Authorisation Application by Air Niugini Limited in respect of a Freight Code-Share Agreement with Qantas Airways Limited for the Port Moresby- Brisbane route

13 December 2013
1.0 INTRODUCTION

The Independent Consumer and Competition Commission (the “Commission”) is issuing this paper to facilitate discussion of significant issues that have emerged in relation to the application for authorisation by Air Niugini Limited (“Air Niugini”) to enter into and give effect to a freight code-share agreement with Qantas Airways Limited (“Qantas”) on the Port Moresby-Brisbane route; before a (final) determination is made.

1.1 The Authorisation Process

The authorisation process under Section 70 of the Independent Consumer and Competition Commission Act 2002 (“ICCC Act”) is a public process which essentially involves extensive consultations with stakeholders, including interested parties and members of the wider public.

The Commission gives careful consideration to the comments provided on the issues for the purpose of assessing competition and public benefit effects of the arrangement, in accordance with the authorisation procedures and processes outlined in the ICCC Act, including:

- inviting submissions on the application;
- issuing a draft determination and circulating to the applicant and interested parties; and
- offering the opportunity to the applicant and interested parties for a conference on the draft determination, or calling on of its own volition within a statutory time limit;

before issuing a (final) determination after taking into account all matters relevant to the application that arises during the public consultation process.

If the Commission is satisfied on the balance of the probabilities that the public benefit arising from the subject of the application outweighs any lessening of competition arising from the arrangement and grants authorisation, that will provide immunity against the application of the relevant prohibition of the ICCC Act.

2.0 BACKGROUND AND MATTERS LEADING TO THE ISSUE OF THIS DISCUSSION PAPER

On 25 April 2013, Air Niugini made an application to the Commission for authorisation to enter into and give effect to a freight code-share agreement with Qantas on the Port Moresby-Brisbane route. After careful assessment of the application following the consultation process outlined above, the Commission released a draft determination on 28 August 2013, proposing to grant conditional authorisation.

No request for a pre-decision conference was made, nor did the Commission exercise its power to call for one, based on the state of its knowledge of the market circumstances at that time.

The issues the subject of this discussion paper arise from the fact that Qantas has recently secured freight capacity rights from the International Air Services Commission of Australia (“IASC”) to operate a dedicated freight service on the Cairns-Brisbane-Port Moresby-Cairns route. It commenced operating the services in early July 2013 and suspended the service “indefinitely” in mid-October 2013. The Commission became aware of this information after the release of the draft determination proposing to grant authorisation and after the time for calling a statutory conference under Section 78 of the ICCC Act had expired. Neither the applicant nor Qantas, nor the IASC informed the Commission about this. The IASC does not have an obligation to notify the Commission of the former’s decisions affecting the latter’s functions. The Commission does not
regularly examine the IASC website, relying on the parties to inform it of relevant developments. The Commission, upon becoming award of Qantas’ operation of a freighter service, enquired about the matter with Qantas and Qantas confirmed that it commenced services in early July 2013 and suspended the service “indefinitely” in mid-October 2013.

A statutory conference cannot now be called by the Commission as the time frame stipulated under the ICCC Act for calling such conference has lapsed. Since no conference was convened, interested parties have had no opportunity to comment on this significant development. The Commission believes, for the purposes of natural justice, transparency and consultation standards, that the parties to the agreement and all other stakeholders and interested parties should be given an opportunity to comment on this new development before a final determination is made.

While not a statutory requirement, the Commission considers it appropriate to give interested parties an opportunity to make submissions in response to this discussion paper in relation to the issues arising from Qantas’ recent entry into the market, now suspended. Such an opportunity to make submissions is consistent with the Commission’s general obligation to carry out its functions in a transparent and consultative manner, as those principles underpin the processes in the ICCC Act.

3.0 CONFIDENTIALITY OF SUBMISSIONS

Consistent with its usual practice and in keeping with the requirements of Section 131 of the ICCC Act, all submissions received by the Commission will be placed on public record, including posting on the Commission’s website unless the submission or parts thereof are granted confidentiality by the Commission, where requested by the submitter.

Where a person or organisation considers certain parts of its submission to be confidential, those sections of the submission should be clearly identified. The person should also provide reasons as to why it considers the designated information to be confidential.

Where information designated “confidential” is submitted to the Commission, the Commission may disclose or require its disclosure if it determines, after considering any representation from interested persons, that such disclosure is in the public interest. The Commission will consider each claim of confidentiality on a case by case basis and decide whether to grant or decline grant of confidentiality. The Commission does not usually grant confidentiality to the entire document and if specific items of information are considered confidential by the submitter, they should be identified accordingly.

4.0 ISSUES ARISING FROM CHANGES IN MARKET CIRCUMSTANCES

4.0.1 Competition Issues

As stated above, after the release of the draft determination the Commission became aware that Qantas had entered the market independently after securing capacity rights of 35 tonnes per week on the PNG-Australia route from IASC. According to Qantas, the capacity granted was intended by Qantas to be used to provide a dedicated freighter service and was not intended to form part of the current code-share agreement to which the current authorisation application relates. This poses some important issues for consideration of the application, which, in the Commission’s view, made it desirable to issue this discussion paper.

