



INDEPENDENT CONSUMER & COMPETITION COMMISSION

DETERMINATION

AUTHORISATION OF THE RENEWED CODE SHARE

AGREEMENT

BETWEEN

AIR NIUGINI LIMITED AND QANTAS AIRWAYS LIMITED

Application Lodged Date : 6th of August 2009
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1 Background

1.1 The Review

On 6th August 2009, Air Niugini applied for authorisation to continue to code share with Qantas until December 2014. Similarly, Qantas applied to the International Air Services Commission (IASC) for a variation to its capacity on the Papua New Guinea/Australia route to code share with Air Niugini until December 2012.

The Commission and the IASC agreed to a joint review of the airlines' respective applications to code share. The joint review was undertaken due to the nature of the Air Niugini – Qantas code share arrangement which required Air Niugini to seek an authorisation from the ICCC under section 70 of the ICCC Act 2002; and Qantas to seek a variation to an earlier determination allocating capacity to itself on the PNG/Australian route which was initially authorised by the IASC.

The joint review enabled the Commission to tap into the vast industry experience and knowledge of the IASC in dealing with the air transport industry, including but not limited to code share arrangements in which the Australian Competition and Consumer Commission's (ACCC) views has been sought.

While there are differences in the legislative framework of both Commissions and in some cases the public benefits considerations, the similarities in terms of the issues which needed to be considered, provided the basis for significant co-ordination that enabled the two Commissions to pool and share information and data under the joint arrangement. The Commissions, however, maintained their independence when assessing the consequential competition effects and public benefits of the code share arrangement consistent with their respective legislative frameworks.

1.2 Code Sharing

As discussed previously by the Commission, the aviation industry on the global scale is characterised by both competition and co-operation. Cooperation in the airlines industry encompasses an array of arrangements, the most notable being code share arrangements. Under a code share arrangement, an airline uses its designator code on a flight operated by another airline. The arrangement involves a blocked space agreement and could involve both a 'hard block' and 'soft block' allocation of passenger seats and/or freight capacity.

The airline operating the flights is referred to as the 'operating carrier' whilst the airline buying seats on the aircraft and resells it to its customers is called the 'marketing carrier'. An airline that sells seats on a flight operated by another carrier under a code share arrangement normally provides services such as ticketing and in many cases check-in and baggage handling.

While code sharing is a commonly applied strategic alliance method in the international aviation industry, these arrangements raise concerns for competition, consumer welfare and

the public benefit and as such attract the scrutiny of competition authorities.

Section 70 of Part VI of the *Independent Consumer and Competition Act 2002* (the ICCC Act) provides for the Commission to authorise restrictive trade practices such as code share arrangement on public benefit grounds. The ICCC Act requires the Commission to firstly, establish the extent to which restrictive trade practices such as the Air Niugini – Qantas renewed code share agreement might produce anticompetitive outcomes. The Commission is then required to assess this outcome against the potential and likely resultant public benefits of the proposed code share arrangement. Based on these findings and consistent with the authorisation test under section 77(6) of the ICCC Act, the Commission is required to make a determination on whether or not to grant authorisation. If the Commission authorises the code share arrangement, the partners may give effect to the code share arrangement without risking a contravention of the ICCC Act, for the period of the authorisation¹.

1.3 The Parties

1.3.1 Air Niugini

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 passengers and airfreight.

Air Niugini operates international services between Port Moresby and ten (10) ports around the world namely: Australia (Sydney, Brisbane and Cairns International Airports), Japan (Narita International Airport, Tokyo), Singapore (Changi International Airport), Hong Kong/China (Hong Kong International Airport), Solomon Islands (Honiara Henderson International Airport), Fiji (Nadi International Airport) and the Philippines (Ninoy Aquino International Airport, Manila), Malaysia (Kuala Lumpur International Airport, Kuala Lumpur).

Air Niugini currently employs 1,725 people worldwide. Its airline related business includes 22 retail sales offices throughout Papua New Guinea, catering, engineering and maintenance services, tour packaging and accommodation services and sales offices in Brisbane, Cairns, Sydney, Singapore, Manila and Tokyo. Air Niugini also operates a frequent flyer program 'Destinations Loyalty Program', which was recently launched in August 2009.

1.3.2 Qantas

Qantas is the world's second oldest airline and is Australia's largest domestic and international airline. It is the eleventh largest globally in terms of revenue passenger kilometres (RPK) and employs approximately 36,000 people worldwide; with nineteen (19)

¹ ICCC Determination of Airline of PNG/Pacific Blue Code share, 2008

of these personnel located in Papua New Guinea.

The Qantas Group operates a portfolio of flying services and airline related business with its core business activity being the provision of air passenger and airfreight services. The group's airline business includes Qantas (full service domestic and international services), JetConnect (domestic New Zealand and Trans – Tasman services), Qantas Link (regional Australia services) and Jetstar (low cost domestic and international services). Qantas' airline related business includes airport operations, airfreight, engineering and technical operations maintenance services, and catering and accommodation booking business. Qantas also operates an extensive frequent flyer program, as a major partner airline in the 'Oneworld' airline alliance, with links to many airline and other partners as part of that program.

In Papua New Guinea, Qantas maintains an administrative and operations office located in downtown Port Moresby. It also operates a customer services and airfreight operations at the Jackson's International Airport.

2. The Air Niugini-Qantas Code share Agreement

The Air Niugini/Qantas code share arrangement commenced on 1st September 2002 and expired on 31st August 2007. In 2007, Air Niugini sought and received an ICCC authorisation to continue with the arrangement for a further two (2) years, until 31st December 2009.

The code share arrangement initially applied to the Port Moresby – Cairns sector and has since been extended to cover the Port Moresby – Brisbane and Port Moresby – Sydney sectors.

The arrangement relates to air passenger and freight services supplied by Air Niugini and Qantas between Papua New Guinea and Australia. Under the current code share agreement and the renewed code share agreement (collectively referred to as the code share agreement/arrangement), Air Niugini is the operating carrier and Qantas is the marketing carrier. The code share agreement allows Qantas to purchase seats on Air Niugini's flights and resells this to its customers. Provision of airfreight is not part of the code share agreement per se; however, as part of an arrangement, Qantas purchases freight capacity on the code shares services on the Brisbane and Sydney routes.

For passenger services, Qantas uses its designator code on flights operated by Air Niugini on passenger ticket sales. In regards to airfreight, Qantas sells cargo space using its own air waybills under the Air Niugini (PX) code, instead of its own designator (QF) code.

In its application to the Commission, Air Niugini submitted that the conditions of the renewed code share agreement that it will enter into with Qantas will be similar to the current code share agreement. The detail of the arrangement is as follows:

- i. Air Niugini will operate the following code share services between Papua New Guinea and Australia. It advised that these routes may be re-negotiated from time to time in response to customer demand and capacity available.

- Port Moresby – Cairns vv (Cairns Route)
 - Port Moresby - Brisbane vv (Brisbane Route)
 - Port Moresby – Sydney vv (Sydney Route)
 - Port Moresby – Sydney – Melbourne (Potential Route)
- ii. Qantas is allocated blocks of seats for sale to its passengers on each code share services. Most of these seats are allocated on the basis that they must be paid for whether Qantas sells it or not. This is referred to as the ‘hard block’ allocation.
 - iii. If Qantas sells all its hard block allocation on any particular flight, it has the option to purchase a certain number of additional seats from Air Niugini. This is referred to as the ‘soft block’ allocation.
 - iv. Air Niugini and Qantas each sells and markets fares on each code share service independently through their respective sales networks in full competition with each other. Each carrier has the freedom in relation to the fare classes it offers, the rules it sets for each class and the price it charges for the fares.
 - v. Qantas is allocated certain airfreight capacity only on the Brisbane and Sydney routes. All airfreight allocations are on a ‘hard block’ basis, that is, Qantas pays for its full allocation irrespective of whether it fills it or not.

Air Niugini submitted that the details of the ‘hard block’ and ‘soft block’ allocations of the renewed code share had not been finalised between the parties. It maintained that this will remain similar to that of the current code share agreement. This issue, of an uncompleted negotiation, is discussed further under section 9.2 of this determination.

3. Application Proposal

The applicant submitted that the code share agreement enables Air Niugini to achieve sufficient passenger loads and commercial airfreight capability. Code sharing enables Air Niugini to sell a proportion of the capacity on its aircraft to Qantas for resale. The applicant further submitted that Qantas’ extensive Australian network and customer base mean that it is able to sell seats on Air Niugini’s Australian services that Air Niugini could not sell on its own. It submitted that the support by Qantas is critical as it strengthens Air Niugini’s ability to achieve sufficient passenger loads and frequency of services on the Australian routes. It submitted that this is critical for Air Niugini’s B767 wide body aircraft operations to remain viable. It contended that without the renewed code share agreement, Air Niugini would be forced to withdraw from operating its wide body aircraft; thus among other consequences, this means that Papua New Guinea would lose its only source of commercial airfreight services.

The applicant submitted that its rationale for seeking continuity of the code share is therefore twofold:

3.1 Wide body Aircraft – Freight capability and other advantages

Air Niugini advanced the argument that it services Papua New Guinea with a wide range of both domestic and international air services. It has traditionally used a ‘wide body’ aircraft for its international services. The wide body aircraft has a wider fuselage and thus airfreight compartment which enables it to carry up to 7 tonnes of freight in containers and on pallets. Air Niugini argued that this is critical if airfreight is to be loaded and unloaded from an aircraft quickly and efficiently. By contrast, it submitted that a regular passenger transport (RPT) narrow body aircraft carries ‘loose’ freight (non – containerise/palletised). This makes loading and unloading of freight from a narrow body aircraft time consuming and inefficient. Large or heavy freight cannot be carried easily on narrow body aircraft due to these limitations.

The application further submitted that by definition, a wide body aircraft is always a big aircraft, examples of which include Airbus 310 and 330 and Boeing 767, 777 and 747 (‘Jumbo’). In addition to the ability to carry commercial airfreight, wide body aircraft offer important advantages over narrow body aircraft. These include:

- Greater range than a narrow body aircraft. This allows Air Niugini to provide direct services to distant destinations such as Japan;
- Greater passenger comfort; and
- If sufficient passenger loads can be achieved, more efficient operations with lower costs and greenhouse emissions per passenger than a narrow body aircraft.

In addition, Air Niugini submitted that most of its long haul international services are operated using a leased wide body Boeing 767–300 series aircraft (the B767 aircraft). It submitted that based on the years of wide body aircraft demand, the Air Niugini Board at its July 2009 Board meeting resolved to purchase a brand new B767–300ER aircraft in order to provide higher customer service and better and improved product. It further submitted that if Air Niugini were unable to afford to continue to operate a wide body aircraft, it could not provide the commercial airfreight service which serves the interest of many sectors of the Papua New Guinea economy. As such, the application argued that its ability to sustain wide body aircraft operations is therefore crucial to both itself and to Papua New Guinea as a nation.

3.2 Australia Passenger Market – Difficulty of maintaining wide body operations

The applicant relayed that although the size of a wide body aircraft provides the advantages of range and the ability to carry commercial airfreight, its size also means that it must achieve sufficient passenger load factor than a narrow body aircraft in order to be economically viable. Air Niugini argued that its experience in Papua New Guinea showed that achieving this outcome is difficult.

It stated that in order to sustain wide body aircraft operations, it must achieve maximum utilization of its aircraft across the whole of its international network. The services which account for the greatest proportion of its wide body aircraft operations are those between

Papua New Guinea and Australia. The viability of continued wide body aircraft operations by Air Niugini therefore depends on achieving viable passenger loads on its Australian services.

Air Niugini also stated that in international terms, the routes between Papua New Guinea and Australia are ‘thin’. This means that Air Niugini has not been able to, and believes it is unlikely in the future to be able to, achieve sufficient loads on its own on its Australian routes to make wide body operations financially viable. It argued that in 2001, Air Niugini came close to financial ruin by attempting to sustain a wide body operation in its own right between Papua New Guinea and Australia. The resulting losses led to a situation where the airline owed millions of Kina to major suppliers and was almost placed into administration by creditors.

4. Application for Authorisation

Air Niugini sought authorisation from the Commission under Section 70 of the Act to give effect to the renewed code share agreement. The application was lodged on 7th August 2009 and the Commission is therefore required under section 77(2) to make a determination on whether to permit Air Niugini to enter into and to give effect to this agreement.

5. Elements of an Authorisation

Section 77(6) of the 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.”

The outcome of the Commission’s determination on whether or not to grant Air Niugini authorisation will be determined by the authorisation test outlined above.

6. Facts and Contentious in support of the application

Air Niugini submitted that when assessing the effect on competition and the public benefits of the code share arrangement, it is necessary to consider and compare the likely outcomes

if authorisation is granted and the renewed code share agreement proceeds, with the likely outcomes if authorisation is not granted and the renewed code share agreement does not proceed. The Commission accepts that such a counter-factual analysis is appropriate and consistent with the authorisation process. The Commission has previously applied this analysis and would continue to do so, where applicable.

6.1 Likely outcome if authorisation is granted

Air Niugini submitted that if the code share agreement is authorised, its code share services would remain viable, at least for the term of the renewed code share agreement. This will make it possible for it to continue providing the B757 service as a backup to provide more reliability to travellers. It also submitted that the Port Moresby – Sydney direct services could continue and if the market conditions allow; Air Niugini would expand its services to Melbourne; as a potential extended service via Sydney.

It further submitted that as a result of the increased utilisation of the B767 aircraft made possible by the code share, Air Niugini is likely to continue to operate this aircraft viably. This outcome would at least over the term of the renewed code share agreement result in the following:

- Both Qantas and Air Niugini will continue to be able to offer consumers high quality and frequency passenger jet services between Australia and Papua New Guinea;
- Qantas and Air Niugini would maintain the two new non-stop services per week between Sydney and Port Moresby operated by the leased B757 aircraft;
- Qantas and Air Niugini will continue to compete in relation to the prices and terms they offer on both passenger and airfreight scheduled services between Australia and Papua New Guinea;
- Both Qantas and Air Niugini will maintain the high frequency of containerised airfreight services between Australia and Papua New Guinea on the wide body B767 aircraft;
- Air Niugini will continue to be able to offer airfreight services between Papua New Guinea and countries such as Japan, Singapore, Hong Kong, Malaysia and the Philippines.

6.2 Likely outcome if authorisation not granted

Air Niugini submitted that if authorisation is not granted for the renewed code share agreement, it will cease the code share arrangement with Qantas. Each Airline will therefore respond to the situation in different ways.

6.2.1 Qantas Response – Passenger and airfreight services

Air Niugini asserted that Qantas may withdraw from the market altogether due to the real potential that it may consider Papua New Guinea a high risk destination for its aircraft and staff. It submitted that should this eventuate; it will result in a lessening of competition resulting from the loss of Qantas marketing presence on the code share routes.

The applicant further submitted that it however expects Qantas to respond to the cessation of the code share agreement by recommencing its own services between Australia and Papua New Guinea. It expressed the view that these services are likely to be provided by either Qantas, or alternatively some or all of these services could be offered by Qantas' subsidiary – Jetstar, which is a low cost domestic and international airline. It added that Qantas would still face the same problem as experienced by Air Niugini if it were to operate a wide body aircraft and maintain the current flight frequency. Air Niugini submitted that without support from a code share partner, under the current circumstances where demand between Papua New Guinea and Australia is not sufficient to support high frequency wide body air services, Qantas would not achieve sufficient passenger and freight load factors that would make the service viable. Qantas would therefore face a choice in the services it offers - it could offer low frequency services (possibly daily) using wide body aircraft, or it could offer more frequent service using a narrow body aircraft such as a B737 aircraft.

Air Niugini contended that consumers in Papua New Guinea have become used to the current frequency of jet services to Australia, thus Qantas would be perceived as uncompetitive if it were to offer a service significantly less than the current frequency levels. Accordingly, the applicant argued that in order to achieve a frequency in the order of six (6) services per week, it expects Qantas to recommence services using a narrow body aircraft such as a B737 or Airbus 320-200s aircraft (for Jetstar service).

It stated that the introduction of services by Qantas would introduce substantial capacity to the market than under the current code share arrangement. Air Niugini submitted that it believes the most likely scenarios is that Qantas would establish itself with an attractive service and introduce at least six (6) B737-800 services per week operating between Brisbane and Port Moresby. It claimed that this would represent a total capacity of 52,000 extra seats per annum in each direction; or an increase in capacity on the Brisbane route of approximately 42 per cent. It further submitted that Qantas presence on the Sydney route using similar aircraft would amount to an increase in total capacity of 36 per cent.

