shareholder, IPBC, has, in effect, argued that these areas of Government policy should not form part of the scope of the Commission’s adjudicatory function under the authorization process of the Act.
- 8.80 A second view is that both are relevant, as has been discussed in detail above, on the basis that State aid/subsidies distort the competitive landscape and that CSOs are a relevant ‘adjustment’ to the State aid/subsidies issue, derogating from their anti-competitive effect. Further, as CSOs are a benefit to some segments of the public, they should be taken into account.
- 8.81 The Commission has discussed the second view in some detail in this draft determination, lest it be adjudged remiss in considering all relevant issues. Under this approach, an attempt has been made to quantify the State aid/subsidies and CSOs balance, albeit without mathematical exactitude, but with some concept of proportion. Given that there has been significant reimbursement of losses arising as a result of operating the Japan route, it is reasonable to infer that such payment amounts to a CSO payment. Some other CSOs for claimed unprofitable operation of domestic routes has been attempted to be put into the balance against State aid/subsidies, again without mathematical exactitude. Given the demonstrated significance of the amounts of State aid/subsidies and the confidential figures provided for the domestic unprofitable routes, the Commission considers that the balance lies substantially in favour of State aid/subsidies over CSOs.
- 8.82 Nothing significant, however, turns on the outcome of a choice, between the two approaches outlined above, in terms of the draft determination as will be seen later in this draft determination, given the significant barriers to entry, considered to be the main driver of competition.
- 8.83 The difficulty arises, however, that the applicant has claimed CSOs as a public benefit against which the anti-competitive consequences of the proposed arrangement should be assessed. The Commission cannot lawfully ignore such a claim and needs to make a reasonable effort to assess it and ‘put it in the balance’.
- 8.84 The applicant, to put it colloquially, ‘cannot have it both ways’. If CSOs are to be considered a public benefit, then State aid/subsidies need to be considered as well, as they distort competition. Both are difficult to quantify, but the Commission has attempted to do so as best it could. The market perceptual aspects of State aid/subsidies are not to be underestimated – perceptions about Government support often drive investment decisions. In that sense, the balance of State aid/subsidies against CSOs stands clearly in favour of the anti-competitive effect of the former.
- 8.85 Furthermore, as a matter of law, whether or not the applicant claims CSOs as a public benefit, the Commission, arguably, needs to take them into account if they exist; and needs to take account of State aid/subsidies if they exist as well. Such an ‘expansive’ interpretation of the assessment process for competitive effects and public benefits appears to sit well with the authorization objectives – to comprehensively weigh up detriment and benefit in the public interest.
- 8.86 On the claim by the applicant and its statutory shareholder, IPBC, that the Commission

should not venture into a discussion or assessment of Government policies, whether they be CSO funding approaches or State aid/subsidies to capitalize or provide loans to Air Niugini for broader National objectives, the Commission respects the process of policy formulation by Government and its authority to do so; however, in assessing an application for authorization, the overriding consideration is the framework of the law which governs the process – the ICCA Act. The statutory criteria for authorization have been explicitly quoted in this draft determination and Government policies are not specifically given extra weight as part of those criteria.

Scale, scope and network economies

- 8.87 The airline industry is characterised by large network economies, in the sense that the costs and revenues involved in carrying passengers on different, interconnected routes are interdependent. There are, in other words, large economies of scale, scope, networks and density present^{xiii}. Economies of scale allow some firms to achieve a cost advantage over their rivals; with economies of scale being a key determinant of market structure and entry.
- 8.88 A firm that operates in a capital intensive industry, such as the airline sector, is more likely to achieve economies of scale and scope if it increases its output relative to its total costs over some output range.
- 8.89 Economies of scale, scope, networks and density appear to be generated from both the supply and demand side. On the supply side, economies of scale originates from using larger aircraft, from increasing the load factor or from longer stage lengths; all these reduce the cost per passenger kilometre. Economies of scale due to firm size are quickly exhausted in the airline industry.^{xiv} Whereas economies of scope on the supply side are, generally speaking, present when the cost of producing two products or services by the same firm are lower than when they are produced by separate firms. “The most important economies of scope in the aviation industry no doubt arise from the complementarity of routes within the network. By operating several interconnected routes, the airline is able to utilise aircraft, crew, reservations systems, marketing devices, and other overhead costs items in various combinations of production lines (i.e. city pair connections).”^{xv}
- 8.90 With that background, the Commission noted that Air Niugini has been investing in bigger and more efficient aircraft with larger belly-hold to carry freight (for its other routes) and importing new technologies and ideas to improve business performances such as a developed online booking platform and frequent flyer programmes, established travel agency arrangements etc. That is not to decry the exercise of business acumen nor to suggest that Air Niugini should not seek to exploit economies of scale, scope, networks and density – quite the contrary. The exercise of business acumen is pro-competitive, not anti-competitive, indeed a vital part of the competitive process²⁷. What is relevant, however, is that incumbents enjoying such advantages should not be given additional market advantages such as being permitted to collaborate in circumstances where concentration is high; entry barriers are high; and prospective entrants and small competitors are made more vulnerable as a consequence of the proposed collaboration. Scale, scope and network economies, therefore, are a legitimate element in assessing barriers to entry.
- 8.91 Whilst efficient for individual airlines, economies of scale, scope and networks are of themselves barriers to entry. They confer the necessary competitive edge to airlines to ward off any competition or threat thereof. New entrants or existing competitors wishing to enter the market may find it unprofitable if they know they will have to compete with established airlines having significant economies of scale and scope.
- 8.92 In addition, as a Government owned airline Air Niugini enjoys many other privileges, as discussed earlier, the key ones being the automatic designation during signing of bilateral aviation agreements with other countries; preferential capacity allocation under such agreements; and receiving Government financial support, which reduces its capital and debt costs and improves the market perception of its counterparty risk.