Concentration
The airfreight industry in PNG is highly concentrated with only a few freight carriers providing freight service between PNG and Australia. Under the PNG-Australia Air Services Agreement (“ASA”), IASC granted capacity to four Australian carriers namely Qantas, Pacific Air Express, Skyforce and HeavyLift to operate freight services into the PNG market. Of these four carriers, Qantas and Pacific Air Express from the Australian side and Air Niugini from PNG side are currently providing regular scheduled services whilst Skyforce Aviation provides ad hoc charter services from Australia with special loads on demand. The Commission is not aware of any operations out of Australia by Heavylift.

While there is no indication whether, and if so, when, Qantas will recommence its dedicated freighter services, as it has suspended them “indefinitely”, the parties are the two largest players in the market in terms of total capacity allocation and a combined market share which crosses concentration measures for unilateral and co-ordinated market power. The action by Qantas to enter the market in its own right, raises the possibility that it could do so again.

Concentration Ratios

From information obtained from the Australian Government Bureau of Infrastructure, Transport and Regional Economics (“BITRE”) the following are the market shares calculated from figures from January to September 2013.

Table 1: Market Shares and Growth before Qantas’ Entry: Jan-Jun 2013

<table>
<thead>
<tr>
<th>Scheduled Operators</th>
<th>Jan</th>
<th>Feb</th>
<th>Mar</th>
<th>Apr</th>
<th>May</th>
<th>Jun</th>
<th>TOTAL</th>
<th>%</th>
<th>CR3</th>
<th>HHI</th>
</tr>
</thead>
<tbody>
<tr>
<td>Air Niugini</td>
<td>343.8</td>
<td>381.7</td>
<td>451.6</td>
<td>361.5</td>
<td>405.6</td>
<td>317.1</td>
<td>2 261.2</td>
<td>73.5%</td>
<td>99.4%</td>
<td>5402.25</td>
</tr>
<tr>
<td>Airlines PNG</td>
<td>2.6</td>
<td>1.2</td>
<td>4.3</td>
<td>2.4</td>
<td>3.5</td>
<td>2.9</td>
<td>16.9</td>
<td>0.6%</td>
<td></td>
<td>0.36</td>
</tr>
<tr>
<td>Pacific Air Express</td>
<td>88.5</td>
<td>111.6</td>
<td>103.8</td>
<td>103.8</td>
<td>102.9</td>
<td>150.2</td>
<td>660.8</td>
<td>21.5%</td>
<td></td>
<td>462.25</td>
</tr>
<tr>
<td>Qantas Airways</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>0.0</td>
<td>0.0%</td>
<td></td>
<td>0</td>
</tr>
<tr>
<td>Virgin Australia</td>
<td>18.6</td>
<td>26.1</td>
<td>27.0</td>
<td>22.9</td>
<td>19.3</td>
<td>136.3</td>
<td>4.4%</td>
<td></td>
<td>19.36</td>
<td></td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td>453.4</td>
<td>520.5</td>
<td>586.8</td>
<td>490.6</td>
<td>534.4</td>
<td>489.5</td>
<td>3 075.3</td>
<td>100%</td>
<td></td>
<td>5884.22</td>
</tr>
</tbody>
</table>

Source: BITRE website – www.bitre.gov.au

Table 2: Market Shares and Growth after Qantas’ Entry: Jul-Sep 2013

<table>
<thead>
<tr>
<th>Scheduled Operators</th>
<th>Jul</th>
<th>Aug</th>
<th>Sep</th>
<th>TOTAL</th>
<th>%</th>
<th>CR3</th>
<th>HHI</th>
</tr>
</thead>
<tbody>
<tr>
<td>Air Niugini</td>
<td>318.8</td>
<td>343.7</td>
<td>356.8</td>
<td>1 019.3</td>
<td>62.5%</td>
<td>99.5%</td>
<td>5776</td>
</tr>
<tr>
<td>Airlines PNG</td>
<td>2.9</td>
<td>3.2</td>
<td>1.9</td>
<td>8.0</td>
<td>0.5%</td>
<td></td>
<td>0.25</td>
</tr>
<tr>
<td>Pacific Air Express</td>
<td>144.0</td>
<td>76.8</td>
<td>88.9</td>
<td>309.7</td>
<td>19.0%</td>
<td></td>
<td>361</td>
</tr>
<tr>
<td>Qantas Airways</td>
<td>50.7</td>
<td>96.2</td>
<td>73.3</td>
<td>220.2</td>
<td>13.5%</td>
<td></td>
<td>20.25</td>
</tr>
<tr>
<td>Virgin Australia</td>
<td>25.1</td>
<td>20.1</td>
<td>27.6</td>
<td>72.8</td>
<td>4.5%</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td>541.5</td>
<td>539.9</td>
<td>548.5</td>
<td>1 630.0</td>
<td>100%</td>
<td></td>
<td>6157.5</td>
</tr>
</tbody>
</table>

Source: BITRE website – www.bitre.gov.au

According to the tables above, the combined code-share market share of Qantas and Air Niugini was about 73.5% before Qantas entered the market independently earlier this year. With independent operation by Qantas, that share decreased to about 62.5%; but the combined share of both carriers (i.e. of Air Niugini and Qantas, including its share from its independent operation) is 75% (62.5% + 13.5%). CR3 indicates that the three top freight operators hold 99.4% of the market.