Air Niugini contended that if Qantas were to commence services in its own right between Cairns and Port Moresby, it anticipates that these services would be provided using the De Havilland Dash 8 or possibly, a small Boeing jet aircraft.

In regards to provision of airfreight, the applicant submitted that since narrow body aircraft providing RPT services are unable to carry containerised airfreight, Qantas would be forced to substantially withdraw from the provision of airfreight between Australia and Papua New Guinea if it deployed a narrow body aircraft.

6.2.2 Air Niugini Response – Passenger and freight services

In regards to passenger services, Air Niugini submitted that if the code share arrangement is not approved, it would be unviable for it to continue direct flights between Port Moresby and Sydney, as currently the Sydney route is unprofitable. Accordingly, in the short term it would cease to operate the Sydney services, and would instead only offer Brisbane and

Cairns services.

Air Niugini submitted that it would lose the contribution towards the operating costs of its B767 wide body aircraft on the Brisbane route that is currently provided by the code share payments received from Qantas.

Air Niugini contended that Qantas would have to increase total capacity in the market by 50 per cent. This would result in a short term price reductions and a battle for market share as each carrier struggles to attract customers to make the schedules viable. Further, it contended that Qantas holds a number of important advances over Air Niugini in the war for market share. Air Niugini argued that:

- Qantas has access to more substantial marketing resources than Air Niugini;
- As a large network carrier, Qantas is able to offer customers discounts on a wide network of routes throughout Australia and other international destinations, which cannot be matched by Air Niugini; and
- Qantas is expected to terminate its reciprocal frequent flyer points agreement with Air Niugini, denying Air Niugini access to this useful marketing tool.

Air Niugini further submitted that if it were to engage in the battle for market share, it does not have the financial resources to ‘tough out’ a sustained battle for market share with Qantas; and consequently it would incur substantial losses on the Brisbane route. Air Niugini added that in the short term, its aircraft lease commitments mean that it would be likely to have no alternative but to continue to operate the wide body B767 services. In order to minimise losses; it would have to substantially reduce the number of services it would operate on the code share routes. As such, Air Niugini is of the view that it is likely that its B767 operations will be reduced from six (6) to two (2) at the most, with concentration on the strongest traffic days of Monday, Friday and possibly Sunday. Air Niugini concluded that without the renewed code share agreement, its B767 operations between Australia and Papua New Guinea would incur substantial losses.

The applicant also submitted that due to the code share arrangement, it was able to, for the first time provide high frequency jet services to Cairns. It stated that non authorisation of the renewed code share agreement would result in the likely reduction of the frequency, and some or all the Cairns service would be reverted to smaller Dash-8 aircraft, thus resulting in loss of speed and comfort for travellers.

In the medium to long term, at least for some time, Air Niugini submitted that it would have little alternative but to try to tough out its losses with continued wide body B767 operations between Australia and Papua New Guinea. The applicant claimed that it would be an unjustifiable drain on national resources for Air Niugini to continue to sustain tens of millions of Kina losses per year on an ongoing basis.

In regards to airfreight, Air Niugini submitted that due to its B767 aircraft lease commitments, it would have no alternative in the short term but to continue to operate wide body services between Australia and Papua New Guinea. During this time, Air Niugini would face little or no competition in the provision of airfreight services. The total capacity and frequency of airfreight services would be substantially reduced compared to the

services offered if the renewed code share agreement is authorised.

In the medium to long-term, in the absence of the code share, Air Niugini submitted that it would be forced to replace the B767 wide body aircraft with a narrow body aircraft. Since narrow body RPT services cannot carry containerised freight, Air Niugini would be forced to substantially withdraw from the provision of airfreight to Australia and the Asian markets. As a result of its withdrawal from the provision of containerised airfreight services to and from Australian and Asia, Papua New Guinea would be forced to rely on dedicated freighters, and that Qantas may take the opportunity to be the primary freight provider. Air Niugini, however contended that the economics of international air services are driven by passenger demand and not freight demand. Qantas's passenger demand between Australia and Papua New Guinea would be more than adequately served for the foreseeable future by narrow body aircraft. Thus it is possible that Qantas may not replace any of the airfreight capacity lost as a result of the withdrawal of Air Niugini's wide body services. It further submitted that whilst it is likely that some lost airfreight capacity between Australia and Papua New Guinea would be replaced by the entry of dedicated freighter aircraft, such services would inevitably be at higher cost and lower frequency than the services currently provided by Air Niugini and Qantas.

Air Niugini submitted that alternatively Qantas could elect to use its wide body aircraft for one or more of its Papua New Guinea services providing at least some capacity to Papua New Guinea. Air Niugini however contended that if Qantas were to price its freight services at sufficiently high levels, this capacity might also be supplemented by the entry of more dedicated air freighter capacity.

It concluded that it is unlikely that any carrier would replace the lost airfreight capacity as a result of withdrawal from providing airfreight services between Papua New Guinea and any of Japan, Singapore, Hong Kong, Malaysia or the Philippines by Air Niugini.

7. Views from Stakeholders

As part of the Commission's wider public consultation process, the Commission published public notices in the print media from 17th – 24th August 2009 and invited submissions on the application from interested parties and the public.

The Commission also sought views from relevant stakeholders, such as Airlines PNG, Civil Aviation Authority, Tourism Promotion Authority, Department of Treasury, and Department of Commerce and Industry, amongst others. The submissions received are summarized below.

On 1st December 2009, the Commission released its draft determination for public comments. Pursuant to subsections 78(2) and (3) of the ICCA Act, the Commission called for public comments and advised of the option for the Commission to hold a public conference regarding its draft determination, should it be requested by an interested party. There was no request for public hearing, although, the Commission received a submission from Air Niugini.

Air Niugini submitted that the Commission considers extending the authorisation period to 3 years, given:

- a) There is increased competition in the market which shows an annual decline in Air Niugini's average revenue yields;
- b) Air Niugini is committed to ensuring that the Commission's competition concerns of the 'hard/soft block' seat allocation are addressed; and
- c) Air Niugini needed a longer authorisation period to replace its current leased B767 aircraft with a newer B767 aircraft.

The Commission notes the issues raised by Air Niugini and considers that these have been taken into account and weighed against the detriment of the arrangement to the public, the resultant public benefit and the likely outcome should the arrangement be declined. But for the current structure of the arrangement, and the continuous risk of uncommercial decisions by the airline and its shareholder, which continue to impose an indirect cost to the public, the Commission considers that the term and conditions of its final determination are necessary to safeguard competition in the market, and the resultant public benefit to consumers and businesses.

In view of the various comments received initially, it is important to note that the Commission would only take into account issues that relate directly to the competition and public benefit considerations of the application, consistent with the authorisation test under the ICCA Act. Where there are comments made by stakeholders that are outside the ambit of the Commission's authorisation role, for example, the comment that the code share arrangement be reviewed to be WTO compatible; the Commission will refer this to relevant authorities responsible for such policy matters.

7.1 Department of Treasury (Treasury) – Treasury submitted that the two existing code share agreements – between Air Niugini and Qantas and between Airlines of PNG and Pacific Blue – currently provide the basis for sustained competition on the Papua New Guinea/Australia route. It submitted that the increase in competition has only occurred since the advent of the second code share arrangement between Airlines of PNG and Pacific Blue in 2008; which resulted in a significant reduction in airfares and increased passenger numbers. Treasury expressed the view that this competition was achieved as a result of the two strong players in the airline industry, the Air Niugini/Qantas partnership and the Airlines of PNG/Pacific Blue partnership. The market has undergone significant changes since the code share was last reviewed in 2007, when Air Niugini and Qantas were the dominant players under the code share partnership.

Treasury supports the approval for a renewed code share agreement by Air Niugini provided that there is evidence of continued competition on the Papua New Guinea/Australia route. It recommended that the code share arrangement continue to be subjected to a regular review (say, every two years) to reflect any further changes to Papua New Guinea's aviation environment.

Treasury noted that before the inception and alignment of Airlines of PNG and Pacific

Blue through a code share arrangement in 2008, there were only three airlines operating and serving the Papua New Guinea/Australia route. The level of the competition at that time was quite minimal since Air Niugini and Qantas had such a large market share compared to Airlines of PNG. However, with the arrival of Pacific Blue into the Papua New Guinea airline market in 2008 under a code share arrangement with Airlines of PNG, increased competition was prevalent in the market.

The entry of an additional airline on the Papua New Guinea/Australia route enabled increased number of flights; reduced fares and effective travelling time. Treasury cited the economic survey of Papua New Guinea by Batten, Gouy and Duncan (2009), which argued that the entry of an additional international airline under a partnership arrangement has increased the level of competition in Papua New Guinea's aviation sector. There have been major reductions in fares and increased services for international travellers. However, this benefit is only evident on the Papua New Guinea/Australia route whereas consumers still face prohibitively expensive airfares to other key destinations in Asia².

Treasury submitted that it is still unclear at this stage whether those benefits currently enjoyed as a result of competition between two (2) pairs of airlines operating under code share arrangements are sustainable, or whether the level of competition will diminish as the market share matures. It expressed that the renewal of the code share agreement between Air Niugini and Qantas will sustain the existing level of competition in the Papua New Guinea/Australia route as a result of challenges the code share parties will encounter from Airlines of PNG and Pacific Blue. It further expressed that by contrast; the removal of the code share agreement between Air Niugini and Qantas would not only impinge on the operation and financial viability of Air Niugini but would also lessen competition in the Papua New Guinea airline market.

It added that the two existing code share agreements between the respective parties have improved the competitiveness of the Papua New Guinea/Australia route and allowed a more level playing field to exist among all participants in the market. Treasury advanced that the cost efficiencies realized by both Air Niugini and Qantas provide opportunities to lower travel costs for passengers, provided that competitive pressures force them to do so. The increased flight frequency from the proposed code share arrangement provides the public with the benefit of additional flying opportunities and the increased availability of seats should provide downward pressure on prices.

Treasury stated that in terms of barriers to entry, the existing code share agreement between Qantas and Air Niugini does not prevent competition. Whilst the existence of two code share agreements may limit competition by discouraging new entrants into the market through combined market power, Treasury believes that the market may be near its saturation point and so there may be limited scope for new entrants to the market without existing providers being forced out. Consequently, Treasury regards the present situation in the airline industry as representing a satisfactory level of competition in the

² Batten, Ghouy and Duncan 2009, PNG Economic Survey: from boom to gloom? Pacific Economic Bulletin, Vol 24 Number 1, pp.13-15.

circumstances.

In light of the applicant's public benefit arguments, Treasury submitted that, the current code share agreement between Air Niugini and Qantas, attracted considerable amount of profit each year, which helped Air Niugini improve its financial position. Benefits to the Papua New Guinea economy in the form of foreign exchange earnings which Air Niugini is likely to contribute to Papua New Guinea's balance of payments would result in an ongoing benefit to the public.

Treasury submitted that most of the recent improvements in aviation services from Papua New Guinea to Australia seem to be due to increased competition, and not just the code share arrangement. Therefore, it is important that the benefits to the Papua New Guinea economy of a single code share arrangement are not overstated.

Treasury further commented that there are potential risks associated with code share arrangements such as the potential reduction in competitive outcomes that may otherwise be achieved under a purely competitive arrangement. It is however mindful of the current code share arrangement between Airlines of PNG and Pacific Blue with possibility of a less competitive airfreight and air passenger services if the current code share agreement between Air Niugini and Qantas is not renewed. Overall, Treasury is of the view that the proposed renewal of code share arrangement offers positive benefits to the public, tourism industry and other sectors of the economy and consequently should be approved.

7.2 Department of Commerce and Industry (DCI) – DCI submitted that efficient international air services are vitally important to Papua New Guinea. It provides links with the rest of the world; facilitate business, trade, investment and technology transfer.

DCI commented that economies around the world are undertaking liberalization efforts to allow more competition, thus the code sharing arrangement had to be reviewed to be WTO compatible. It also submitted that 'open sky policies' eliminates restrictions on air services between and beyond the participating countries. Hence, Papua New Guinea needs to replace restrictive agreement with open skies competition and possibly explore options such as creating Port Moresby as a hub under this policy.

DCI further argued that in line with the Government's broader economic and trade policies objective, Papua New Guinea should seek the most flexible air services arrangements possible, which provides entry to international airlines and therefore, increased competition in the market.

DCI noted that the Air Niugini/Qantas code share services between Papua New Guinea and Australia will create more opportunities for air services by enabling passengers to enjoy more frequent services. The arrangement would promote and enhance trade and tourism between Papua New Guinea and Australia; benefiting passengers, shippers and businesses. DCI expressed that the arrangement will not impair competition, but create opportunities for air services by opening up markets and providing additional gateway

for other overseas travellers to Papua New Guinea.

It recommended that civil arrangements must make allowance for free market competition where pricing must be determined by market forces; and there must be fair and equal opportunity for competition.

7.3 PNG Divers Associations (PNGDA) – PNGDA submitted that it believes a strong and profitable national carrier operating in a stable environment is absolutely vital to the continued development of a viable tourism industry. It submitted that the code share arrangement enables Air Niugini to operate at profitable levels on the Papua New Guinea/Australia route, thereby strengthening its ability to operate to other international ports. Importantly, it enables the national carrier to continue to service its domestic network, a crucial element from a tourism perspective. The code share arrangement guarantees frequent flights and a choice of competitive airfares between Papua New Guinea and Australia.

The association submitted that competition between all carriers to Papua New Guinea has seen an increased level of competitive fare pricing. Code sharing has become almost common practise throughout the world, where airlines consolidate operational resources while still maintaining their own identity. Each code share partner with its individual merits (network, customer service, loyalty program etc.) continues to vie for a share of the market, and remain profitable on those shared sectors. These conditions can only bode well for the consumers that are presented with a range of options from which to choose.

PNGDA further stated that the absence of such an arrangement between Air Niugini and Qantas could potentially see the reduction in the number of services on the Papua New Guinea/Australian route and the possible eventual withdrawal of some carriers, to the detriment of consumers, be they tourism or business travellers. It submitted that in this respect, it would become increasingly difficult for smaller airlines to compete directly with larger airlines. Faced with the possibility of fewer flights, the effects to Papua New Guinea tourism industry could be devastating.

It submitted that continuation of the code share arrangement deserves favourable consideration for its capacity to generate long-term stability for all business in Papua New Guinea. An arrangement which positions the national carrier to operate profitably both internationally and domestically is an arrangement which benefits tourism and business in Papua New Guinea.

7.4 Shell Oil Products Limited (SOPL) – the management of SOPL submitted that while the code share partners' airfares have been competitive since 2007; these are still relatively higher compared to Airlines of PNG. There is still opportunity for airfare reductions.

The management of SOPL added that to fully realize the benefits of the code share agreement; the services must go beyond Port Moresby and link up with all outer lying local ports. It expressed that this will offer reduced airfares in comparison to Airlines of

PNG and delivers mutual benefits in terms of; increased revenue as a direct result of high passenger uplifts utilizing reduced airfares. Airlines of PNG is currently providing reduced airfares on some domestic routes. Airfares will reduce further if the code share service is linked with the domestic travel market.

It submitted that airfreight tariffs are comparatively high in both domestic and international routes. It submitted that if the rates are reduced, more volume of cargo will be realised, reflecting a “win-win” situation where reasonable rates benefits the market and increased freight volume equate to higher returns to the code share partners. It submitted that when other freighters enter and service the routes serviced by the current code share service; competition will further reduce the freight rates.

In addition, the management of SOPL submitted that the level of in-flight service currently enjoyed by the general public is reasonable but can be improved to match the cost of airfares. Comparatively, the in-flight service on Airlines of PNG Dash-8 service is said to be better with still lower airfares than the code share service.

Whilst it noted that benefits of the code share to the Papua New Guinea economy are in the form of tax revenue, employment opportunities to nationals and contribution to tourism; it raised doubts about the benefits in the form of dividends paid to the state by Air Niugini, despite the airline’s reported profits.

The management of SOPL contended that a number of synergies can be realized by the code share service to unlock efficiencies available to make the arrangement more beneficial to both partners and the wider community. It submitted that this includes change in technology and modern techniques of business strategies in the airline industry. Organizational structures, manpower strengths and competencies, optimization of overheads, establishing good agency service agreements with third parties and placement of seats are factors that contribute to the overall profitability of such arrangements.

7.5 Lihir Gold Limited (LGL) – LGL stated that it is a major user of Air Niugini’s domestic freight and passenger services and not its international services. LGL submitted that during the period that the current code share arrangement has been in place, it has not seen any deterioration in the level of competitiveness of airfares, air-freight tariff; and the level of in-flight customer service on the international routes.

7.6 Airlines PNG (APNG) – APNG submitted that in it does not object to the Air/Niugini Qantas code share arrangement. It has since entered into a code share arrangement that was approved by the Commission.