²⁷ See *US v Grinnell Corporation*.

Frequent flyer programs, executive lounges and loyalty incentives

- 8.93 Business travellers are more attracted to carriers that have FFP arrangements, and being members of an alliance than those who are not. Although an FFP is intended to be an efficient means to enhance customer loyalty or fidelity, it constitutes another well thought-out strategy by which the carriers are able to practically divide the market between them and thus lessen the competition in each market segment^{xvi}. Such programmes have been expanded to confer ‘loyalty points’ for credit cards and purchases at participating retailing outlets, all aimed at ‘tying up’ the customer.
- 8.94 The Commission notes that Air Niugini and Qantas both have an established frequent flyer program, although Air Niugini’s FFP is relatively recent. Passengers flying on airlines that have code-share arrangements (such as Air Niugini and Qantas) usually enjoy the benefits of earning points by flying on a partner’s services. Such partnerships are very attractive to persons travelling on business or government purposes. As noted above, travel between PNG and Australia is predominantly business. It seems then that the existence of the FFP creates an anti-competitive effect of inhibiting market access to ‘business’ customers by new entrants. The effects of FFP can however be reduced over time if other competing carriers (such as Airlines PNG and Pacific Blue) operate their own FFP’s. The Commission notes that Airlines PNG does not have an FFP, however, the parties have an arrangement where persons flying on Airlines PNG’s international service to Brisbane or Cairns will earn Pacific Blue’s Velocity points.
- 8.95 Under current circumstances, competition from Airlines PNG or new entrants would have a negligible constraint on the behaviour of the alliance within this market. Airlines PNG’s withdrawal of capacity is arguably demonstrative of this matter.
- 8.96 Where airlines have FFPs, new competition is less likely to emerge as that airline would be unable to access clientele especially the high yield (Government and Business) customer base of incumbent firms due to strong effects of FFP’s, which increase switching costs of such customers, dissuades new entry due to risks of being unable to generate sufficient revenue to recover sunk costs in a reasonable period of time. Together with other economic characteristics discussed earlier and below, would ultimately produce strong public detriments.

Seat dumping

- 8.97 This matter has relevance to scale, scope and network economies with consequent implications for barriers to entry. In this regards, the Commission considers that the current excess capacity retained and introduced by the parties in the market is akin to ‘seat dumping’ or ‘capacity dumping’, which has led to Airlines PNG reducing its services on that route substantially. Air Niugini disputes that conclusion. It is the case, however, that the entry of Qantas has created a ‘stair step’ capacity increase, requiring Airlines PNG to reduce services. The applicant contends that Airlines PNG’s service reduction is a consequence of its Twin Otter crash on the Kokoda charter service, which has led to a demand slump on safety considerations. No evidence has been adduced to support such a claim. The crash occurred on a charter service which deployed that particular aircraft type, which is not used on the Port Moresby/Cairns route. The Commission considers it much more likely that seat dumping has led to such service reduction by Airlines PNG and has the potential effect of forcing out the only other current player, and deterring or preventing new entrants into that market. Such reduction of services and possible exit by Airlines PNG would deprive it of the scale, scope and network economies in competing on other routes, such as the Port Moresby/Manila route.
- 8.98 Seat dumping acts as one of the main barriers to entry or expansion by competitors. The fact that Airlines PNG has withdrawn capacity and restricted its participation in market to a substantially less significant scale is demonstrative of the deterrent impact of excess capacity on an existing small airline to become an effective competitor over time in that market or other markets. The code-share agreement, if authorised, would work more to the advantage of the two large carriers, as it will address the excess capacity introduced into the market, rather than forcing them to compete and reduce fares, or reduce capacity unilaterally, under competitive conditions.

- 8.99 Given sufficient time and the effective removal of the current breath of competition by Airlines PNG and no new entry as a consequence of persistent excess capacity under an authorisation of the code-share agreement scenario; real airfare reduction by the parties on Port Moresby and Cairns route is unlikely. Indeed there are no such claims by the applicant on this matter in its submission. Thus, it is probable that the code-share agreement, if authorised, will only strengthen the joint dominance of two strong firms in the market that are responsible for the excess capacity. Removal of competition will then be likely to lead to a progressive increase in fares in the market overtime. Experience is a good guide and the pre-Airlines PNG fare levels suggest the likely trend if the code-share is authorised.