APNG relayed that even with their current code share arrangement; it perceives itself as the only effective competitor to Air Niugini and its code share partner Qantas on routes between Papua New Guinea and Australia and on most routes domestically within Papua New Guinea.

APNG also stated that theoretically it stands to be disadvantaged if it were to believe

that the code share arrangement embraced possible negative competitive behaviour that could occur.

It stated that the relationship with Qantas does provide greater ‘leverage’ to Air Niugini with its access to Qantas’s Frequent Flyer Programme (this may decrease with Air Niugini announcing their own Frequent Flyer scheme), lounges and other benefits it can provide – in particular to its frequent and higher yielding passengers. But that simply provides the traveling public with greater choice – and that cannot be a bad thing. It added that this same situation applies under their current codes here, where they also provide greater choice.

It further submitted that APNG competes vigorously with Air Niugini, and by extension Qantas and its own code share partner Pacific Blue on some routes. APNG also offers even greater choice in terms of competitive airfares, frequency, service levels etc – and believe that APNG must be able to present an alternative product that can stand up against the best that its competitors can offer

It expressed the view that code share arrangements are now a widespread, worldwide and effective way of utilising very expensive airframe capacity in order to allow carriers to become/remain cost efficient in order to provide consistent and stable air services. Accordingly, on balance APNG is of the view that the benefits – to the traveling public, tourism operators, other aviation-related entities and generally – provided by a code share arrangement as the one under review outweigh by a considerable margin any of the perceived or actual detriments.

APNG therefore does not object to Air Niugini/Qantas Code share Arrangement.

8. The Market

For the purposes of the ICCA Act, the market is defined under Section 45 (2) as;

“...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”.

Consistent with the definition of the market provided for under the ICCA Act, the Commission would need to first, identify the relevant market/s for the purpose of establishing actual and/or potential competition effects; and secondly, assess the competition effects and the public benefit claims of the applicant in the wider Papua New Guinea market. The notion of relevant market within the definition provided for under the ICCA Act is essential in order to identify the products and undertakings which are directly competing between the code share partners. It refers to the market where competition takes place.

Approaches by overseas regulators to the analysis of competition consequences of

acquisitions and/or restrictive trade practices generally begin with a consideration of the product or products the subject of the proposed arrangement; for the purpose of defining the relevant market or markets; then taking account of substitution possibilities in both demand and supply; in the likely geographic areas, products, or suppliers, at relevant functional levels, capable of constraining the parties to the arrangement in their ability to raise prices significantly above those that would otherwise prevail in the market.

8.1 Applicant's Definition of the Market

Air Niugini contended that there is one product market for air passenger services, with no separate markets for business customers and leisure customers, or for different cabin classes (business and economy). It argued that there is unlikely any material difference whether the relevant market is defined as a single product market for air passenger services or separate product markets for business and leisure air passenger services.

It also submitted that there is no distinction between function levels of the air services market, and commented that it is not necessary to define or analyse separate functional levels within the air passenger services market. It maintained the view that the relevant geographical market for international passenger services are between countries.

In its submission to the Commission, Air Niugini defined the market in terms of the product and geographic dimension. The applicant submitted that the immediate relevant passenger market affected by the renewed code share agreement is the market for passenger air services between Papua New Guinea and Australia. It referred to this market as the 'Australia Air Passenger Market'.

It further submitted that the relevant freight markets under the renewed code share Agreement are:

- The market for the provision of airfreight services between Papua New Guinea and Australia, the 'Australia Air Freight Market'; and
- The market for the provision of airfreight services between Papua New Guinea and other international destinations currently serviced by Air Niugini's B767 aircraft. It referred to this market as the 'Asian Air Freight Market'.

The applicant referred to the Australian Air Passenger Market; and the Australia Air Freight Market collectively as the 'Australian Market'. It further submitted that the renewed code share agreement would have a likely adverse material effect on competition in the markets for ancillary services such as for the supply of engineering and maintenance services.

8.2 Commission's approach to defining the Market

The Commission notes the arguments advanced by the applicant and it considers this to be consistent with the definition of the relevant market pursuant to section 45(2) discussed above. The Commission also notes that in defining the market, Air Niugini relied on the

New Zealand Commerce Commission and the Australian Competition and Consumer Commission's determinations of the 2004 Qantas/Air New Zealand alliance application.

Bearing in mind the approach applicable to defining the relevant market, the Commission notes that the renewed code share agreement between Air Niugini and Qantas is the subject of the proposed arrangement. Hence, the starting point for market definition is the competing product/service provided by the parties under this arrangement.

The Commission notes the applicant's comment that there is one product market for air passenger services, with no separate markets for business and leisure customers, or for different cabin classes (business and economy). Without analysing the issue in detail, the Commission considers that the separation of cabin classes and fares and fare type for business and leisure customers indicate that there is likely to be a number of separate sub-markets within the overall product market for air passenger services. The Commission considers that the separation of cabin classes and fares between business and leisure travellers is a response by carriers to meet the competing demand and preference of consumers. For example, in contrast to leisure passengers consisting of visiting friends and relative (VFR), holidays and tourism travellers, business class passengers prefer fully flexible fares including the ability to book or cancel fares at short notice; and generally are not too particular about airfares because of the necessity to travel to work.

The Commission further notes that the application relates to code share services on the Port Moresby-Cairns, Port Moresby-Brisbane and Port Moresby – Sydney sectors. The Commission considers that in some circumstances it may be necessary to define the market in terms of the specific routes because of peculiarity of the routes, including the structure and state of competition on those routes. However, under the current application, the Commission considers that the common feature on each of the specific code share route points to passengers and airfreight services, but importantly the structure of the block allocation of seats. These common elements make it necessary to bundle the routes as a collective market within specific geographical settings. Based on these considerations, the Commission considers that the specific code share routes are part of a larger market between Papua New Guinea and Australia, the Papua New Guinea/Australia route.

The Commission also notes that the usage of the B767 and B757 aircraft on the code share routes extend to the ports of Singapore, Philippines, Hong Kong, Malaysia and Japan. The Commission therefore considers that the provision of air passenger and air freight services under the renewed code share agreement extends between Papua New Guinea and Australia, and Papua New Guinea and the Asia region.

This follows that the demand for passenger and airfreight services are between Papua New Guinea and Australia, and Papua New Guinea and the Asia region. The Commission understands that competition in the airlines industry in regard to passenger and freight, amongst other things, focuses on the type of aircraft deployed on the route, frequency of flights, loyalty programs, passenger airfares and fare types, freight rates, the range and quality of in-flight service and seamlessness of flight connections. These features and the marketing techniques adopted by airline carriers influence the decision of passengers and businesses. In this regard, the Commission considers that Air Niugini and Qantas compete with each other and with Airlines of PNG and Pacific Blue to uplift passengers and freight,

mainly on the routes between Papua New Guinea and Australia. In addition, Air Niugini and Qantas compete with scheduled and ad hoc dedicated freighters and ad hoc passenger and freight charter services between Papua New Guinea and Australia.

Consideration also needs to be given to whether the market includes the domestic air travel market within Papua New Guinea. Code share arrangements for international services certainly can affect domestic services – indeed, the knock-on effect of better access to domestic services for international carriers, and interlining arrangements for code share airlines which would otherwise have no direct presence in a country, can be a major reason for entering into international code share agreements. In the present case, neither Air Niugini nor Qantas is putting forward domestic air travel issues as part of the matters to be taken into account. The Commission considers that the Papua New Guinea domestic air travel market is relevant here, but not so much as to have it included in the market definition. Nevertheless, the impact code share arrangements have on the Papua New Guinea domestic market should not be ignored.

In considering the demand side substitutability, the Commission considers that if there is any significant non transitory increase in the Air Niugini – Qantas passenger fares, holding other factors equal, passenger are likely to switch to Airlines of PNG and Pacific Blue, but only for services between Port Moresby and Cairns and Port Moresby and Brisbane. Other factors such as size and speed of aircraft, frequency, and passenger comfort and in flight services may influence passengers' choice but where airfare is the main determining factor, passenger would choose the carrier/s offering lower fares. The Commission notes that on the Port Moresby-Cairns sector Airlines of PNG operates a De Havilland Dash-8 aircraft and competes against Air Niugini and Qantas' Dash 8 and Fokker 100 services. On the Port Moresby-Brisbane sector Airlines of PNG code shares with Pacific Blue using a B737 aircraft and competes with the Air Niugini/Qantas alliance, which operates Fokker 100, B757 and B767 services. Passengers travelling to Sydney would have no alternative but to utilise the Air Niugini – Qantas B757 code share service as the partners are the only RPT carriers on this route.

The Commission considers that the frequency and nature of ad hoc charter services where individual bookings are not entertained; and the limitation imposed by aviation authorities on these services competing against RPT scheduled services would mean that passengers would not be able to switch to ad hoc charter services without cost and inconvenience. Similarly, assuming there are such services, passenger would not be able to switch quickly to sea ferry services operated by ships, because the differences in the schedules, frequency and speed of travel, amongst other factors, would render this alternative less favourable.

With respect to freight, the Commission considers that if there is any significant non-transitory increase in the Air Niugini – Qantas freight rates, holding other factors equal, customers are likely to switch to Airlines of PNG and Pacific Blue, but only for freight services between Port Moresby and Cairns and Port Moresby and Brisbane. The Commission however notes that whilst Airlines of PNG competes for loose freight on the Cairns routes, its freight capacity is somewhat limited due to the size of the aircraft it currently operates on that route. On the Brisbane route, the Commission notes that Airlines of PNG and Pacific Blue operate a narrow body B737 aircraft and therefore provide some freight capacity, but limited to loose cargo (non-containerised/palletised). In addition,

HeavyLift Cargo Airlines operates twice weekly dedicated freight services on the Brisbane route; with containerised freight capability. This means that customers that require the provision of high value/time-sensitive cargo such as fresh produce, sea food and dairy goods between Port Moresby – Brisbane and the Asian Freight Market where these need to be transported in chillier containers, could choose between the Air Niugini-Qantas alliance and HeavyLift Cargo Airlines.

In this regard, the Commission considers the decision by customers between these competing services will boil down to price and non-price factors. The Commission considers that customers would choose HeavyLift Cargo Airlines if its freight rates are less than the increases in freight rates charged by Air Niugini-Qantas. The Commission considers that in contrast to passenger carriers where flight frequency and cost of freight is largely underwritten by passenger services; unless dedicated freighters such as HeavyLift Cargo Airlines can achieve similar economies of scope and or scale, through increased frequency, capacity and seamless flight connection to meet market schedules, they would not be able to match the frequency and freights rates offered by passenger carriers.

On the Port Moresby-Sydney sector, the Commission considers that businesses requiring freight would have no alternative but to utilise the Air Niugini – Qantas code share service as the carriers are the only operators servicing this route using a B757 narrow body aircraft. Again, ad hoc frequency of charter services and the limitation imposed by aviation authorities on ad hoc charter services competing against scheduled services would mean that customers would not be able to switch to ad hoc charter services for their freight requirement. In addition, the Commission considers that customers would not be able to switch quickly to sea freight because the high value/time-sensitive cargo, transported in the belly holds of aircraft is quite different to that generally carried by sea.

This suggests to the Commission that the product range and service offered by competing airlines in the market are substitutes on the demand side. However, under the current circumstances, it considers that there are no close substitute for airfreight services in regards to time-sensitive/high valued goods between Papua New Guinea and Australia. In addition, the Commission considers that sea freight is not a close substitute to airfreight.

In considering the supply side substitutability, as discussed, the Commission considers that Air Niugini and Qantas compete with each other and with Airlines of PNG and Pacific Blue to provide scheduled passengers and freight services. They face competition from scheduled and ad hoc dedicated freighter and charter services providing passenger and freight services on the code share route, particularly the Cairns and Brisbane routes. The Commission, however, considers that in reality, the competition provided by ad hoc charter services is very limited due to existing regulatory conditions and frequency of these services, respectively. In the same respect, the freight rates, schedule and frequency of dedicated freighters to some extent limit their competitiveness against the RPT operators in the market.

The Commission further considers that while there are no sea passenger ferry services, there are cargo shipment services by registered domicile and international companies operating between Papua New Guinea and Australia, and Papua New Guinea and the Asian sea ports. The Commission considers these services as an alternative to air freight service

offered by the airlines, in particular general cargo and high value/ non-time sensitive goods.

Notwithstanding the above, in determining whether sea freight services should be considered as substitutes of airfreight services on the supply side; the Commission considers that if there is any significant non-transitory increase in freight rates as a result of increased demand, sea freight operators would not be able to quickly and willingly without significant investment and cost be able to innovate and expand their freighting operations to compete for airfreight in response to this price increase because differences in speed and the peculiarity of high value/time-sensitive goods would be an issue. The Commission therefore considers that suppliers of airfreight services and sea freight services operate in separate markets rather than a wider Papua New Guinea freight market.

In regards to the argument on the functional aspect of the market, the Commission notes the comment by the applicant that the renewed code share agreement could have an adverse material effect on competition in the markets for ancillary services such as for the supply of engineering and maintenance services. In considering this issue, the Commission is of the view that strict safety requirements pertaining to the airline industry's operations, to a larger extent limit competition between airlines in the areas of ancillary services such as the supply of engineering and maintenance services. The Commission considers that whilst there are other ancillary services such as aircraft ground handling services which may be affected by the renewed code share agreement, it is of the view that the markets for ancillary services would not by itself be a significant issue; and further considers that in reality these are confined to the operations of the respective airlines' main business of providing air passenger and commercial airfreight services, except where the ancillary services are provided by private contractors.

In view of the above discussions, the Commission is of the view that there is likely to be several products and a functional market which exists within the overall market of passenger and freight services between Papua New Guinea and each of the international destinations. The Commission considers that irrespective of the approach taken to define the relevant market, the competition assessment of the renewed code share agreement would have the same outcome because of the reasons discuss throughout this determination.

Taking into account the above facts and considerations, consistent with section 45(2), the Commission accepts that the renewed code share agreement would impact on air passenger and airfreight services primarily between Papua New Guinea and Australia. As such, the Commission considers that the relevant principal markets appropriate for the consideration is the 'Australian Air Passenger Market' and the 'Australian Air Freight Market'; collectively referred hereunder as the 'Australian Market'.

The Commission also considers that since the renewed code share agreement underpins Air Niugini's usage of the B767 wide body aircraft between Papua New Guinea and Australia; and Papua New Guinea and Asia; its decision on the code share arrangement would also have a consequential impact on the public benefits accruing from the 'Asian Air Passenger Market' and 'Asian Air Freight Market'. Consequently, the Commission views these as related markets and would consider these in its overall assessment of the renewed code share agreement. The Commission, however, maintains the view that the 'Asian Passenger

Market’ and ‘Asian Air Freight Market’, collectively referred hereunder as the ‘Asian Market’ are not the principal relevant markets.

9. Commission’s assessment of the effects on competition in the relevant markets

In assessing the competition effects under the proposed renewed code share arrangement, the Commission maintains that it is necessary to examine the nature of competition in the relevant markets and the likely outcomes in the event the code share agreement is not authorised by the Commission. Importantly, the outcomes of the renewed code share arrangement cannot be presumed to be pro-competitive or anti-competitive. The competition effects of the arrangement in the market, if any, must be assessed in detail.

The Commission also notes its earlier determination concerning the parties and considers that under the current circumstances where the merits of the renewed code share agreement would need to be tested; it will draw upon its 2007 determination in view of appropriate data and information that may be relevant and applicable.

In this regard, the Commission is of the view that careful consideration would need to be given to the analysis of changes, if any, in the structure and state of competition in the market since the last determination was made in 2007. Consequently, the Commission is of the view that and due weight must be given to the underlying key competition indicators in the market. These are discussed in detail under subsections 9.1 – 9.6 below.

9.1 Market share

A measure of the market share provides an indication of how well a firm is fairing in the market compared to its rivals who are faced with relatively the same challenges and opportunities. It is therefore often used to determine the competitive strength of the players within the market under consideration³. As discussed, the market under consideration is the Australian Market.

The Commission considers that periodic changes in the market share, if any, provide an indication of the degree of competition in the market. Thus, analysis of the market share of the airlines operating in the market, especially that of the code share partners would provide a picture of how well the participants have vie since the Commission’s initial approval of the arrangement in 2007. In this respect, the Commission recalls that one of the key indicators that underpinned the approval of Air Niugini’s code share application in 2007 was the declining market share trend of the code share partners as a result of viable competition from Airlines of PNG.

Notwithstanding the above, the Commission is of the view that market share estimates, on its own would not be adequate to fully assess the effects of competition in the market. The Commission therefore considers that market share would need to be assessed together with

³ ICCC Determination, NBPOL Clearance Application, 2007

other structural and behaviour issues such as barriers to entry, the structure of the hard block seat allocation, level of airfares, amongst others to fully ascertain the competitive effects of the code share arrangement in the relevant and related markets.

In its 2007 determination, the Commission noted that Air Niugini was initially the sole operator of RPT services on the Port Moresby - Cairns sector and enjoyed 100 per cent of the market share on that sector. In 1987, it entered into a code share arrangement with Qantas which saw some of its market share captured by Qantas. Under the arrangement, Air Niugini and Qantas provided air passenger services as the operating and marketing carrier, respectively. Air Niugini, however, remained as the sole freight service provider on this sector. The Commission noted that Air Niugini was the only operator at that time and the code share enabled Qantas to enter the Cairns route as a marketing carrier and compete without having to incur significant start up cost.

The alliances were the only RPT operators on the Cairns route until the entry by Airlines of PNG in 2005. In the wake of viable competition, Air Niugini in competition with Qantas under the code share arrangement competes with Airlines of PNG and ad hoc passenger and freight service providers from time to time. Airlines of PNG captured slightly over 5 per cent of the alliance's market share. The Commission noted that notwithstanding competition on the Cairns route by Airlines of PNG and others, Air Niugini and Qantas enjoy a commanding share of the market with their combined market share of over 80 per cent.

On the Port Moresby – Brisbane/Sydney sector, the Commission noted that Air Niugini and Qantas maintain their independent operations and competed for market share. Ongoing competition between the airlines on these route and the contraction of passenger numbers on the Australian Air Passenger Market leading up to 1999, contributed significantly to Air Niugini's precarious financial state. The Commission understood that this posed a threat to Air Niugini's long term sustainability in the market. Consequently, the Government of Papua New Guinea as the shareholder of the carrier made representation to the Government of Australia for Air Niugini and Qantas to code share on the Port Moresby – Brisbane/Sydney sector.

In August 2002, Air Niugini and Qantas entered into a formal arrangement to code share on the Port Moresby – Brisbane/Sydney sector. The Commission noted that the expansion of the code share onto this sector was developed as a means to support the financial viability of Air Niugini. The arrangement involved Qantas withdrawing services from the Port Moresby – Brisbane/ Sydney route on 1 September 2002, leaving Air Niugini as the only operator of a wide body B767 aircraft, with Qantas purchasing seats on Air Niugini's flights as a marketing carrier.

In the years preceding 2006, Air Niugini and Qantas competed with each other for passenger and freight under the code share arrangement and maintained market shares as the only operators on the Port Moresby-Brisbane/Sydney sector. In recent years, the market share of the code share partners has changed due to the evolving state of competition on the Papua New Guinea/Australian route. Particularly, in 2006, Airlines of PNG commenced services on the Port Moresby – Brisbane sector. As anticipated, Airlines of PNG grew its market share to approximately 12 per cent. Two years later, Airlines of PNG entered into a

code share arrangement with Pacific Blue to provide code share services on the Port Moresby-Brisbane sector. Under this arrangement, all seats are allocated to Airlines of PNG and Pacific Blue. The airlines compete as marketing carriers while Virgin Blue operates the code share service. The freight capacity of this code share service has been presold to a freighting company called Toll Air Express, as part of Virgin Blue's ongoing freight arrangement.

The Air Niugini/Qantas alliance also competed with HeavyLift Cargo Airlines that operated twice weekly dedicated freight service on the Brisbane route.

On the Port Moresby – Brisbane/Sydney sector, Air Niugini in competition with Qantas under the code share arrangement competes with Airlines of PNG and Pacific Blue for passengers. In regards to freight, Air Niugini and Qantas compete with Toll Air Express and HeavyLift Cargo Airlines.

In its submission to the Commission, Air Niugini submitted that there is no official market share data available in Papua New Guinea. The market share estimates provided by Air Niugini is therefore confidential and is based on the actual number of passengers carried by itself and Qantas and estimates of those carried by Airlines of PNG and Pacific Blue. The Commission notes that these market share estimates are based on passenger air service.

Air Niugini contended that although Airlines of PNG and the Airlines of PNG/Pacific Blue alliance have captured a modest market share, their stake represents a substantial and aggressive growth for carriers that have recently entered the Australian Market. It claimed that market share has changed substantially each year as each market participant competes for market share. It argued that when combined with the absence of significant cost of barriers to entry, this suggests that Airlines of PNG and Pacific Blue have a powerful effect in constraining both Air Niugini and Qantas during the term of the renewed code share agreement.

Confidential estimates provided by the applicant shows that the market share of the code share partner has declined gradually since 2003; whilst that of Airlines of PNG has increased. The data shows that the market share of Air Niugini and Qantas declined in 2007. The market share of Air Niugini rebound whilst that of Qantas continued to decline. It further shows that the market share of Airlines of PNG has increased in 2007, and remained unchanged in 2008. The Commission further notes that the data shows that the combined market share of the code share partners remained unchanged between 2007 and 2008. Air Niugini submitted that since Pacific Blue only commenced in late 2008, there are no available estimates. The Commission further notes that Qantas' estimates closely follow that of Air Niugini, however, its estimates showed a decline in Airlines of PNG's 2008 market share due to the carrier sharing capacity with Pacific Blue.

The Commission notes that Air Niugini continues to hold the majority of the market share on the Papua New Guinea/Australia route. Airlines of PNG's market share declined between 2007 and 2008, reflecting the split of capacity between itself and Pacific Blue under their code share arrangement. The Commission notes that in contrast to the other carriers operating in the market, Pacific Blue did not have a marketing presence on the Papua New Guinea–Australia route until recently.

In terms of the dual alliances' operations on the Papua New Guinea/Australia route, data from the IASC shows a similar trend. As previously noted, the entry of Airlines of PNG into the market impacted the combined market share of the Air Niugini/Qantas alliance, which declined over the first three years. The Commission notes that the alliances' market share was roughly 87 per cent in 2007. This declined to approximately 80 per cent in 2008, and then rebound in 2009 to approximately 84 per cent. The Commission notes that Air Niugini and Qantas experienced growth in their market share despite the expectation that the entry into the market by Pacific Blue would further impact on the alliances' market share, as did Airlines of PNG. In contrast, the Commission notes that the market share of the Airlines of PNG/Pacific Blue alliance's which commenced in 2008, declined from 18 per cent in 2008 to just over 16 percent in 2009⁴.

The Commission notes that Airlines of PNG operates seven (7) Dash 8 weekly services on the Port Moresby–Cairns sector on its own and four (4) B737 services on the Port Moresby – Brisbane sector in code share with Pacific Blue. The carriers do not operate services to Sydney. In contrast, it notes that Air Niugini and Qantas provide a higher frequency of flights to Cairns, Brisbane and Sydney using Dash–8, Fokker 100 and Boeing 757 and 767 aircraft. The Commission notes that the Air Niugini/Qantas alliance maintains a wider coverage of the Papua New Guinea/Australia route, higher frequency of flights and aircraft capacity compared to the former alliance, and considers these as likely explanation for the differences in market shares and why the entry of Pacific Blue did not further erode the combined Air Niugini/Qantas market share.

In light of the above, and news of Airlines of PNG apparently seeking regulatory approvals to service the Asian route⁵, the Commission notes the view that it may be premature to draw conclusions on the ability of Airlines of PNG to expand its operations and grow its market share over time either on its own, or in partnership with Pacific Blue or other carriers. Whilst the Commission does not discount this outcome, it shares the same view as the IASC that the increase in the Air Niugini/Qantas alliance's market share causes concern about the alliance's market power and raises doubt about the extent to which the Airlines of PNG/Pacific Blue alliance has been able to moderate Air Niugini and Qantas' combined market share.

Overall, the Commission understands that in the year ending July 2009, the Papua New Guinea/Australia market grew by approximately 32 per cent over the last two years. This represents an average of 15 per cent annual growth rate. In view of the above, the Commission considers that Air Niugini holds the large part of the market on its own and in code share with Qantas. The Air Niugini/Qantas alliance market share has not been impacted by the entry of Pacific Blue but has since rebounded.

⁴ The market share calculation is based on passenger volumes uplifted by the respective airlines/alliances on the Papua New Guinea-Australian route. The estimates are calculated for year ending June 2003 – 2009.

⁵ Post-Courier, Friday, September 18, 2009

9.2 Structure of the Code share Agreement

The Commission maintains the view that the impact of code sharing on competition will depend on the extent to which the carriers operating on a code share basis compete with each other on the same route, or use code sharing to connect their services. Where carriers are already operating on the same route, and individually have relatively high market presence, with unfavourable competitive provisions of the terms of their agreement, then code sharing is most likely to reduce competition⁶.

In particular, the presence of code sharing arrangements has the potential to limit consumer preferences in terms of choice of carrier and in-flight service, frequency of flights and airfares and freight rates. In regards to pricing, code sharing arrangements have the potential to significantly reduce competitive pricing pressures but not as far as the significant reduction that would occur as a result of potentially a complete withdrawal of competitive pressure in the market.

In hindsight, the Commission is aware that code sharing arrangements could potentially play an important role as a precursor of development to allow entry of carriers on marginal thin routes without incurring significant start up cost; where this can be demonstrated on public benefit grounds.

In its submission to the Commission, Air Niugini argued the pro-competitive aspects of the code share arrangement. It argued that under the 'hard block' code share, Qantas must pay Air Niugini for the seats allocated to it whether or not these are sold by it. The 'hard block' allocation that Qantas is required to purchase is significantly higher than the number it normally sells. Unsold 'hard block' seats represent an absolute loss to Qantas. Consequently, it advanced that Qantas has a strong incentive to market these seats aggressively in competition with Air Niugini.

The Commission noted that Qantas expressed similar views in its submission to the IASC that it remains in Qantas commercial interest to sell every seat that it can beyond its 'hard block'. The 'hard block' component of the code share provides incentive for Qantas to price competitively, as it must sell sufficient seats to at least cover the seat block charge it pays to Air Niugini.

In the 2007 joint review of Air Niugini/Qantas code share arrangement, the Commission identified that under the agreed 'hard block' code share arrangements, Qantas generally purchases less than half, in some cases it purchases much less than half of the seats available. The Commission also noted that the number of seats in the Qantas 'hard block' varies from day to day, with smaller blocks purchased by Qantas on days of lower demand. As discussed, the number of seats in the Qantas 'hard block' allocation on some flights is small. The Commission agreed that the arrangement works to Qantas' advantage where Qantas matches its supply of seats to the considerable demand variations on the route on different days of the week. For example, peak demand for southbound services ex – Australia is on Sundays and Mondays. On these days, between the code share partners, Air

⁶ ICCC Determination, Air Niugini Code share Authorisation Application, 2007

Niugini is under greater competitive pressure to sell the balance of seats on all code share flights, with a higher number of seats to sell on days of weaker demand⁷.

The Commission also noted that a reinforcing feature of the code share arrangement was that, Qantas has the option to purchase further seats up to an agreed limit on each Air Niugini flight within a 'soft block' of seats. The Commission observed that the inherent structure of the code share arrangement means that Qantas has considerable flexibility in managing the supply of seats it has available for sale. It can purchase more seats if its 'hard block' is likely to be fully sold, or not to do so if the 'hard block' is only partially sold. The Commission accepted that given this flexibility in supply, and the overall matching of 'hard seat' block sizes to day to day demand, Qantas is in a position to generate strong returns without intensive marketing effort or the need to discount significantly⁸.

In view of this information, the Commission agreed with the view that the block arrangement inherently favours Qantas relative to Air Niugini in the Australian Air Passenger Market. Of the two partners, Air Niugini is likely to be placed under more pressure to price competitively to sell its seats than Qantas, particularly on days of low demand when Qantas buys from Air Niugini through its 'hard block' seat purchase a smaller proportion of the seats on the aircraft. The Commission noted that although airfreight carriage is not part of the code share arrangement per se, Qantas buys fixed freight capacity on the Brisbane and Sydney code share services. There is however, room to negotiate additional capacity annually over the duration of the renewed code share agreement.

In light of the structure of the code share arrangement, the Commission agreed with the view that the code share arrangement would be more competitive if the allocation of the hard block seats to Qantas were larger and uniformly spread across different days of the week, with smaller or no soft block component. The Commission stated that it strongly supports a revised block structure which provides for more competition between the code share partners.

Qantas commented in 2007 that it is no different from any other carrier seeking to enter into arrangements that enhanced its competitive position. It stated that it was not unusual for the operating carrier to carry greater risk than the marketing carrier. Qantas however commented that it would take the concerns of the Commission and the IASC into consideration when renegotiating the next code share arrangement with Air Niugini. The Commission understands that the renegotiation of the arrangement referred to by Qantas in 2007 is the impending renewed code share agreement between itself and Air Niugini; which is the subject of the current determinations by the Commission and the IASC.

Information before the Commission shows that the structure of block allocation under the code share arrangement remains in Qantas' favour in terms of the number seats bought by it in the Australian Market where these continues to vary by day of the week.

⁷ ICCA Determination, Air Niugini Code share Authorisation Application, 2007

⁸ Ibid

In view of the above, the Commission studied Qantas's submission to the IASC and noted that it has not addressed the Commission's concerns relating to the structure of the arrangement. In addition, the Commission notes Air Niugini's comment, "...the conditions of the renewed code share agreement will be similar to the current code share agreement". In this respect, the Commission enquired with Air Niugini whether the carriers will consider revising the block arrangement in light of its concerns of the fundamentals of the block arrangement. Air Niugini advised that as part of the renewed code share agreement between the carriers, it is currently negotiating for an equitable 'hard block' arrangement with Qantas, in particular those relating to the business class.

The Commission understands from the applicant that the parties are currently discussing the pricing aspect of the block seats. Air Niugini advised that in light of the Commission's on-going concern and increasing complaints by passengers missing out on business class seats when purchasing Air Niugini tickets, Air Niugini is determined to push for the 'hard block' allocation of business class seats to be equally split between the two carriers. It also expressed that the 'soft block' allocation of seats is not so much of an issue because the option to sell seats which might otherwise be left unsold is an incentive to Air Niugini to off load these to Qantas when required. Air Niugini also advised that it would provide a copy of the renewed code share agreement to the Commission once this is finalised towards the end of December 2009.

The Commission is encouraged by Air Niugini's effort to address the imbalance of seats under the renewed code share agreement and expects to see some positive changes to the current allocation of seats. However, in light of the failure by Air Niugini and Qantas to seriously address the issue previously, as part of its present consideration of the renewed code share agreement, the Commission will take a slightly tougher stand as per condition (a) in section 12 of this determination.

Under the circumstances, whilst the Commission maintains the view that it does not consider that it is its role to directly intervene into private commercial arrangement and or operations of the airline concerning the block arrangements, the terms of the code share arrangement, including business and yield management strategies; it strongly maintains that due consideration must be given to make the block arrangement uniform and equitable. Where necessary the Commission would take necessary steps to influence the negotiations of the airlines in order to safe guard the market and the interest of the public, which could include the termination of the code share authorisation as discussed under condition (a) of section 12 of this determination.

The Commission considers that from a competition perspective, the continuation of the current 'hard block/soft block' allocation of seats between the code share partners would provide a somewhat less than optimal outcome compared to the circumstances if Air Niugini and Qantas were operating in a competitive market. To put it in more context, the Commission agrees with the views expressed by the IASC that whilst the 'hard block' nature of the code share arrangement created some incentive for price competition between Air Niugini and Qantas, the degree of competition was greatly reduced from the situation which had prevailed when both airlines operated their own services in direct competition with each other.

9.3 Revenue yields, airfares and freight rates in the market

The Commission agrees with the IASC that revenue yield data provides the best way to examine trends in the fares paid by passengers. Consequently, one of the key indicators that underpinned the Commission's 2007 approval of the code share arrangement was the declining trend in Air Niugini and Qantas' total class revenue yields on the Papua New Guinea/Australia route. The Commission noted that the trend was consistent with the expectation that the entry of competitors, in this case Airlines of PNG, would result in lower airfares.

The Commission noted that in 2007 the code share partners enjoyed attractive passenger revenue yields on the Papua New Guinea/Australia route. The Commission observed that this was attributed to the unusually high proportion of business traffic on the route. Analysis from the IASC showed that well over half of Australian resident travellers, comprising of approximately 60% of the total market travel for business purposes, including a quarter of Papua New Guinea residents.