Designation and capacity allocation

- 8.100 The Commission considers that access to capacity allocation and designation to operate services are crucial if any airline is to expand operations and realise economies of scale, scope and networks. Where these are artificially constrained by regulatory decisions, they unnecessarily impede growth of smaller airlines and, of significant importance inhibit the development of a vibrant and competitive airline market. The capacity and designation issues have been raised and discussed by the Commission in the Issues Paper dated 4 April 2011.
- 8.101 As discussed above, Papua New Guinea's capacity and designation allocation is governed by the PNG Civil Aviation Act 2000 (CAA Act). Section 178 of that CAA Act provides for the Minister to be the Licensing Authority for Papua New Guinea International Airlines; while section 186 provides for the Departmental Head to be the Licensing Authority for Foreign International Airlines. The statutory process and matters to take into account in granting an international airline license is also provided for in that Act.
- 8.102 The Commission reviewed this matter with the Department of Transport (DOT). For present purposes, it is sufficient to say that the consequence of the processes administered by DOT is that it unnecessarily delays Airlines PNG's application or that of any other prospective PNG carrier, for designation or capacity allocation; the delays in securing bilateral capacity discussions, especially for the Port Moresby/Manila route unnecessarily hindered growth of competition for PNG, considering the economic boom in PNG. Whilst some of the delays of bilateral negotiations are beyond the individual scope of the DOT, such as capacity negotiations, it is imperative that regulatory agencies responsible for such matters be proactive, as an aid to improved competition and new entrant activity.
- 8.103 Whilst some routes, such as the PNG/Australian routes have sufficient passenger capacity available for airlines of both countries, other routes such the Port Moresby/Manila route is capacity constrained. Even on the PNG/Australia routes, there appears to be some question about the adequacy of freight capacity in a dynamic environment. Negotiations to increase capacity on the Manila route have not resulted in capacity increases, despite scheduled meetings for discussions, which shows the less liberal nature of ASAs that constrain growth of PNG's international aviation sector in general.
- 8.104 The relevance of the issue of capacity and its allocation as between Airlines of PNG and Air Niugini on the PNG/Philippines route and other routes to this application is that it prevents Airlines PNG from accessing economies of scale, scope and networks by expansion into the Port Moresby/Manila or other international routes which could provide through traffic. That point is discussed in further detail below.

Preventing or hindering competition

- 8.105 Section 45(3) of the *Independent Consumer and Competition Commission Act 2002* defines lessening of competition as "...a reference to the lessening of competition includes a reference to the hindering or preventing of competition". The Commission, in its Issues Paper, invited comments from stakeholders on whether the circumstances of:
- a) the automatic designation of Air Niugini as a PNG designated international carrier on ALL routes;
 - b) the grant of all available capacity between PNG and the Philippines to Air Niugini;

- c) the application for designation by Airlines PNG as a PNG designated international carrier for five countries under the relevant air services arrangements;
- d) the delay in grant of such designation to Airlines PNG in respect of the PNG-Philippines route;
- e) the limitation on grant of such designation to three countries, rather than the five countries for which Airlines PNG had applied for designation;
- f) Airlines PNG's application for allocation of capacity to the Philippines;
- g) the inability of Airlines PNG to secure capacity on the route;
- h) the proposal for the code-sharing arrangements between Air Niugini and Philippines Airlines which has the effect of freeing up the unused capacity entitlement of the latter for use by the former; and
- i) the practical effect of Airlines PNG being prevented from entry into the route by its effective regulatory exclusion resulting from regulatory decisions; delay in regulatory decisions which enable its participation; and the take-up of all available route capacity by the incumbent;

cumulatively constitute 'preventing' or 'hindering' of competition within the meaning of section 45(3) of the Act. Most submitters agreed that the above cited factors do cumulatively constitute 'preventing' or 'hindering' competition, within the meaning of section 45(3) of the ICCA Act.

- 8.106 The applicant's statutory shareholder, IPBC, argued that the raising of this issue suggests that "*the impression could be formed that the ICCA is considering a Minister has acted in contravention of section 50*" (implying that the Commission is exploring the possibility of suing the then Minister for Transport for breach of that section of the *Independent Consumer and Competition Commission Act 2002*,) when it is clearly Governmental action, not in trade or commerce. There was no suggestion of such a contravention enforcement possibility or intention raised in the Issues Paper and it is perplexing that such an interpretation has been placed on this issue by the applicant and IPBC. This is an authorisation matter, not an enforcement matter.
- 8.107 The interpretation proposed by IPBC and Air Niugini ignores the purpose of the authorisation process, which is to weigh up the public benefits arising from the proposed conduct or agreement against 'any lessening of competition'. If 'hindering or preventing' of competition occurs, under the statutory 'deeming' definition above, that becomes part of the assessment of the conditions of competition in the market in which the arrangement is proposed. In this case, the nature of the 'preventing or hindering' is regulatory action which appears to favour one participant versus another. That amounts to a barrier to entry or expansion. This is directly relevant to the claim by the applicant, and contradictory to such claim, that barriers to entry are low. Such a significant barrier inhibits potential competition, which is not only an important factor in assessing likely future competition in markets, but is encompassed by the deeming provision in question.
- 8.108 Such a significant barrier forms part of the competitive context in which a collaborative agreement is sought to be superimposed on the market in which the 'preventing or hindering' is possibly occurring. IPBC and Air Niugini appear to have overlooked the words "*In this Part*", which preceded the words of the provision quoted by the Commission. That Part (Part VI), includes the provisions which regulate the authorisation process.
- 8.109 Seen in the context of the code-share agreement, these circumstances, whether intentional or otherwise, collectively distort the competitive landscape that works against the aim of the competition law of Papua New Guinea to promote fair trading and a competitive market place for the benefit of the Papua New Guinean public.
- 8.110 In view of the forgoing discussions, the Commission considers that the code-share agreement between two strong carriers on the Port Moresby/Cairns route, a highly concentrated market, will strengthen the imbalance that currently exists on the playing field. It will also stifle competition, through creating a strong collaboration between the two largest carriers in the market and affecting 'competition on the merits'. The proposed agreement between Air Niugini and Qantas, within the context of the other factors discussed, therefore, appears to produce strong anti-competitive effects and would significantly inhibit competition on the merits.