The analysis also showed that the uniquely large proportion of business travellers contributed significantly to the high revenue yields on the route. The Commission noted that business travel demand is far less sensitive to fare levels in the market compared to leisure travel demand. This illustrated that the necessity to travel for work means that business passengers will generally not alter their frequency of flying despite high fares. It further showed that business passenger, who would generally prefer fully flexible fares including the ability to book or cancel fares at short notice, were also less sensitive to high fares when travelling in the economy class.

The Commission accepted that although the expansion of the code share onto the Port Moresby – Brisbane/Sydney sector has elements of competition between Air Niugini and Qantas, the degree of competition between the code share partners did not reflect on the airfares in the market. The Commission noted that the higher revenue yields enjoyed by Air Niugini and Qantas over the initial period of the expanded code share arrangement reflected high average airfares that would otherwise have been moderated in a more competitive market, in the absence of the code share arrangement.

The Commission also noted that whilst the threat of entry by other carriers has previously had little effect on Air Niugini and Qantas' airfares, the actual entry of Airlines of PNG into the market has constrained and prompted Air Niugini and Qantas to revisit their fares and fare structures. The entry by Airlines of PNG on the Port Moresby – Cairns sector in late 2005 and later on the Port Moresby – Brisbane sector in late 2006 resulted in marked improvement in the competition landscape. There has since been improvement in airfares and significant reductions in revenue yields for Air Niugini and Qantas to a lesser extent. Airfares have fallen mainly in the economy class.

Information before the Commission in 2007 also showed that airfares for business class have slightly dropped, but mainly for Air Niugini rather than Qantas. Despite Air Niugini's lower airfares, some travellers prefer to fly with Qantas. The Commission and the IASC agreed that there are non-fare related factors which influence the preference of these

travellers. The Commissions attributed this to the extensive marketing channels in ‘own’ country than in ‘other’ country; customer loyalty where the majority of flying customers in Papua New Guinea are loyal to Air Niugini while Australian customers are loyal to Qantas. Other factors include, ease of booking and baggage transfers and perception of schedule performance.

The Commission observes that this scenario continues to be true under the current circumstances. As discussed, in 2007, the Commission and the ISAC analysed the total class yield of the three code share sectors. At that time, the Sydney sector was serviced via Brisbane. Under the current application, both Commissions exclude the Sydney sector from their analysis of the total class yield. This is because until recently, there is a twice weekly direct flight to Sydney, thus, it would be misleading and inconsistent to consider revenue yield on this route and compared it to the trend analysed in 2007.

In this regard, the Commission notes from data supplied by the IASC that Qantas’ overall revenue yield has significantly improved. It shows that yields in the business class are very strong and are consistently increasing. In particular, the overall yield on the Port Moresby – Brisbane sector is on an upward trend over the last twelve (12) months, notwithstanding the entry of Pacific Blue on that route. On the Port Moresby – Cairns route, overall yields have continued to trend downwards. The data further shows that business class yields have recently increased on the Brisbane route while it has been stable on the Cairns route. The Commission considers that this may be due, in part, to Air Niugini having replaced some of its Cairns – Port Moresby Fokker F100 flights (which have 8 business class seats per flight) with Dash 8 aircraft which have no business class available.

The Commission also notes from the IASC that whilst airlines’ revenue yields have generally dropped over the last 12 months, Qantas’ overall yields on the Papua New Guinea/Australia route has increased over this period. The Commission attributes this outcome to the unique characteristics of the Papua New Guinea/Australia route, where travel is dominated by business passengers who are generally insensitive to airfares. In addition, the Commission considers that the growth in the Papua New Guinea/Australia market by 32 per cent since the last review, and findings that yields on business class are very strong and are consistently increasing supports this view.

As regards Air Niugini, the Commission notes that its overall revenue yield has been on a downward trend. In particular, its shows that overall yield on the Port Moresby – Brisbane sector is on a downward trend over the last twelve (12) months. As with the Qantas scenario, the Commission notes that the entry of Pacific Blue on the route in 2008 did not impact Air Niugini’s yields which increased during that period. On the Port Moresby/Cairns route, yields continue to trend downwards despite levelling off in 2008.

In regards to airfares, the Commission observes that the entry of Airlines of PNG albeit a smaller competitor, continues to exert some competitive pressure in the market which has resulted in the significant decline in airfares, especially in the economy class on the Cairns and Brisbane sectors. These outcomes also resulted in the introduction of a wide range of fares and fare types and an improvement in the level of services over the last few years due to viable competition. The trend continued following Airlines of PNG code sharing with Pacific Blue on the Port Moresby – Brisbane sector. The parties introduced a bigger B737

narrow body aircraft with additional 52 seats, adjusted their frequency of flights, interline their individual operations with their code share service, introduced a frequent flyer program and provide competitive packages in competition to the Air Niugini/Qantas alliance. The Commission notes that whilst the entry by Pacific Blue did not significantly, moderated the revenue yields and market share of the Air Niugini/Qantas alliance, it nevertheless kept a competitive pressure on their fares. The Commission considers that the state of competition in terms of airfares and fare types in the market has improved, particularly for economy class passengers on the Port Moresby – Brisbane sector.

The Commission further notes that since Airlines of PNG has code shared with Pacific Blue, it has intensified its efforts to offer special airfares and discount to domestic travelling passengers. The Commission notes similar response by Air Niugini, and attributes this as a response by Air Niugini to fares offered by Airlines of PNG in the market. This signals competition at work, benefitting consumers.

As part of its enforcement role to ensure compliance of the trade practice provisions under the ICC Act, the Commission continues to monitor the price in light of discounts and special fare offers by competing carriers and notices no evidence that suggests that the price competition is predatory in nature, though it does result in a benefit to consumers.

In regards to freight rates, the Commission notes that Air Niugini provides the bulk of airfreight capacity in the Australia and the Asian Air Freight Markets. It provides freight services on all the code share routes and is the primary containerised/palletised RPT carrier transporting high value/time-sensitive goods on the Port Moresby – Brisbane sector and the Port Moresby – Asian route. Qantas purchases freight capacity on the Brisbane and Sydney routes. As discussed, the carriers compete with Airlines of PNG and occasional ad hoc freight services on the Cairns route; including Toll and HeavyLift Cargo Airlines on the Brisbane route.

Information supplied by Air Niugini shows that its freight revenue increased marginally in 2007, and declined substantially in 2008. The Commission understands that the decline is attributed to low freight revenue and cargo tonnage uplifted by Air Niugini. The applicant advised that the decision by Qantas to remove its surcharges on its freight rates has resulted in Air Niugini receiving lower freight revenue in 2008. The Commission also understands that the allocated freight capacity to Qantas by Air Niugini on the Port Moresby – Sydney sector has not been utilised by Qantas. The Commission considers this as a likely contributing factor to Air Niugini's declining freight revenue despite its freight rates remaining relatively constant.

The Commission also notes that the overall southbound and northbound freight tonnage carried by Air Niugini in the belly hold of the B767 aircraft on the Brisbane route has been on a declining trend since 2006. The quantity of northbound freight carried by air Niugini is higher than that carried on its southbound flights. Of the total tonnage uplifted between January 2006 and October 2009, 63 per cent comprise northbound freight compared to 37 per cent southbound freight. The Commission notes that Air Niugini average tonnage (kg) per flight has also been declining over this period. However, it further notes that current statistic ending October 2009 shows that Air Niugini's freight tonnage is likely to rebound above the 2008 levels.

The Commission considers that the decline in freight revenue signals possible improvements in freight competition in the market. The Commission also expects further improvements in the market, as additional participants enter the market and offer consumers increased choice in regard to freight rates, frequency and freight capacity. For example, the Commission understands that HeavyLift Cargo Airlines operates up to three (3) weekly freight services on the Brisbane route, and often ad hoc freight services on the Cairns route. It has recently sought and received approval from the IASC to commence a scheduled once weekly dedicated freighter service on the Cairns route. In addition, Qantas' subsidiary, Express Freighters Australia has sought and received approval from the IASC to commence a once weekly B737-300 dedicated freight services between Cairns and Port Moresby.

In this regard, the Commission expects Air Niugini to revisit its freight rates to remain competitive.

9.4 Load/Seat factors and capacity

Load factor refers to the number of passengers relative to the number of seats available on a flight. Where load factors are high, airlines are under little pressure to compete with each other via discounting to fill seats which might otherwise be left empty. The Commission understands that aircraft load factors can potentially influence fare levels in the market.

When looking at the Air Niugini/Qantas code share arrangement initially in 2007, the Commission noted that the carriers' load factors on the Brisbane and Cairns routes rose following the commencement of the code share arrangement in 2002. Load factors on the Sydney route were, however, relatively low reflecting the stop-over at Brisbane. The Commission noted that this is mainly due to the Australian Government policy on air transport bilateral arrangements, which restricted Air Niugini from carrying Australian domestic passenger between Brisbane and Sydney. The data at that time showed that Air Niugini's load factors were generally lower than that of Qantas. The Commission noted that Qantas was able to achieve a higher load factor for the same number of seats sold as Air Niugini; and so is often under less pressure than Air Niugini to sell seats on any particular flight. The Commission noted that this was a possible explanation for the price differential seen between Qantas and its competitors. The discussion under section 9.3 above closely followed this trend. The overall analysis showed that load factors were not significantly high on the code share routes, although there were marked differences in the load factor of both airlines.

Under the current application, the Commission understands that the number of passenger ferried by Qantas on the Brisbane route slightly increased in 2008 then slumped in 2009. Passenger numbers on the Cairns routes has been on a declining trend since 2005. The Commission notes that the number of passenger carried on the Sydney route has been mixed. After a steady increase in 2007, it declined sharply in 2008, then spiked in 2009. The Commission considers that trend on the Sydney route is due to the recently introduced twice direct Port Moresby - Sydney weekly services, which replaced the Port Moresby - Sydney service via Brisbane.

The Commission also understands that Qantas' load factors showed an upward trend between August 2002 and 2005. However, over the last two years load factors have declined and fluctuated. Notwithstanding this, the number of passengers ferried by Qantas has been increasing since been low between 2006 and 2007.

Data submitted by Air Niugini on its Australian sectors for 2004 – 2008 shows a similar trend to that of Qantas. Passenger numbers on the Brisbane route has been steadily increasing since 2004. Passenger numbers on the Cairns route, however, has been mixed. It declined two consecutive years then peaked in 2008. Passenger numbers on the Sydney route has also been mixed. The Commission notes that this declined in 2007 after three years of consecutive growth. In 2008, passenger number on the Sydney route peaked well above the highest figure recorded in 2004.

In addition, the Commission notes that Air Niugini's load factors on the Brisbane and Cairns route have improved over the last two years. Preliminary statistic for year ending June 2009 indicates further improvements. Load factors on the Sydney routes showed very slight improvement. The Commission expects load factors on the Sydney route to improve over time following the recent introduction of the B757 direct Sydney services. The Commission notes that Air Niugini's load factors closely follow its passenger uplift on the code share routes. Notwithstanding this, the number of passengers ferried by Air Niugini has been steadily increasing since 2004.

In contrast, the Commission understands that the Airlines of PNG/Pacific Blue alliance's seat factors on the Brisbane sector are lower than those for the Air Niugini/Qantas alliance, reflecting the recent entry of this new competitive arrangement. As discussed, although the alliance provided various airfares and fare types since its code share, it has yet to capture a disproportionate size of the market. Further, as noted, the Commission considers that the Airlines of PNG/Pacific Blue alliance's trailing seat fact is due to the limited capacity and frequency of the alliance on the Brisbane route. On the Cairns sector, the Commission notes that Airlines of PNG achieved a slightly higher seat factor than that on the Brisbane route.

Overall, the Commission shares the IASC's view that overall load factors are not very high on the Papua New Guinea/Australia route. However, of the two code share partners, Qantas is able to achieve higher load factors than Air Niugini due to less number of seats its sells in comparison to Air Niugini on the code share services.

9.5 Capacity

The Commission notes that under the air services arrangement between Papua New Guinea and Australia, passenger capacity and dedicated freighters' freight capacities are regulated. Each country has a separate fixed amount of capacity entitlement that it can allocate to designated passengers carriers and dedicated freighters. In contrast, freight capacity in the belly hold of passenger carriers is not regulated. Passenger carriers can uplift any quantity of freight depending on the size and capability of the aircraft used.

In regards to passenger capacity, where load factors are high, capacity in the market is likely to be constrained, thus impeding potential entrants from establishing their operation

and competing in the market. Under the current circumstances, the Commission notes that there continues to be sufficient capacity under the Papua New Guinea – Australia air services arrangement for additional passenger carriers to enter the market. The entry by Pacific Blue and the introduction of a bigger B737 aircraft capacity in code share with Airlines PNG clearly demonstrated that the market is not capacity constrained. The Commission understands as at July 2009, of the 3,200 seats per week available under Papua New Guinea’s capacity entitlements, 2,450 seats per week was utilised as flights to Australia and 2,429 seats per week as flights from Australia to Papua New Guinea. The Commission notes that there is spare capacity still available for additional carriers to enter the market.

The Commission understands that when capacity is allocated to a designated carrier, there are conditions that restrict the use of this capacity by the carrier, including time limits within which the allocated capacity must be fully utilised. Where circumstances change and a carrier is unable to use all or part of its capacity, the conditions require this to be returned to the aeronautical authority concern. For example, a case in point relates to Queensland Regional Airlines (QRA) which sought and received approval from the IASC to commence services between Cairns and Port Moresby in November 2007. QRA delayed its entry into the market and when market circumstances changed, it perceived that its plans would be costly and consequently returned to the IASC, the capacity it received.

In regards to freight capacity, the Commission understand that Papua New Guinea and Australia each have 100 tonnes of cargo capacity available under the Papua New Guinea – Australia air services agreement. The Australian capacity entitlements has been recently fully allocated following the approval of HeavyLift Cargo Airlines and Express Freighters Australia’s application to provide dedicated freight services. The Commission is aware that there are no registered dedicated freighters in Papua New Guinea currently serving the Australian Air Freight Market. The Commission understands that where there is demand for additional freight capacity, in this case by Australian carriers, the relevant authorities of Papua New Guinea and Australia would need to negotiate to expand the current freight capacity thresholds. This would enable future entry and expansion of the market thus improvements to freight competition.

9.6 Barriers to entry

In its application to the Commission, Air Niugini asserted that barriers to entry into the market are low. Air Niugini submitted that:

- 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;
- There are no slot constraints at any of Port Moresby, Cairns, Brisbane or Sydney airports that would be likely to hinder the entry of a new carrier on any of the code share routes, although the Commission notes slots at Sydney can be difficult to

- organise given the airports operating time limits;
- ❑ Ground facilities and common user terminals are readily available at all airports relevant to any of the code share routes; and
 - ❑ There is an active international market for the purchase or lease of appropriate aircraft. Sunk costs are minimal as aircraft can be easily resold.

In this regard, the Commission notes the comment by DCI that restrictive agreements should be replaced with open skies competition that seek the most flexible air services arrangements possible, which provides entry to international airlines and therefore, increased competition in the market. As previously discussed, the Commission maintains the view that an ideal competitive outcome would be achieved if Air Niugini and Qantas compete in a purely competitive market. However, for reasons discussed throughout this determination, the parties have since entered into a code share arrangement. The application by Air Niugini under section 70 of the ICCA Act requires the Commission to assess the merits of the code share arrangement on public benefit grounds.

In addition, the Commission notes that the *Civil Aviation Policy 2002* (the CAP) advocates and promotes an open and liberalised international air services. Amongst other things, the CAP's objective is to encourage the international aviation community to serve Papua New Guinea with a more flexible and liberal international aviation policy by promoting the development of bilateral deregulated markets and the granting of fifth⁹ freedom rights to foreign airlines, when in the economic interest of Papua New Guinea".¹⁰

The Commission observed that consistent with the CAP, the Papua New Guinea Government has pursued bilateral Air Services Agreements (ASA) with a number of countries, which formed the basis for designated carriers to service these destinations. Typically, rights granted under an ASA will only be exercised by 'designated carriers' of the countries that are parties to the agreement. The ASA specify the terms and conditions of the airlines' activity between political boundaries of the parties to the ASA, including the 'freedom of the air'. Papua New Guinea is currently a signatory to fifteen (15)¹¹ ASA agreements worldwide, with only ten (10) of the ASA currently serviced by the local flag carrier – Air Niugini.

Further, the Commission understands that 'open skies policy' is one form of an ASA between two countries. Where countries agree to an 'open skies policy', they agree to grant each other all the freedoms of the air.

The Commission looked at this matter in some detail in 2007 and established that although Papua New Guinea advocates open sky competition and the issuance of operating licences by the appropriate authorities embraces competition in the airlines industry; structural issues such as infrastructure and security, including demand and route profitability, to a greater extent, deters additional carriers from seriously considering operating services to

⁹ Fifth Freedom Right refers to the right or privilege, in respect of scheduled international air services, granted by one State to another to take on, in the territory of the first State, traffic coming from or destined to a third State.