- 8.111 The extent of the detriment likely to be produced by the proposed agreement encompasses various markets, including the Port Moresby/Cairns market; the various other routes comprising a market or markets between PNG and Australia (Port Moresby/Brisbane; and Port Moresby/Sydney); domestic PNG aviation markets; and various PNG international aviation markets. While currently ‘workable competition’ exists on the Port Moresby/Brisbane route, which also constrains the Port Moresby/Sydney route, significant anti-competitive effects on those routes are unlikely from the code-share proposal on the Port Moresby/Cairns route and reduce concerns in relation to them. However, the earlier discussion on the regulatory risk to Airlines PNG’s continued participation in the Port Moresby/Brisbane route with Pacific Blue remains relevant.
- 8.112 Assessing the effect on competition under the authorisation process is not an exercise exclusively in theoretical analysis. Competition dictates the price-quality-service package for consumers. The significantly anti-competitive effect assessed as being likely to flow from the proposed code-share agreement, if authorised and implemented, would be likely to raise prices significantly and reduce the quality and service levels on offer in a substantial way.
- 8.113 Having concluded that this code-share agreement would or would be likely to lessen competition to a significant extent in the various markets identified above, within the meaning of the relevant provisions of the ICCC Act, the Commission will need to consider the public benefits of this arrangement as advanced by the applicant, and whether they are rationally sustainable and would on the balance of probabilities outweigh the lessening of competition resulting from the arrangement.

9. Public benefits

- 9.1 Since the law does not define the term ‘public benefit’, the Commission considers that the term be approached from the perspective of its broadest meaning. The Commission notes that the applicant submitted a number of public benefits to the Commission, but seems to have elaborated on only three in its summary of application; these are (1) employment, (2) improvement to services and (3) a stronger and capable flag carrier for the nation, as discussed immediately below under their respective headings.
- 9.2 The applicant did not elaborate on some of the public benefits in its application, although, it elaborated and also reinforced some of these alleged public benefits when commenting on the Issues Paper. Accordingly, these have been discussed under the “Other Public Benefits” heading further below..

Public benefits submitted by Air Niugini

- 9.3 Air Niugini submitted a number of public benefit arguments as follows:
- a. Benefits to the Papua New Guinean economy through increasing Air Niugini’s foreign earnings;
 - b. Benefits to the Papua New Guinea economy through enabling Air Niugini to earn profits on code-share routes (rather than the losses that may result without the code-share) which can be returned to the people of Papua New Guinea through the payment of dividends to the government;
 - c. More efficient use of resources through sharing of operating aircraft on code-share flights and therefore lowering per passenger costs and lowering greenhouse emissions than a more duplicated model of services that could result without the code-share;
 - d. Provision of more frequent services than either Qantas or Air Niugini could offer on their own;
 - e. Maintaining a substantial number of airline jobs in Papua New Guinea;

- f. Greater customer choice of available services, where customers can choose to purchase Air Niugini fares on either a dedicated Air Niugini service or on Code-share services operated by Qantas Link;
- g. A stronger, more capable flag carrier for the nation.

Discussion of public benefits

Likely outcome under authorisation and no authorisation

- 9.4 Air Niugini submitted that when assessing the effect on competition and the public benefits associated with the proposed code-sharing agreement, it is necessary to consider and compare the likely outcomes if authorization is granted and the new code-share agreement proceeds with the likely outcomes if authorization is not granted and the new code-share agreement does not proceed.
- 9.5 Air Niugini submitted that if authorisation is granted both Qantas and Air Niugini will continue to be able to offer consumers high quality, high frequency passenger services between Cairns and Papua New Guinea in accordance with their flight schedule; and Qantas and Air Niugini will continue to compete in relation to both the prices and terms they offer passenger services between Cairns and Papua New Guinea; and that Air Niugini will be able to offer an increased number of seats and frequency of services between Port Moresby and Cairns.
- 9.6 Air Niugini submitted that if authorisation is not granted Qantas and Air Niugini will continue to operate services in their own right between Cairns and Port Moresby. Air Niugini anticipates that these services would continue to be provided by QantasLink Dash-8 Q400 aircraft and a mixture of F100 and Dash-8 Q400 aircraft by Air Niugini. It said that market expansion would most likely be met by each airline adding extra flights or increasing the aircraft size on the route. This would be a more costly and expensive model, adding to their operating costs and putting upward pressure on fares.

Employment

- 9.7 Under its employment public benefit argument, Air Niugini stated that “[a]lthough employment levels would not be dramatically affected if this code-share application was not approved, it would in a small way have the effect of limiting Air Niugini’s expansion of sales options. This, Air Niugini contends would have the effect of stifling competition rather than enhancing it and could have a negative impact on the growth and development, reducing employment and opportunity for PNG citizens in the aviation industry”.
- 9.8 In noting the above argument, the Commission considers that a non authorisation of the code-share agreement would impact employment in a number of sectors positively such as the aviation industry itself, tourism and other industries reliant on the aviation industry. It is well recognised that competition expands the size of the market. As one submission noted, non authorisation of the code-share agreement is likely to indirectly increase employment in the tourism industry because the airlines would be competing independently and offering more customer travel choices, thereby generating demand for travel and use of services such as hire cars, taxis, accommodation, and general spending which would produce multiplier effects in the overall economy.
- 9.9 The Commission considers that an authorisation of the proposed code-share agreement would act to the contrary. It would limit the prospects for competitive pressure, which would lead to a maintaining of fares at higher levels than would otherwise exist; consequently, having a negative multiplier effect on demand for travel, tourism and spending within the economy. Indeed, total employment in the international aviation sector would be likely to increase more under competition than under monopoly.

Improvement to services

- 9.10 Under its public benefits claims of improvement to services, Air Niugini stated that the Code-share Agreement with Qantas would allow Air Niugini to offer a higher standard of services to Papua New Guinean consumers in a range of ways. It submits that these are:
- *“Air Niugini will be able to offer higher frequency of services to Cairns using high speed modern aircraft.*
 - *Air Niugini will be able to better meet the demand for increased services by our customers without adding further demands on the Air Niugini fleet.*
 - *Air Niugini customers will have more choices, being able to purchase Air Niugini seats not only on our own aircraft but also on services operated by Qantas Link flights.*
 - *Competition will be increased with Air Niugini marketing seats on more services and competing for sales with Qantas Link on their flights.”*
- 9.11 Air Niugini is currently providing high frequencies to Cairns using its F100, which is a larger aircraft compared to the Dash-8 Q400. The Commission considers that Air Niugini could deploy its own Dash-8 Q400 if it chooses not to use the F100 and provide the higher frequency with its modern Dash-8 Q400. Customers would still have a wider choice of seats to purchase from Qantas and Air Niugini independently, even in the absence of the code-share agreement. The increment of 5 seats per flight can hardly be said to constitute a substantial increase in consumer choice.
- 9.12 A submission on these applications made by a passenger utilising Qantas services between Boston/Sydney/Port Moresby identifies the lack of benefit to passengers from such code-sharing arrangements, which in this case consisted of a Qantas/American Airlines agreement and a Qantas/Air Niugini agreement. Essentially, the passenger’s baggage could not be checked through to Port Moresby from Boston because of the lack of an ‘image’ of the ticket to Port Moresby from Sydney. Furthermore, a boarding pass from Sydney to Port Moresby could not be issued in Boston. The passenger’s baggage had to be unloaded in Sydney; collected by the passenger off the carousel; ingress had to be made through border control (immigration and customs control); check-in at Air Niugini was required; and egress had to be made through border control to connect with the Air Niugini flight. Other issues such as inability to check baggage from an inland PNG airport to the border control airport in Australia, despite the through carrier being Air Niugini; and lack of notation of a Qantas flight number on a code-share ticket booked through it on an Air Niugini flight, were noted. The identity of the person making the submission was granted confidentiality because of the submitter’s desire for privacy to be observed, but Qantas was advised by the passenger, with flight details, of these circumstances and a copy of the submission, with the identity of the submitter redacted, has been placed on the public register. The passenger queries what benefits accrue to passengers from code-share agreements that appear to be one-sided in the benefits they generate for the airlines, in terms of rationalisation savings.
- 9.13 The Commission notes that Air Niugini’s fleet refurbishment is a direct result of support from public funds, through the Government to re-fleet the airline. There are many options for access to the aircraft market available to Air Niugini as a strong carrier with Government backing. If the code-share agreement is approved, the possibility of there being any competition and real fare reduction will be unlikely, since the cost base of Air Niugini block booked seats would have been set by its partner, constraining airfare competition hence negatively impacting on travel due to price levels.

National flag carrier

- 9.14 Under its National flag air carrier public benefit claim, Air Niugini stated that *“[h]aving a flag air carrier with the strength and service capability of Air Niugini provides important benefits... from a security and safety perspective. In times of national crisis or emergency, a national carrier is a valuable resource. For example after the Bali bombing on 12 October 2002, many injured Australians required evacuation to Darwin, and then to burns units around Australia. In response, Qantas was able to transport approximately 1,700 people from Bali to Sydney on six special flights from Bali to Australia, as well as transport medical staff*

and supplies to Bali. Similarly, in the wake of the earthquake and series of tsunamis that devastated South East Asia in 2004, Qantas operated special flights to Phuket, the Maldives and Colombo in Sri Lanka to bring travellers home to Australia. When the Ansett Australia Group collapsed in 2001, Qantas leased extra aircraft and withdrew aircraft from a number of services (including its Papua New Guinea service) in order to add hundreds of special domestic flights to assist stranded Ansett passengers.”