¹⁰ Civil Aviation Policy 2000, National Objectives

¹¹ Cited from the PNG Air Services Agreement listing provided by Department of Transport – Air Transport Division. The ASA are signed with Australia, New Zealand, Indonesia, Singapore, Malaysia, Thailand, Hong Kong, Japan, Philippines, Fiji, Vanuatu, Solomon Islands, Marshall Islands, Palau, and South Korea (pending).

and from PNG. For example, the IASC recently reported that “... *Pacific Air obtained the necessary approvals to operate ...as an Australian carrier. However, it was unable to implement its plans because of ongoing security concerns associated with operations to Lae airport. This is a situation which was not in control of the airline. But for the issue, the airline is likely to have implemented its services as planned*¹².”

The Commission notes that recently, the minister responsible for Transport echoed the Government’s position on open sky policy where, amongst other things it was reported¹³ that “...*when negotiating new bilateral air services agreements and reviewing existing ones, Papua New Guinea will seek to incorporate, multiple destinations, multiple carriers, airlines to determine capacity, bilateral charter arrangements; and practices that supports fair and equitable competition.*”

In view of the above, the Commission considers that impediments to entry into the market are issues which need to be addressed by the Government if it were to accomplish its objectives in the medium-long run.

The Commission further considers that unless airfreight capacity entitlements, especially those from the Australia side are addressed between the authorities of the respective countries, this would indirectly act as a technical barrier to entry.

Overall, the Commission notes that barriers to entry are not onerous for potential carriers to enter the market as demonstrated above. The necessary regulatory approvals and cost of entry, although are excessively high especially of plant and equipment, these can be easily overcome by potential carriers. The Commission, however, notes that in spite of this, there are no third country carriers operating on the Papua New Guinea/Australia route. The only entry on the route since the last approval is by an Australian carrier, Pacific Blue Australia and an expansion by the incumbent carriers on the respective code share routes. Nonetheless, these illustrate the ease of entry provided there is readily available capacity on the route and favourable market conditions.

10. Public Benefits

Air Niugini submitted that the renewed code share agreement between itself and Qantas would result in a wide range of public benefit for both Air Niugini and Papua New Guinea as a whole. It advanced the following public benefit claims, of which under each of these claims, the Commission sets out its analysis.

10.1 Contribution to Papua New Guinean Government Revenues

Air Niugini submitted that its profits are returned to the Government to use for the benefit of the nation for critical welfare and infrastructure projects. It argued that loss of the code share would force Air Niugini to restructure its operations and withdraw from wide body operations. This will substantially reduce its overall profitability in millions of kina. The

¹² ISAC Determination No: [2009] IASC 117

¹³ Post-Courier, Tuesday 21, July 2009, p.5

applicant argued that losses incur by Air Niugini represent a direct loss of funds that would otherwise be available to the Government to use elsewhere for the benefit of the nation.

In addition, it submitted that the current level tax revenue from increased employment by Air Niugini would be lost. It argued that this outcome would have a significant impact on the Papua New Guinea economy.

Furthermore, Air Niugini submitted that the code share will result in the current costs of travel and import maintained and/or reduced. It argued that the lack of it will cause the prices to rise resulting in inflation. The applicant also argued that if Air Niugini were to withdraw from its wide body operations, any form of dividend available to the Government from Air Niugini's operations is likely to be substantially reduced.

The Commission acknowledges the likely impacts in the absence of the code share. As previously discussed, the Commission noted that the expansion of the code share arrangement between Air Niugini and Qantas in 2002 was necessary to ensure the financial viability of Air Niugini. The arrangement was supported by the Governments of the respective carriers at that time. The Commission noted that the precarious financial state of Air Niugini as a national carrier put a lot of financial strain on the Government of Papua New Guinea, which struggled to keep the airline in operation.

As a general proposition, benefits to the participating businesses arising from restrictive business practices to which an authorisation applies are distinct from, and should not be classified as, benefits to the public. Thus, such private benefits should not be taken into account when assessing the 'balancing test' in an authorisation application. The particular benefits Air Niugini is talking about here are private benefits to Air Niugini itself, not benefits to the public at large. Air Niugini is arguing that because it is Government owned, the government, and therefore the public, benefit from dividends paid by Air Niugini to the Government when it is profitable, and that the government suffers when the airline suffers losses, which the Government is asked to pick up.

The Commission considers that, in general, the ultimate owner of the business should be irrelevant when assessing benefits to the public. However, Air Niugini is in a somewhat unique position in that the Government has imposed on it some non-commercial operations – in particular the continuation of the loss-making Port Moresby – Narita service (for which the government has given Air Niugini a direct subsidy), and the purchase or lease of the Falcon executive jet – while the government has also made some direct financial contributions to Air Niugini in recent times. In addition, the government is understood to be contributing significantly to the purchase of a Boeing 787 'Dreamliner' which, because of its high cost, would otherwise be unlikely to be a commercial proposition for Air Niugini.

It could be argued that this significant government involvement in Air Niugini's operations and asset purchases, involving large sums of public money, means that benefits to Air Niugini could be thought of as benefits to the public. If this is so, the Commission considers that claims of benefits to the public should be considered as benefits to a small degree only. And more particularly, it would be wrong for Air Niugini to expect customers on its Papua New Guinea /Australia flights to pay higher prices because of the code share,

to subsidise Air Niugini's non-commercial operations of the Falcon executive jet and loss-making routes like Port Moresby – Narita.

The Commission is concerned that recent non-commercial decisions or services – the continued operation of the loss-making Port Moresby/Japan route and the recent purchase of a Falcon executive jet with a maximum capacity of 14 passengers – may have the propensity to return Air Niugini to a precarious financial state, unless there is substantial and on-going direct government subsidy to Air Niugini for these services. Certainly, the Commission would be concerned if Air Niugini were to seek to rely on its code share with Qantas to overcome losses on its Port Moresby/Narita flights and on its operation of the Falcon executive jet.

In light of the applicant's argument, the Commission acknowledges that Air Niugini's sound financial position would indirectly mean that limited public funds available to Government can be used in priority areas such as education, health and infrastructure. Notwithstanding these developments, the Commission notes that Government continues to inject funds into the carriers operations. For example, the Government has made available funds to assist Air Niugini with its re-fleeting program. In the 2010 budget, the Government provided K30 million subsidy to Air Niugini. The Commission also notes that while the Government continues to require Air Niugini to operate services which, even with Government contribution, are likely to be non-commercial, the public benefit flowing to a few should not be as highly weighted in the Commission's decisions, as public benefits which would otherwise be shared by a greater proportion of Papua New Guineans.

In 2007, the Commission noted from Air Niugini's financial statements that since 2005, the airline had regained its financial strength. Under the current circumstances, the Commission notes from the latest financial statements that Air Niugini's financial position continues to be sound although its profit levels have decline between 2007 and 2008.

In addition, the Commission observes from confidential financial data the applicant's estimates of the different scenarios of Air Niugini's annual profitability between 2010 and 2014. The Commission considers that these estimates are conservative and understands that these are based on actual data to the date of application and forecasts of amongst other things, passenger numbers, freight volume, and operational cost.

The Commission notes that the estimates show a picture of what the carrier's profitability would look like if the code share arrangement is authorised and if it is not authorised. The estimates depict the profit and loss forecasts under different scenarios which include the likely outcomes if Air Niugini maintained its wide body B767 operations and frequency, if it maintained its wide body B767 operations but reduce its frequency; and if it replaced the wide body B767 aircraft with a narrow body aircraft. The estimates show Air Niugini's profit and loss forecast on all the routes that the B767 wide body is and would be operated on under the above scenarios.

The Commission observes that under the different scenarios, the overall picture shows that Air Niugini's financial profitability would substantially diminish without the code share arrangement. The Commission considers that if Air Niugini maintains its current capacity and frequency in the event the code share is not authorised, it is likely that the airline would

return to its pre code share financial state that is to being potentially financially unsustainable. The Commission however considers that Air Niugini would be forced to restructure its operations to ensure that it continues to operate at or above breakeven with continuous government support. In this regard, the Commission considers that the improved financial position of the airline then and now is partly attributed to the ongoing code share arrangement.

Looking at the possible outcomes were the Commission to deny authorisation of the code share arrangements more closely, the Commission accepts that the possibility of Air Niugini withdrawing its B767 wide body services on the Port Moresby – Brisbane sector and the Asian route is very likely under these circumstances. The Commission understands that an aircraft of this size requires sufficient passenger and freight loads to make the flight economically viable. Considering that Air Niugini is reliant on the code share to underpin the viability of its B767 operations, the purported outcome is likely. In addition, the Commission notes that the Papua New Guinea/Australia route is a ‘thin route’ by international standards and the unique characteristics of the route which consist of high numbers of business passengers which are insensitive to airfares; indicate that Qantas is likely to operate on the Brisbane route on its own as it commands the patronage of the northbound passengers and continues to enjoy high business revenue yields. Increased competition on this route would likely result in Air Niugini withdrawing its B767 wide body services over time. This would have consequences for private travellers and businesses in Papua New Guinea.

In regards to tax revenue, whilst the Commission accepts that current tax revenue would be lost in the event Air Niugini scales down its work force, it is of the view that the impact of this outcome on the Papua New Guinea economy should not be overstated. Displaced employees are likely to be absorbed by other airlines operating domestically and within the region. The loss of tax revenue can easily be offset by income from other economic activities such as growth in the construction and building industry, hotel and accommodation and in the medium-long term, and the PNG LNG projects. The Commission’s arguments are further elaborate under section 10.7 hereunder.

Overall, the Commission considers that the financial impact of denial of authorisation of the code share arrangements on Air Niugini could be serious given its continued reliance on the arrangement and Government subsidies. Air Niugini’s improved financial situation means that to some extent, there is less dependence on the Government for financial support; and that in future, it can be expected to pay dividends to the government in the long run, although this has not materialized to date.

10.2 Benefits to PNG Economy and Balance of Payments

Air Niugini submitted that foreign exchange earnings provided by the code share agreement with Qantas is important to the Papua New Guinea economy. It argued that if it loses Qantas’ code share support, it will withdraw from significant parts of its business, thus the balance of payments transferable to the Government would be substantially reduced.

In addition, it submitted that loss of the code share would force Air Niugini to become a

smaller airline with less flying to spread fixed costs across its operations. Air Niugini would therefore increase its business' breakeven domestic and international prices to ensure it remains viable. It submitted that this may lead to increases in domestic airfares, including a reduction by the airline to continue to operate loss making or marginal domestic routes that are currently serviced as part of its community service obligation.

Air Niugini supported these arguments with confidential projections and estimates, which show millions of Kina, can be earned and lost from the result of either an authorisation or non-authorisation of the renewed code share agreement.

The Commission maintains 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, many of which depend on international airfreight services provided by Air Niugini that allows for Papua New Guinea exports to reach their international markets. Businesses also rely on high value/time sensitive imports air freighted mainly from Australia by the code share service.

The Commission notes that Air Niugini in code share with Qantas holds the greater part of the passenger and airfreight capacity under the Papua New Guinea – Australia air services agreement. Air Niugini is therefore able to uplift more passengers and freight in the Australian Market and contribute to Papua New Guinea's balance of payment.

For example, when authorising the current code share agreement in 2007, the Commission noted air freight data on the code share routes to and from Papua New Guinea and Australia provided by the Australian Customs for 2006. The data showed that Papua New Guinea's exports to Australia are dominated by gold in value and fish by weight. Imports to Papua New Guinea are dominated in terms of both weight and value by machinery of various description and IT equipment. There is also a significant amount of dairy products, eggs, fruits and vegetables being imported from Australia. From a balance of payments perspective, the value of Papua New Guinea export was recorded at AUD\$ 9.6 million compared to imports of AUD\$1.7 million. The Commission noted that this amounted to approximately K22 million worth of exports carried by airlines operating between Papua New Guinea and Australia in 2006; and accepted Air Niugini's balance of payment public benefit claims. However, based on freight tonnage as discussed under section 10.3 of this determination, the Commission is of the view that this should not be over stated.

The Commission notes from recent market data that the passenger number on the Papua New Guinea – Australia route has since constantly increased. Additional aircraft capacity and frequency has been added onto the route. In addition, the freight market is gradually becoming competitive as aircraft capacity on the code share routes increase. The Commission notes that following the entry by Pacific Blue, two (2) additional Australian carriers, HeavyLift Cargo Airlines and Express Freighter Australia (Qantas subsidiary) will commence dedicated freight services between Cairns – Port Moresby. The commencement by the dedicated freighters on the Cairns route would result in the provision of scheduled freight services capable of uplifting containerised freight, a service which is currently lacking on this route. In this regard, unless Air Niugini offers competitive passenger fares and freight rates, the Commission expects its freight tonnage will be further moderated thus its balance of payment contributions.

Further, the Commission is of the view that the potential scaling down of Air Niugini's operations would result in a reduction of current services that benefits the public. For example, Air Niugini continues to operate on less profitable domestic routes as part of its community service obligation. Amongst other, these include Rabaul – Kavieng, Vanimo – Wewak, and Port Moresby – Tabubil sectors. In addition, any increase in Air Niugini's domestic fares as purported by it, in the Commission's view, would be perceived as a negative public benefit, especially when there is currently ongoing discounts and specials as a result of increased price competition between Airlines of PNG and Air Niugini. Moreover, the Commission does not discount the possibility of Air Niugini making losses in the absence of the code share arrangement. The Commission therefore accepts that the renewed code share agreement would capture positive public benefit discussed above.

10.3 Air Freight

Air Niugini submitted that airfreight services enable a nation, regardless of its location, to connect to distant markets and global supply chains in a speedy and reliable manner. It advanced that the availability of efficient and frequent airfreight services is therefore critical to the growth of Papua New Guinea's economy and the welfare of its people.

The applicant further submitted that low cost airfreight services make Papua New Guinea's exportable products more competitive in the international markets and increase the profitability of Papua New Guinea industries. It argued that the non-renewal of the code share arrangement would affect imports into Papua New Guinea because most perishable and high value commodities used throughout the economy are imported in the belly hold of Air Niugini's wide body services. The applicant therefore submitted that the effect of non-authorisation of the code share arrangement will be severe on export industries, particularly on Papua New Guinea's fisheries industry.

It also submitted that the result of the loss of the code share would be as follows:

- ❑ In the short-term, there would be a loss of air freight capacity and frequency in the Australian Air Freight Market due to the loss of the B767;
- ❑ In the medium-term, this would be followed by an increase in airfreight rates in the Australian Air Freight Market; as Papua New Guinea would become dependent on higher costs freighter services;
- ❑ Papua New Guinea Industry and customers would lose their direct air freight services to the Asian Air Freight Market; exporters will pay extra to on-forward their freight from Australia to the Asian Markets.

In addition, it asserted that the price at which freight services can be provided is also important for the economy because airfreight services provided under a code share arrangement (as in the current case) will be cheaper and of higher quality than if it were to exist under a non-code share operating situation. It advanced that the primary difference for service quality would be a reduction in the frequency of flights where the code share arrangement is removed. It stated that this would reduce the broader ability of the Papua New Guinea economy to compete in time-sensitive exported and imported products. As

such, the implications for the competitiveness of Papua New Guinea in the global market will be affected.

The Commission understands that the freight market is currently serviced by RPT carriers and dedicated freight carrier.

On the Port Moresby – Cairns sector, Air Niugini in code share with Qantas operates eight (8) Fokker 100 jet services and four (4) Dash–8 turbo prop aircraft services per week. Airlines of PNG provide five (5) daily services per week using a De Havilland Dash 8-100 series aircraft. There are occasional ad hoc freight services by HeavyLift Cargo Airlines using a B727. In addition, there are direct charters into Papua New Guinea from Cairns which service the major mining centres such as Lihir and Ok Tedi. These chartered services are currently provided by Airlines of PNG and Fubilan Air Transport, respectively.

The Commission is aware that under the code share arrangement, Air Niugini is the only partner providing freight services on the Cairns route. In addition, it notes that currently all carriers on the Cairns route, except HeavyLift Cargo Airlines uplift cargo as loose freight. There are no scheduled containerised freight services on this route.