- 9.15 Air Niugini therefore stated that “ *the maintenance of Air Niugini as a strong national airline means that similar resources are available to the people of Papua New Guinea should they ever be required.*” Air Niugini therefore believes that “ *its proposed code-share arrangements with Qantas on Cairns services lead to very substantial public benefits, whilst not resulting in a lessening of competition.*” In addition to Air Niugini’s assertions, the Commission noted the Minister for Public Enterprise’s submission that “ *...the Government is pleased to support the national flag carrier that has exhibited a solid growth in both capacity and strength and especially over the last four years, including in the wake of the global financial crisis. This is critical from a security and safety point of view.*” The Minister for Treasury and Finance at the time, the Hon Peter O’Neill, CMG, MP in his submission also said that “ *Code-share has contributed to Air Niugini’s profitability which is part of the Government’s long term objective. It added that “[a] strong and profitable national carrier is critical to national security and development.*”
- 9.16 The Commission notes that there are ongoing concerns about Air Niugini’s service quality, its domestic flight disruptions and airfares, including international customer service and baggage handling which raise questions of Air Niugini’s overall service and efficiency. These factors, to some extent mitigate the national flag carrier public benefit argument put forward.
- 9.17 In addition, the Commission noted that at the time of Bali Bombing, Qantas was already a private operator and was undertaking the job to evacuate the victims of the bombing on a commercial basis. It is therefore arguable as to whether such operations can only be performed by a State Airline and not by any private carrier contracted by the Independent State of PNG. Moreover, the Commission is aware that such operation by Qantas was performed on a commercial rather than a free service. Since establishment of the airline, the Commission is not aware of any similar operations undertaken by Air Niugini. Unlike citizens of other developed countries, not many Papua New Guineans travel overseas for tourism purposes and possible requirements of such services are unlikely. The recent tsunami in Japan, which triggered a nuclear explosion impacting some Papua New Guineans studying overseas, did not result in Air Niugini performing services to ferry them home.
- 9.18 Whilst this argument remains to be tested, the Commission considers that it is unlikely that Air Niugini would be the only airline that could perform such services in times of crises affecting Papua New Guinea citizens overseas. If such a situation did arise, it would be possible for any government to seek the services of available charter or scheduled service providers paid for on a commercial basis rather than through provision of a free service from the State owned national airline. This could be performed by either Airlines PNG if it does expand and grow its operations or Air Niugini. It is also possible that foreign airlines or other charter operators could be utilised on a commercial basis, if Papua New Guinean owned airlines are unable to perform such operations in future.
- 9.19 Significantly, Air Niugini’s shareholder, IPBC, appears to accept the position posited by the Commission on this point.
- 9.20 The above factors reduce the weight that should be given to the national flag carrier public benefit argument put forward.

Other public benefits

- 9.21 As stated above, Air Niugini submitted a number of other public benefits to result from this new code-share agreement which it did not elaborate further on, and these are:
“
...
(1) *Benefits to the Papua New Guinean economy through increasing Air Niugini foreign earnings;*

- (2) *Benefits to the Papua New Guinea economy through enabling Air Niugini to earn profits on code-share routes (rather than the losses that may result without the code-share) which can be returned to the people of Papua New Guinea through the payment of dividends to the government;*
- (3) *More efficient use of resources through sharing the operating aircraft on code-share flights and therefore lowering per passenger costs and lowering greenhouse emissions than a more duplicated model of services that could result without the code-share;*
- (4) *Provision of more frequent services than either Qantas or Air Niugini could offer on their own;*
- (5) *Maintaining a substantial number of airline jobs in Papua New Guinea;*
- (6) *Greater customer choice of available services, where customers can choose to purchase Air Niugini fares on either a dedicated Air Niugini service or on a Code-share services operated by Qantas Link; and*
- (7) *A stronger, more capable flag carrier for the nation.”*

9.22 In respect of the claim of benefits to the Papua New Guinean economy through increasing foreign earnings, the Commission accepts the view that foreign exchange earnings are important to Papua New Guinea’s balance of payments. Air Niugini plays an equally important role in this respect as with other export industries. Whilst the extent of such foreign earnings has not been quantified, the Commission thinks that there will be very limited, if any, direct foreign earnings generated from an approved code-share on this route *per se*. Indeed, as discussed elsewhere above, a non-authorisation outcome for the code-share agreement would, in the longer term, by generating competition, promote tourism to a greater extent, which in the Commission’s views would indirectly generate significant foreign earnings into the economy, which would be likely to exceed the foreign exchange earnings that would be generated by the code-share *per se*. On the other hand, competition will expand the market, expanding economic growth and increasing aggregate foreign exchange earnings with the increased participation of another PNG carrier.

9.23 The Commission considers that a healthy competitive market, without any market distortions from code-share arrangements or other forms such as Government support to one airline vis a vis another, have a much higher likelihood of generating foreign earnings that could be distributed widely for the PNG public, through tourism growth, and would outweigh any foreign earnings foregone to Air Niugini. Accordingly, the Commission considers that this public benefit argument cannot be justified to result from this code-share agreement.

9.24 Air Niugini also said that the code-share would produce benefits to the Papua New Guinea economy through enabling Air Niugini to earn profits on code-share routes (rather than the losses that may result without the code-share) which can be returned to the people of Papua New Guinea through the payment of dividends to the Government.

9.25 The Commission noted that at the time of its assessment of the Airlines PNG/Pacific Blue Code-share Agreement, many economies were suffering from the effects of Global Financial Crisis. Governments worldwide were preparing major fiscal bailout packages for failing firms. By then Air Niugini had recovered financially, recording double digit Return on Equity (RoE). It has however never paid any dividends to the Government to date. Air Niugini has also been privileged to benefit from the ‘public purse’ through explicit budgetary support in 2006 and 2007 and a Government bank guarantee. This aid enabled the airline to re-fleet its aging fleet that is now used to service international and domestic markets. The Commission does not discount the argument that this support could possibly enable the airline to more easily secure debt from the capital markets. However, such a benefit to Air Niugini needs to be demonstrated to be likely to flow on to the public. A lessening of competition makes that unlikely.

9.26 By contrast, the only PNG domiciled international airline, Airlines PNG operates as a private sector financially independent entity with no Government subsidy or assistance and needs to bear and service its market-based costs of capital and debt solely from income derived from its commercial operations. The airline is obliged to produce profits and to declare dividends for its many shareholders, about 2,300, who are PNG institutional investors and nationals.

9.27 The Commission understands that the Department of Public Enterprises is preparing

appropriate policies to address dividend payment issues. Whilst the Commission acknowledges the approaches taken by the Government's policy making agencies, in the context of this application, the justification for allowing a collaborative arrangement, which is anti-competitive, has to be demonstrable preponderant public benefit. Air Niugini has never provided a dividend to Government. While that is a matter for Government, the weight to be given to the claim as a likely future public benefit has to be assessed as minimal. As discussed above, Government involvement with Air Niugini has only distorted competition, and regulation has hindered or prevented its development by foreclosing potential competition. Besides, there have been lessons that PNG has learnt in recent times, in the entry of Airlines PNG in the international aviation sector; and the mobile telecommunications competition with Government owned Telikom and its joint venture enterprise, BeMobile, which has generated benefits to the PNG public never seen and experienced before. Such benefits will pay more 'effective dividends' and distributing of wealth across the PNG public than a monopoly in the hands of a government owned enterprise, which is buttressed by an anti-competitive agreement.

- 9.28 Air Niugini also argues that the code-share would generate the public benefit of *'More efficient use of resources through sharing the operating aircraft on code-share flights and therefore lowering per passenger costs and lowering greenhouse emissions than a more duplicated model of services that could result without the code-share'*;
- 9.29 This is an issue that relates to allocative, productive and dynamic efficiencies. Section 46 of the Act requires the Commission to take this into account. The Commission considers that any productive efficiency resulting from the code-share agreement will be transient; appropriated over time by management, capital and labour; and would be far exceeded by the dynamic and allocative efficiency benefits arising from competition²⁸ that would be foregone. A competitive market is better positioned to produce an efficient outcome and allocation of economic resources than a market that is interfered with, or where unnecessary competitive constraints are being placed on it by the behaviour of stakeholders, including the State and its regulatory agencies.
- 9.30 In terms of the public benefits point 4, 5 and 6 above - *'Maintaining a substantial number of airline jobs in Papua New Guinea; Greater customer choice of available services, where customers can choose to purchase Air Niugini fares on either a dedicated Air Niugini service or on a Code-share services operated by Qantas Link; and A stronger, more capable flag carrier for the nation'*, the Commission considers that generation of tourism growth, through international traffic into PNG and within travel domestically, will create substantially greater number of jobs. Such an outcome is more likely under a competitive environment than under the environment to emerge under an approved code-share agreement. Under competitive markets, carriers will face effective competition and adopt best management practices, pursue most efficient operations and rationalise systems to be ahead of their competitors.
- 9.31 As to the claim that without authorisation, parties would *'chase sales seeking to cover extra operating costs and may lead to a less efficient and, ultimately, less competitive market structure than authorization of the new Code-share Agreement'*, that has been discussed under *'The nature of the competitive process'* above. In summary, however, competitive conduct that drives efficiencies into industry behaviour, will likely produce substantial public benefit not only in the aviation industry but, in other industries that rely on aviation, such as the hospitality and tourism industry, accommodation and the wider economy by reducing business and personal expenditure on travel.

Public/consumer deception possibilities

- 9.32 Code-share arrangements can also have the potential to deceive the public. Where there is a lack of consumer/public transparency, it creates dissatisfaction rather than satisfaction for a fair and transparent service received at face value in respect to the services expected by consumers under those arrangements.
- 9.33 A code-share service may give several impressions if there is only incomplete information

²⁸ See for example, In *Re: QCMA* and the writings of Professors Oliver Williamson and Michael Porter.

made available to the consumers/public; such can lead to: consumer may feel misled if an airline or travel agent does not indicate at the time of booking that a different airline will be operating all or part of a service under the booking airline's code and number; decision to book a seat on a particular flight will often be affected by the consumer's perceptions of non-price factors such as safety, on-board service or reliability and or aircraft type; potential lack of consumer transparency; and, impression that a particular flight is non-stop or involves only refuelling stops; misleading advertising of airfare specials in terms of quantity and duration of time of the offer to the public. Such are examples of lack of consumer transparency with code sharing arrangements becoming particularly relevant when airlines base their marketing on characteristics such as a high level of safety, superior on-board service or a specific aircraft.