On the Port Moresby – Brisbane sector, the Air Niugini/Qantas alliance operate six (6) Boeing B767 weekly services plus one (1) weekly B757 and two (2) Fokker 100 jet service. Airlines of PNG in code share with Pacific Blue operate four (4) weekly B737-800 series aircraft. HeavyLift Cargo Airlines operates three (3) weekly dedicated freighter services using a B727–100 series aircraft. The Commission notes that Qantas is allocated half the freight capacity of the B767 aircraft and competes with Air Niugini and HeavyLift Cargo Airlines to uplift loose and containerised freight. The Commission also notes that freight capacity on the Airlines of PNG/Pacific Blue code share service has been presold to Toll Air Express as part of the alliance code share arrangement. Toll Air Express competes with Qantas, Air Niugini and HeavyLift Cargo Airlines but uplifts cargo as loose freight.

On the Sydney route, Air Niugini in code share with Qantas operates the only passenger and freight service. The alliance operates a twice weekly B757 services. The Commission understands that although Qantas has an option under the Sydney code share service to uplift 200 kilograms of freight, it has yet to utilise its freight capacity on the code share service.

Freight services to other international ports such as Singapore, Japan, Hong Kong and Singapore are serviced exclusively by Air Niugini using the B767 aircraft. In addition, Air Niugini services the Papua New Guinea – Manila route using the B757 aircraft.

As discussed, the Commission notes that under the Papua New Guinea – Australia air services agreement, both countries have readily available capacity entitlement for additional passenger carriers to enter the Australian – Papua New Guinea – Australian route. Australia’s capacity entitlement for dedicated freighters has until recently been fully utilised when it allocated capacity to HeavyLift Cargo Airlines and Express Freighter Australia for each to commence once weekly dedicated freight service between Cairns and Port Moresby.

The Commission understands that there is demand for additional capacity by dedicated freighters. For example Pacific Air Express has recently missed out in its bid to secure Australian capacity to provide dedicated freight services between Cairns and Port Moresby. It has since incorporated a Papua New Guinea subsidiary to meet the requirements of the Investment Promotion Authority, amongst others, and has lodged its application with the national aeronautical authorities to commence its service as a Papua New Guinea registered carrier between Port Moresby and Cairns.

The Commission notes that dedicated freighters will for the first time provide scheduled containerised freight service on the Cairns route.

The Commission also notes that Air Niugini and Qantas continue to argue that the continuation of the code share agreement is critical to ensure the operation of the B767 wide body aircraft in the market to support Papua New Guinea's export industries. The Commission notes that the wide body B767 aircraft has the capability to fly long distances, transport loose and containerised freight suitable for high value/time-sensitive goods; and can carry up to 7 tonnes of freight per flight. The Commission also notes that Air Niugini in code share with Qantas holds the largest part of the Australia Air Freight Market. Similarly, Air Niugini has a monopoly over freight services to the Asian Air Freight Market.

As discussed, the bulk of the freight is transport between Port Moresby and Brisbane and Port Moresby and the Asian Market. Air Niugini utilises the B767 aircraft on these routes. Statistics cited in 2007 shows that on the Papua New Guinea/Australia route, freight transported by the Air Niugini/Qantas alliance was mainly general cargo and high value/time-sensitive goods. Freight to Papua New Guinea was mainly machinery/equipment, fresh produce and dairy products. Freight to Brisbane comprised mainly of commodities such as gold and sea food. The Commission noted that most freight transported to Brisbane is trans-shipped to other destinations. The Commission understands that airfreight to the Asian Freight Market consist mainly of fisheries products and other exportable commodities. Incoming freight from the Asian Market consists mainly of general cargo. The Commission understands that this continues to be the case where the bulk of the freight is ferried on the Brisbane route. As discussed HeavyLift Cargo Airlines operates a B727-100 dedicated freighter service capable of ferrying loose and containerised freight and competes with the Air Niugini/Qantas alliance. Toll Freight Express competes for loose freight. In the absence of freight competition on the Papua New Guinea – Asian route, Air Niugini maintains exclusivity in servicing this market.

The Commission maintains the view that there are a number of benefits to businesses which arise from an efficient air transport industry. Air transport plays a significant role in the movement of high value/time-sensitive freight and mail. The timely and efficient delivery of airfreight services would help Papua New Guinea firms conduct business which results in a general increase in economic efficiency and activity. Also, an efficient air transport industry would assist Papua New Guinea firms compete with international rivals for the supply of goods to world markets. Further, an efficient air transport industry also facilitates the importation of key inputs which are required throughout the Papua New Guinea

economy¹⁴.

The Commission considers that the loss of the code share arrangement will result in loss of the B767 aircraft freight capacity in the Australian and Asian Air Freight Markets. Due to the size of the B767 aircraft which requires sufficient load factors to ensure its flight viability (passenger loads currently underpins its viability), the Commission is of the view that in the absence of the code share arrangement, Air Niugini will replace this aircraft with a narrow body passenger aircraft in the medium – long run. Consequently, the configuration of the narrow body passenger aircraft would mean that Air Niugini can only uplift cargo as loose freight but not containerised freight.

Under these circumstances, the Commission considers that in the short-term the demand for freight services, especially on the Port Moresby – Brisbane sector and the Port Moresby – Asian sector will outstrip supply. The Commission considers that freight rates are likely to increase. Except for Australian registered carriers, the increase in freight rates in the Commission’s view would most likely prompt existing dedicated freighters, to apply for additional freight capacity, and vary their frequency to meet the market demand. The Commission also considers that entry by new dedicated freighters, for example Pacific Air Express is likely. For the reasons discussed above, Australian and Papua New Guinean aeronautical authorities would need to urgently negotiate and expand their respective freight capacity entitlements to enable market growth and expansion.

In addition, the Commission is of the view that entry into the market will be on the Port Moresby – Brisbane sector where exporters would take advantage of freight trans-shipment via Brisbane to the Asian Markets, amongst others currently serviced. In this regard, the Commission considers that while there are suitable long distance aircraft capable of providing dedicated freight services to the Asian Markets, the lack of economies of scope and scale would render this operation unviable.

In this regard, whilst freight rates might increase, the Commission is of the view that this would be true if services are sustained at current levels absent the B767 aircraft. The Commission considers that increase in frequency and aircraft capacity by dedicated freighters over time would in the medium-long run result in competitive freight rates as freight competition intensifies. For example, the Commission notes that HeavyLift Cargo Airlines has increased its Brisbane service frequency from twice to three (3) weekly. The Commission understand that the freighter plans to increase its frequency to four (4) weekly services later this year. The Commission also notes that proximity of Cairns makes it an attractive trans-shipment port for general cargo and high value/time sensitive freight between Papua New Guinea and Australia, and other countries. In this regard, the Commission notes comments by Sanko Bussan (PNG) Limited. These comments are summarised by the IASC¹⁵.

“Sanko Bussan explained that it, and its associates Equatorial Marine Resources Limited and Fairwell Fisheries Limited, are fresh tuna and other seafood exporters from Port

¹⁴ ICCC Determination, Air Niugini Code share Authorisation Application, 2007

¹⁵ IASC Determination, [2009] IASC 117

Moresby to Japan via Cairns and Brisbane. Sanko Bussan stated that its fresh tuna exports were increasing from 8,000 kilograms per week to 42, 000 kilograms per week. HeavyLift Cargo Airlines had been contracted to uplift freight from Port Moresby to Cairns for trans-shipment to Japan. The B727 aircraft to be operated on the Port Moresby – Cairns sector provided better cargo uplift than a B737-300 aircraft. The ability of tuna exports to travel via Cairns rather than Brisbane would reduce cargo costs and transit and connection times.”

In addition, the Commission notes that Qantas’ subsidiary Express Freighter Australia has also been recently allocated capacity by the IASC to operate a once weekly dedicated freight service between Cairns and Port Moresby. As discussed, the Commission considers that these developments suggest that the freight market is gradually becoming competitive.

In terms of the volume of freight, the Commission notes that the uplift of freight tonnage for 2006 – October 2009 indicates that the B767 wide body aircraft imports more freight than it exports to the overseas market. The Commission is therefore of the view that the importance of the B767 aircraft supporting the export industry should not be overstated.

Overall the Commission acknowledges that the airfreight capacity of the wide body B767 services in the market supports the Papua New Guinean export industries and businesses. The competitive freight rates, freight capacity and flight connections allow Papua New Guinea export industries to take advantage of the freight service offered by Air Niugini. Similarly, domestic businesses reliant on import of high value/time-sensitive goods and general cargo for commerce benefit as well. The Commission considers that if Air Niugini replaces the wide body B767 aircraft with a narrow body aircraft, this would result in the loss of freight capacity. The Commission further considers that the increase in freight services and frequency by the existing RPT and dedicated airlines would still fall short of replacing the lost capacity. The Commission also considers that whilst dedicated freighters would be able to offer alternative competitive freight rates, it doubts that this would be lower than what wide body aircraft can be able to offer.

10.4 Improvement to Services

Air Niugini submitted that the code share arrangement with Qantas allows better services to be provided to Papua New Guinea consumers in a range of ways:

- The code share arrangement has enabled Air Niugini to deliver on its promise to commence non-stop services to Sydney. The approval of the code share arrangement by the Commission in 2007 enabled it through code share with Qantas to offer two weekly non-stop flights to Sydney. This provides significant benefits to travellers and makes travel to Papua New Guinea more attractive for both the business and leisure travellers from Sydney. These services will be lost if the renewed code share agreement is not authorised.
- Air Niugini has been able for the first time to provide a high frequency jet service to Cairns under the current code share agreement. These services will need to revert to

smaller, propeller Dash-8 aircraft, with a resultant loss of speed and comfort for travellers on this route, if the renewed code share agreement is not authorised.

- In addition to allowing for carriage of freight, the larger size of a wide body B767 aircraft provides a smoother ride and, for many passengers, a greater sense of security and wellbeing than travelling on narrow body aircraft, especially to Brisbane. This benefit will be lost if the renewed code share agreement is not authorised.

One of the potential public benefits that the Commission considered in 2007 included the potential direct services between Port Moresby and Sydney. At that time, passenger and freight services to Sydney were provided via Brisbane. The Commission also noted that due to Australia's policy on air transport bilateral arrangements, except for Qantas, Air Niugini was restricted to upload Sydney bound passengers travelling via Brisbane. The Commission observed that this reflected negatively on Air Niugini Sydney load factors and its profitability on the route. The Commission considered that the introduction of this service, if it materialised would benefit the public as it would address the delay as a result of the stopover in Brisbane and improve Air Niugini's overall profitability.

The Commission notes from latest data provided by Air Niugini that its load factors on the Port Moresby – Sydney sector are mixed but have generally improved. The airline has also improved its losses on the Sydney route. In addition, the Commission considers that direct Sydney services have the potential to boost Papua New Guinea tourism and commerce where this is currently concentrated on the Brisbane route.

The deployment of Fokker 100 jet services on the Port Moresby – Cairns sector has resulted in service improvements on the route. The Commission accepted that this was partially attributed to Air Niugini's financial profitability as a result of the code share arrangement; and the need for Air Niugini to comply with Australian aviation requirements. The Commission understands that the frequency of Air Niugini's service has since increased. The Commission notes that whilst the frequency of Fokker 100 services has declined from nine (9) to eight (8), this has been complemented with four additional Dash 8 services. In this regard, the Commission notes that notwithstanding the increased frequency, Air Niugini is currently operating propeller Dash-8 services on the Cairns route, thus Air Niugini's argument that the loss of the code share arrangement will result in Cairns services provided by smaller, propeller Dash-8 aircraft is an over statement. The Commission, however, agrees that a complete withdrawal of Fokker 100 jet services would lessen the benefits currently enjoyed by the public.

The Commission notes the arguments advance by the applicant on the usage of its wide body services and considers that the prospect of Air Niugini reducing its frequency and reverting to smaller aircraft on the Brisbane route would result in a loss of public benefit in passenger comfort, speed of flight, frequency and passenger and freight capacity. From a commercial perspective, the Commission notes that whilst B767's profitability on the Brisbane route is sound, its profitability on its combined sectors appears less than optimal at present. In this regard, the Commission is of the view that the size of the B767 aircraft and its requirement for sufficient load factors on the Papua New Guinea/Australia route, which is classified a 'thin route' by international standards, suggests that there is mismatch between aircraft size and the aggregate demand on the route.

10.5 Efficiencies

Air Niugini reiterated that the effect of loss of Air Niugini's code share arrangements with Qantas would ultimately result in the current Air Niugini wide body B767 services replaced with narrow body services between Australia and Papua New Guinea. It submitted that a wide body aircraft provides lower passenger costs and results in lower per passenger greenhouse gas emissions than carrying the same number of passengers on duplicate narrow body services.

It submitted that failure to authorise the renewed code share agreement would be likely to result in a significant increase in per passenger costs and per passenger greenhouse gas emissions compared with the likely outcome if the renewed code share agreement is authorised.

The Commission notes the environmental arguments advanced by the applicant and considers that whilst a wide body aircraft may have a smaller environmental footprint compared to a narrow body aircraft, it understands that once emissions per available tonne of capacity are considered, there is likely to be very minimal difference. As such, the Commission is of the view that the public benefit argument in support of the superiority of a wide body aircraft over a narrow body aircraft is not strong.

10.6 Direct Services to Australia from Regional Ports

Air Niugini submitted that it has trialled several scheduled services from regional ports to Cairns. These include Rabaul – Cairns; Gurney – Cairns and Lae – Cairns services. It stated that whilst it has not determined to introduce such services on a permanent basis at present, its future consideration to trial and actually operate alternative routes will depend on its finances and efficiency provided by code share arrangement.

The applicant submitted that such services, if sustainable on a long term basis, will clearly offer substantial benefits to residents of these regions, allowing them to travel directly to Australia rather than via Port Moresby, with consequent cost savings and improvements in travel time and convenience.

It further argued that, if Air Niugini believes these services can be made sustainable after the initial trial periods, it will seek to commence permanent services on these routes, and explore the possibility of other new services on similar routes. The prospects of permanent services on these routes will be substantially enhanced if the renewed code share agreement is authorised and Qantas is able to code share on the services. Qantas will have an incentive to bring its considerable Australian marketing resources to support these services.

The Commission notes that Air Niugini advanced these public benefit arguments in 2007. At that time the Commission was of the view that it was necessary to upgrade the regional airports due to their deteriorating state and conditions as this would ensure a successful trial by Air Niugini. The Commission notes that the Civil Aviation Authority has over the last two years upgraded a number of regional ports to cater for Fokker 100 jet services.

In addition, the Commission considered that the commencement of these services would benefit the travelling public, tourists and businesses located in the relevant regional ports. There would be potential resultant benefit in terms of expanding Papua New Guinea's tourism market and commerce directly between these ports and Australia.

In this regard, the Commission considers that Qantas' marketing presence on the routes and its extensive network would be likely to result in tourist numbers to Papua New Guinea increasing. This would result in further spin off benefits to businesses related to the airlines industry given the small number of nationals commuting on the Papua New Guinea/Australia route. As such, the Commission considers that the continuation of the code share arrangement would underpin Air Niugini plans to bring to market these potential services with backing from Qantas; and considers these are potential public benefits.

10.7 Employment benefits

Air Niugini argued that the loss of the code share would in the short term; would result in the loss of half of its pilots and crew personnel operating the B767 and B757 aircraft on the Papua New Guinea/Australia route. The reduction of its B767 and B757 services and personnel would also be likely to result in job losses in other areas such as catering, engineering and maintenance and other ancillary services. It also expects Qantas to terminate its ground handling agreement with Air Niugini in Port Moresby.

Air Niugini also submitted that loss of the code share would in the longer term result in further job losses. It submitted that since Air Niugini would be forced with the loss of the code share, to become a smaller, less significant airline, it would undertake larger scale restructuring. It estimates that, ultimately, it would be forced to bring down its workforce from 1700 employees to 1300.

The Commission notes that Air Niugini's employee numbers has increased from around 900 to 1,700 over the last two years. The Commission attributes the increase to the expansion of the airline's operations as indicated by the number and aircraft type, including frequency in the market. The Commission also considers that the current employment level, including resultant tax receipts is a public benefit to the labour force and Government of Papua New Guinea, respectively.

The Commission also notes the applicant's arguments about possible job losses and maintains that any job loss, arising from the restructuring of Air Niugini due to loss of its wide body operations from non-authorization of the code share, would be offset by the likely demand for employees by Qantas if and when it commences its own operations on the Papua New Guinea/Australia route. Further, the Commission agrees that if narrow body operations prove viable, for both Air Niugini and Qantas, additional staff would be required, rather than less. A viable operation by the respective carriers would have spin-off benefits for other sectors such as tourism, which are associated with the airline industry. These potential outcomes mitigate the likely loss of employment benefits referred to by Air Niugini.

10.8 National Flag Carrier

Air Niugini maintained its contention that wide body operations by its code share arrangements with Qantas underpin the strength of Air Niugini as the nation's national carrier in a range of ways.

It argued that having a national flag carrier with the strength and service capability of Air Niugini provides important benefits to the people of Papua New Guinea. For example, having a strong national air carrier is important from a security and safety perspective. In times of national crisis or emergency, a national carrier is a valuable resource. The retention of Air Niugini as a strong national airline means that those resources are available to the people of Papua New Guinea should they be ever required. It made specific reference to the Bali bombing during which Qantas evacuated 1,700 Australians from Indonesia to Australia and the tsunami in South East Asia when Qantas operated special flights to assist stranded Australians. It also made reference to Qantas rescuing stranded Ansett passengers when the Ansett Australia Group collapsed in 2001.

The Commission maintains the view that the public benefit to be derived from the concept of a national carrier as discussed by the applicant is potential future occurrence which remains to be tested. Part of the symbolism of a national flag carrier is to have it as a showpiece for the nation. 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 by the applicant.

The Commission further maintains that importantly, there are wider public benefits to Papua New Guinea from a viable national flag carrier that serves both the domestic and international aviation needs of Papua New Guinea.

11. Summary and Conclusion

Air Niugini seeks authorisation under section 70 of the ICCA Act to enter into a code sharing arrangement with Qantas for five (5) years. The terms of the code sharing arrangement are contained in the renewed code share agreement currently negotiated by the carriers.

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)...unless it is satisfied that...the entering into of the contract or arrangement...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..., from it”.

In order to apply the authorisation test under section 77(6), the Commission would need to consider the issues discussed above and weigh these against the likely outcomes if the code

share arrangement is not authorised; and the public benefits claims of the applicant.

11.1 Anticompetitive effects

In 2007, when the Commission considered Air Niugini's application to code share with Qantas, it identified a number of competition concerns that had the potential to substantially lessen competition in the market.

In particular, amongst other things, the Commission observed that;

- a) the 'hard block' structure of the code share arrangement was skewed in Qantas' favour. Qantas had the flexibility to vary the number of hard block seats it buys from Air Niugini in each direction by day of week to match the demand pattern of the week; thus was under little competitive pressure to price competitive against Air Niugini. As discussed, the Commission considered that given this flexibility in supply, and the overall matching of 'hard block' seat sizes to day to day demand, Qantas was in a position to generate strong returns without intensive marketing effort or the need to discount significantly;
- b) the expansion of the code share onto the bigger Port Moresby – Brisbane/Sydney sector in 2002 resulted in the withdrawal by Qantas stand alone services. This resulted in the removal of Qantas' fleet as an alternative carrier, including reduction in frequency on the Sydney route from four (4) to two (2) and higher fares and revenue yields which would otherwise be constrained in a competitive market;
- c) Air Niugini and Qantas' individual and combined market shares were high, they enjoyed monopoly RPT passenger and freight services on the Cairns and Sydney routes; and their load factors were high which indicated that the carriers were under little pressure to compete against each other;

Against these outcomes, the Commission noted that there were some positive developments;

- d) Notwithstanding the inherent structure of the code share and the potential public benefits that could accrue in a competitive market, the Commission noted that code sharing on the Cairns route resulted in positive public benefits in the form of increased choice of airfares, fare types and flight frequency, which was lacking at that time. The Commission noted that historically, Qantas has never operated on the Cairns route. This route was well served by Air Niugini until, when the airlines code shared.
- e) Under the Papua New Guinea – Australian air services agreement, there was adequate passenger and freight capacity for additional carriers to enter the market; and barrier to entry was not onerous and can be overcome. Notwithstanding this, the Commission considers that Air Niugini and Qantas maintained a large share of the passenger and freight capacity, including market share.

- f) Queensland Regional Air (QRA) sought and received approval from the IASC to commence operations between Cairns and Port Moresby. The impending entry of QRA was expected to further enhance competition, especially on the Cairns route.
- g) The Commission further noted that the threat of entry by other carriers has had little effect on Air Niugini and Qantas in terms of the airfares in the market. However, the actual entry of Airlines of PNG into the market on the Cairns route in 2005, and the Brisbane route in 2006 has to some extent constrained and prompted Air Niugini and Qantas to revisit their fares and fare structures in the market. The entry by Airlines PNG also impacted on the code share partners' market share and revenue yields. The entry by Airlines of PNG signalled price competition, increase in carrier choice, in-flight service and frequency.

When considering the detriments of the code share arrangement, together with its benefits, the Commission had to weigh these against the likely outcomes if the code share was approved or otherwise. It considered that if it disapproved of the arrangement, there would be likely consequences on Air Niugini's long term sustainability as a national carrier and the benefits accruing to the travelling public, businesses and the nation at that time. The Commission determined that the continuation of the codes share arrangement would result in some positive public benefit, and consequently authorised the arrangement with conditions for two years.

Looking at the market and the arrangement under the current circumstances, the Commission notes that since its approval of the code share in 2007, there have been a number of developments and setbacks. The Commission notes that:

- i. The code share arrangement has achieved its objective of assisting Air Niugini to return to profitability. Air Niugini's financial situation has improved over the period of the expanded code share since September 2002. Although it has experienced losses in 2008, the airline's level of retained earnings shows that its financial position continues to be sound under the code share arrangement. Projections of the airline's profit and loss estimates over the next five (5) years shows that the airline is likely to experience significant reductions in its overall profitability;
- ii. Pacific Blue has commenced services on the Port Moresby – Brisbane sector in code share with Airlines of PNG. Although the number of carriers in the market increased from three (3) to four (4); the Commission would need to monitor how well Pacific Blue will fair in the market over time and whether it would be able to moderate the dominance of the Air Niugini/Qantas alliance going as did Airlines of PNG;
- iii. HeavyLift Cargo Airlines and Express Freighters Australia have received approval to operate dedicated freight services between Cairns and Port Moresby. This services will commence later this year;
- iv. Flight frequency on all the code share routes has increased. In particular Air Niugini has increased its frequency on the Cairns route from nine (9) to twelve (12) whilst

Airlines of PNG's frequency remains unchanged. On the Brisbane route, Air Niugini and Airlines of PNG increased their frequency from seven (7) to nine (9) and three (3) to four (4), respectively. On the Sydney route, Air Niugini has commenced direct services and maintains its twice weekly code share frequency;

- v. Both carriers have introduced bigger aircraft onto the routes. In particular, Air Niugini introduced a B757 aircraft for its direct Sydney services. Airlines of PNG on the other hand has replaced its B737-200 series aircraft with a B737-800 series in code share with Pacific Blue;
- vi. The B757 aircraft introduced by Air Niugini further increases its capacity in the market. When combined with market share, this has the potential to deter potential entrants from entering the market, especially on the Sydney route. Entry in the past by Airlines of PNG, and recently Pacific Blue, including the impending by HeavyLift Cargo Airlines under similar circumstances on the Cairns and Brisbane sector proves otherwise. However, the lack of competition on the Sydney sector is a concern;
- vii. The entry by Pacific Blue and its code sharing with Airlines of PNG has not materially moderated the market share of the code share partners, including their airfares, particularly those in the business class. The Commission attributes this to structural issues such as frequency and aircraft capacity than the ability of Airlines of PNG and Pacific Blue to aggressively compete;
- viii. There continues to be an imbalance in the structure of the code share 'hard block/soft block' seat sale arrangement which inherently favours Qantas. Despite comments that the airlines would make the block arrangement more equitable and uniform in 2007, the Commission notes from the Air Niugini and Qantas applications that neither party has addressed this issued. This matter is of significant concern to the Commission. The Commission considers that competition between the code share partners would be more competitive if the allocation of the hard block seats to Qantas were larger and uniformly spread across different days of the week, with smaller or no soft block component.
- ix. While there may be some incentive to compete under the current structure of the code share arrangement, it does not appear to have resulted in any significant discounting of business class or economy class fares by Qantas, and to some extent by Air Niugini.
- x. Despite the poor performance by the airline industry over the last 12 months, coupled with a number of factors which were likely to impact revenue yields of the Air Niugini/Qantas alliance, Qantas' and Air Niugini's overall revenue yields on the Papua New Guinea/Australia route has increased during this period;
- xi. Over the last two years load factors have declined and fluctuated. Notwithstanding this, the number of passengers ferried by Qantas and Air Niugini has been increasing; this indicates that the carriers are still under little pressure to compete

against each other;

Taking into account the above, the Commission considers that a number of factors that reinforce the effects of the code share arrangement in the Australian Market are still evident. The Commission considers that these factors limit competition between Air Niugini and Qantas, compared to the situation if both carriers operate in a competitive market. The Commission also notes that there have been a number of positive developments over the last two (2) years and considers that this could potentially change the competition dynamics of the market compared to the situation initially observed in 2007.

11.2 The Counterfactual – the scenario, absent the code share arrangement

The competition effects which would arise from the renewed code share agreement have been discussed in detail under section 9 of this determination. The summary of these effects is also discussed under section 11.1 above. The Commission reached the conclusion that there are anticompetitive elements under the code share arrangement that curtails Air Niugini and Qantas from freely competing with each other as would be expected if both airlines operated on their own. In other words, the Commission concludes that a lessening of competition would result, or would be likely to result, from entering into the renewed code share agreement.

In reaching this conclusion, the Commission also noted that there have been some positive developments which stimulated competition in the market and thus softened (but not eliminated) the anticompetitive effects of the code share arrangement. In this regard, the Commission must ascertain whether the level of net public benefits of approving the code share arrangement is equal to or greater than the likely outcome absent the code share arrangement.

In the circumstance that the Commission declines Air Niugini's application to code share with Qantas; it considers that the following would be likely to occur:

- a) Given the high revenue yield on the Brisbane route currently enjoyed by Qantas, it is likely that Qantas would enter the market on its own. Qantas will deploy a suitable aircraft and operate its own services on the Brisbane route. It may service the Sydney route separately or combine this with the Brisbane services as was previously the case;
- b) Due to the difficulty of sustaining a wide body operation on the Papua New Guinea/Australia route as the experienced by Air Niugini, Qantas would elect to use a suitable narrow body aircraft;
- c) Air Niugini's lease arrangement would force it to continue to operate the B767 wide body aircraft, at least in the short–medium term. The introduction of a narrow body aircraft by Qantas will substantially increase aircraft capacity on the Brisbane route. Air Niugini would have difficulty sustaining its B767 services on its own as

passenger number would be split; and therefore Air Niugini would reduce its flight frequency and concentrate its services on strong traffic days to remain in operation;

- d) The outcome of Air Niugini and Qantas operating their own services is increased competition in the form of price war, at least in the short term. This price war would be inevitable as Air Niugini, Qantas and the Airlines of PNG/Pacific Blue compete for market share. However, to remain profitable on the route some or all of the carriers would have to reduce their flight frequencies;
- e) The price war would result in a short-term reduction in airfares and possibly freight rates. The resultant reduction of fares and freight rates is unlikely to stimulate enough growth in the market in the long-run and this would limit the opportunity for Air Niugini, Qantas and the Airlines of PNG/Pacific Blue to operate profitably at those capacity levels;
- f) Increased competition as a result of the price war would not necessarily result in a material growth of the market because of the unique characteristics of the Papua New Guinea/Australia route where traffic consists of a high proportion of business passengers who are price insensitive. Therefore, any growth in the market in the short to medium-term would be largely attributed to holiday or discretionary travellers taking advantage of lower economy fares. Because those travellers comprise a smaller proportion of total traffic on the Papua New Guinea/Australia route than on other comparable international routes, the growth in the overall PNG/Australia market would be less than in other markets, and that the increased traffic consisting of holiday or discretionary travellers may not necessarily be sustained in the long-term;
- g) A potential detriment of the price war is the likelihood of the further scaling down and/or complete withdrawal of services by a number of carriers. Airlines of PNG is likely to reduce or withdraw its Cairns operations. Air Niugini would be likely to operate at a loss, and may further reduce its operational cost but not fixed overheads. It is very likely that Air Niugini will cease the direct Sydney services and may combine this with its Brisbane services as was the case in the past. It will however still incur losses due to reasons discussed above. Qantas and Pacific Blue would remain as the viable carriers in the market due to their vast financial resources and extensive network;
- h) If Air Niugini's operations on the Papua New Guinea/Australia route remain loss-making, in the medium term, it is likely to withdraw completely from serving the Brisbane and Sydney routes. Because of the size of the wide body B767 aircraft and Air Niugini's limited operations in the region, it will have very limited alternative from which to deploy the B767 aircraft;
- i) The resultant effect is that Qantas will emerge as the monopoly operator on the Sydney sector and the dominant operator on the Brisbane route than Pacific Blue. Even still, it is unlikely that Qantas would introduce its own wide body B767 aircraft because of the reasons discussed in preceding bullet points;

- j) Dedicated freighters, such as HeavyLift Cargo Airlines currently operating in the market would take advantage of the shortage in freight capacity and increase their freight rates. Even if existing dedicated freighters increase their frequency and new dedicated freighters enter the market, it is unlikely that they would replace the loss airfreight capacity. Similarly, it is unlikely that their freight rates would be lower than those of passenger carrier providing freight services. This is because passenger carriers usually apply marginal pricing principles to their belly hold cargo;
- k) The loss of substantial freight capacity and increased freight rates would greatly affect Papua New Guinean exports and operations of businesses reliant of air freight. This would have consequential effect on balance of payment, tourism dollars, tax revenue and in some cases loss of job. This would result in lower public benefits compared to the situation if the code share arrangement is authorised;
- l) As noted previously, if the renewed code share arrangement is not approved, it is unlikely that Qantas would enter the Cairns route and provide passenger services. Qantas has traditionally never operated on the Cairns route due to this sector being well serviced by Air Niugini.

Taking into account the counterfactuals, the Commission considers that the likely outcome, absent the code share arrangement would potentially bear less public benefits compared to the situation where the code share arrangement is allowed to continue.

11.3 Public Benefits

Having concluded that a lessening of competition would result, or would be likely to result, from entering into the renewed code share agreement, the Commission must then consider whether entering into this agreement will in the circumstance result, or be likely to result in public benefits which would outweigh the lessening of competition discussed above.

The Commission concludes, subject to what is said below and subject to the conditions set out hereunder, that there would, in the circumstances, be public benefits resulting or likely to result from entering into the renewed code share agreement as disused above, which would outweigh the lessening in competition.

12. Decision

In assessing the outcomes that would arise from the proposed code share arrangement, in particular Air Niugini's long – term sustainability and the continuation of its wide body services and the resultant current and potential public benefits, along with the scenarios of the likely outcomes in the event the code share is not authorised, the Commission notes and gives weight to Government and various other industry stakeholders views, especially key stakeholders comments supporting the proposed code share arrangement to ensure greater competition and continued stability in the industry and its flow on effects onto the Papua New Guinea economy.

Taking into account the above analysis, the Commission is satisfied that the proposed code share arrangement by Air Niugini and Qantas will result, or will be likely to result, in such a positive benefit to the public that it should be permitted for a term of two and half years until 30th June 2012 unless a situation arises which warrants a review of the authorisation.

As part of this determination, the Commission imposes the following conditions in order to reduce any potential anti-competitive effects which may arise from the code share arrangement, in order to maximise public benefits and aid transparency.

- (a) Unless, within twelve (12) months from the date of this Authorisation, the hard block/soft block arrangements have been revised to provide a substantial reduction in soft block capacity available to Qantas, with a commensurate increase in hard block allocation arrangements, the Commission will consider whether to review this authorisation, to consider whether the authorisation should be varied or revoked in accordance with section 80(1)(c) of the ICCC Act;
- (b) Air Niugini to submit six monthly report to the Commission on the monthly number of code share seats available for sale and sold by it on each of Air Niugini's operated services on the Port Moresby – Brisbane, Port Moresby – Sydney and Port Moresby – Cairns sectors; and its yields per revenue passenger kilometre for all passenger classes on these services inclusive of relevant levies such as fuel surchargers for all passenger classes on these services. Those reports would be made public by the Commission subject to exclusion of agreed commercially confidential data.
- (c) Air Niugini must price and sell its code share service independently of Qantas;
- (d) Air Niugini must not share or pool its code share revenue with Qantas;
- (e) Qantas to disclose clearly in its timetables and on its web site that Air Niugini is the carrier of all QF flights to and from Papua New Guinea;
- (f) Air Niugini to clearly disclose to participating passengers conditions applying to the any frequent flyer programs and fares; and
- (g) Air Niugini and Qantas to clearly disclose to passengers that bookings are available from either carrier and prices may differ between the two.

This authorization is therefore granted pursuant to section 77(6) of the ICCC Act.



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Thomas Abe
(Commissioner)
18 December 2009



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David Dawson
(Associate Commissioner)



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Dr. Billy Manoka
(Associate Commissioner)