- 9.34 The Commission notes that there are ongoing concerns about Air Niugini's service quality, its domestic flight disruptions and airfares, including international customer service and baggage handling which raise questions of Air Niugini's overall service and efficiency examples of which are discussed below.
- 9.35 A submission on these applications made by a passenger utilising Qantas services between Boston/Sydney/Port Moresby identifies the lack of benefit to passengers from such code-sharing arrangements, which in this case consisted of a Qantas/American Airlines agreement and a Qantas/Air Niugini agreement. Essentially, the passenger's baggage could not be checked through to Port Moresby from Boston because of the lack of an 'image' of the ticket to Port Moresby from Sydney. Furthermore, a boarding pass from Sydney to Port Moresby could not be issued in Boston. The passenger's baggage had to be unloaded in Sydney; collected by the passenger off the carousel; ingress had to be made through border control (immigration and customs control); check-in at Air Niugini was required; and egress had to be made through border control to connect with the Air Niugini flight.
- 9.36 Other issues such as inability to check baggage from an inland PNG airport to the border control airport in Australia, despite the through carrier being Air Niugini; and lack of notation of a Qantas flight number on a code-share ticket booked through it on an Air Niugini flight, were noted. The identity of the person making the submission was granted confidentiality because of the submitter's desire for privacy to be observed, but Qantas was advised by the passenger, with flight details, of these circumstances and a copy of the submission, with the identity of the submitter redacted, has been placed on the public register. The passenger queries what benefits accrue to passengers from code-share agreements that appear to be one-sided in the benefits they generate for the airlines, in terms of rationalisation savings.

10. Weighing up of competitive detriment and public benefits

- 10.1 The Authorisation Test under section 77(6) of the ICCA Act provides that the "*Commission shall not make a determination granting an authorisation pursuant to an application under Section 70(1), (2), (3) or (4) unless it is satisfied that:*
- a) *The entering into the contract or the arrangement or the arriving at the understanding; or*
 - b) *The giving effect of the provision of the contract, arrangement or understanding; or*
 - c) *The giving or the requiring of the giving of the covenant; or*
 - d) *The carrying out of enforcing of the terms of the covenant,*

as the case may be, to which the application relates, will in the circumstances result, or be likely to result, in a benefit to the public which would outweigh the lessening in competition that would result, or would be likely to result or is deemed to result, from it."

- 10.2 For the Commission to grant or decline grant of authorisation, it has to be satisfied that the code sharing agreement would produce benefits to the public that would outweigh the public detriments resulting from the lessening of competition.

11. Decision

- 11.1 Anti-competitive outcomes, of course, mean higher prices and reduced standards of quality and service for consumers. In this case, the range and extent of anti-competitive consequences of such a code-share agreement in the relevant markets have been shown. Hence, public

benefits need to be shown that are sufficiently substantial in range and extent to 'outweigh' the anti-competitive effect adjudged to be likely to arise.

- 11.2 In assessing the outcomes that would be likely to arise from the proposed code-share arrangement, and other market circumstances that impact on competition in the relevant market, as well as consequences for other markets, including issues of competitive neutrality, market concentration; and barriers to entry; and weighing them against the public benefits; the Commission does not consider that the code-share will result, or will be likely to result, in a benefit to the public which would outweigh any public detriments arising from the lessening of competition that would result or would be likely to result from the proposed agreement.
- 11.3 The Commission considers that the code-share agreement would be likely to produce strong anti-competitive outcomes which would not be, or be likely to be outweighed by any public benefits that will or are deemed to be generated from it.
- 11.4 Accordingly, the Commission's draft determination is to decline to grant authorisation to Air Niugini Limited pursuant to section 77(6) of the ICCA Act for its application in respect of the proposed code-share agreement with Qantas Airways Limited.

Assoc. Prof Billy Manoka, PhD

(Commissioner)

David Dawson

*(Associate Commissioner)
(Non-Residential)*

Dated this day the 15th of July 2011

Endnotes

ⁱ Data used to estimate market shares on the PNG/Australia route are obtained from the website for the Australian Government; Department of Infrastructure and Transport; Bureau of Infrastructure, Transport and Regional Economics; Statistical Report International Airline Activity, table 2.

ⁱⁱ Data used to estimate seat utilization and passenger growth on the PNG/Australia route and Cairns route are obtained from the website for the Australian Government; Department of Infrastructure and Transport; Bureau of Infrastructure, Transport and Regional Economics; Statistical Report International Airline Activity.

ⁱⁱⁱ See for instance, January 2007, Final Report on Competition of Airline Code-share Agreements, European Commission Directorate General for Competition, which explores these matters in detail.

^{iv} Ibid page 76.

^v Ibid page 176.

^{vi} Queensland Wire Industries Pty Ltd v Broken Hill Pty Co Ltd ("Star Picket Fence Post case") [1989] HCA 6; (1989) 167 CLR 177 (8 February 1989), cited from case downloads from Paclii.

^{vii} Air Niugini's submission dated 28th October 2010 can be found on the Commission's website under the Authorisation Application by Airlines PNG/Pacific Blue.

^{viii} See for instance the Hilmer Report, National Competition Policy of the Government of Australia; And OECD 2009, State Owned Enterprises and the Principle of Competitive Neutrality.

^{ix} See European Commission website -http://ec.europa.eu/competition/state_aid/overview/index_en.html, State Aid Control.

^x Commentary by Frédéric Louis and Ann Vallery on "State Aid and Financing of Public Services; A comment on *Altmark* Judgment of the Court of Justice; published in September 2003 Issue of Competition Law Insight."

^{xi} The Hilmer Report discusses 'competitive neutrality matters' and recommendations for the Australian Government to implement to remove concerns arising from government involvement in competitive markets through its SOE's.

^{xii} OECD, 2009; Policy Roundtable Discussions, "State Owned Enterprises and the Principle of Competitive Neutrality".

^{xiii} See Report from the Nordic competition authorities, No.1/2002, Competitive Airlines towards a more vigorous competition policy in relation to the air travel market, page 5.

^{xiv} Ibid page 109.

^{xv} Ibid page 109.

^{xvi} Ibid page 8.