---

1 Qantas provides this service via the code-share arrangement with Air Niugini.
2 This includes the freight carried on code-share services; hence Qantas also has some shares in this freight
3 Same as the footnote above.
The CR3 with independent operation by Qantas of one dedicated freight service per week, using a B737, is still 99.5, not markedly changed.

Furthermore, its capacity entitlement allows it to increase the volume of its freight services almost three-fold. Whatever measure is used, by internationally accepted standards, a very high level of concentration in the joint hands of Air Niugini and Qantas results in the market and would in normal competition analysis result in a substantial lessening of competition. A HHI\(^4\) value of 5884.22 and 6157.5 respectively for the ‘before and after’ situations of Qantas’ independent entry, which indicates that the market is very highly concentrated.

Please refer below to the concentration classification.

**Concentration classification\(^5\):**

- **Unconcentrated Markets:** HHI below 1500
- **Moderately Concentrated Markets:** HHI between 1500 and 2500
- **Highly Concentrated Markets:** HHI above 2500
- **Small Change in Concentration:** Mergers involving an increase in the HHI of less than 100 points are unlikely to have adverse competitive effects and ordinarily require no further analysis.
- **Unconcentrated Markets:** Mergers resulting in unconcentrated markets are unlikely to have adverse competitive effects and ordinarily require no further analysis.
- **Moderately Concentrated Markets:** Mergers resulting in moderately concentrated markets that involve an increase in the HHI of more than 100 points potentially raise significant competitive concerns and often warrant scrutiny.
- **Highly Concentrated Markets:** Mergers resulting in highly concentrated markets that involve an increase in the HHI of between 100 points and 200 points potentially raise significant competitive concerns and often warrant scrutiny. Mergers resulting in highly concentrated markets that involve an increase in the HHI of more than 200 points will be presumed to be likely to enhance market power. The presumption may be rebutted by persuasive evidence showing that the merger is unlikely to enhance market power.

The CR3 has not changed substantially for the duration of the independent freight operation by Qantas, but the decrease in Air Niugini’s share suggests that the market share of the code-share joint operation has been ‘cannibalised’ by the Qantas independent share.

If Qantas, however, were to re-enter on a longer-term basis, it is conceivable that Air Niugini could regain some or most of its previous share, thus possibly leading to enhancement of the joint share of the code-share partners and to market concentration.

**While the Commission’s analysis of market shares on the basis of freight carried by each carrier between PNG and Australia is possibly incorrect, interested parties are invited to:**

1) comment on the significance of the increase in concentration for analysis of the market structure;

2) comment on whether, for conceptual purposes, could the market shares of Air Niugini and Qantas, including both its code-share traffic and its independent freighter traffic

---

\(^4\) The Herfindahl-Hirschman Index is calculated by aggregating the squares of the market shares of all participants. It indicates both aggregate and relative concentration.

when operated, be regarded as a ‘single firm’ market share due to the possibilities for joint strategic behaviour; and

3) provide any other comments relating to market concentration, including relevant data.

Although market shares alone do not guarantee that Air Niugini and Qantas will jointly hold substantial market power it could be a signal that the code-share agreement may result in the parties engaging in anti-competitive behaviour in the future, necessitating further analysis of its significance based on entry barriers and dynamic factors.

Entry barriers

Without repeating material covered in the draft determination, to which parties are referred, the Commission has concluded therein that the barriers to entry are high. For reasons in this paper discussed under *Dynamics and Incentives* immediately below, those barriers may be heightened.

*Dynamics and Incentives*

In the draft determination, various competition factors were discussed and it is unnecessary to repeat them here.

Arguably, the market dynamics could change incentives for competition substantially, with the potential entry by Qantas in the future, which should be considered. The parties could collaborate to extend their market power with the intention of extracting economic profits through increased freight rates. In normal competition analysis this would have resulted in a substantial lessening of competition and the fact that Qantas independently entered the market and then withdrew, is an indication that if authorisation is granted for this application, it is certainly possible that it could do so again in the future. These two players, in those circumstances could arguably then operate as a cartel for the provision of air freight services, should Qantas re-enter the market independently on one hand, and collaborate in the code-share arrangement on the other.

Strategic behaviour by the code-share partners could be facilitated in that they could overtly or tacitly collude to resist vigorous new entry by jointly reducing prices to ‘see off’ entrants and subsequently raise them. More importantly, the apprehension by new entrants of such possible strategic behaviour would deter them from actually entering the market. This relates to the issue of *Barriers to Entry* discussed above.

The Commission notes from a submission by the Department of Transport (‘DOT’) on a previous code-share application that under the current bilateral ASA that PNG has with Australia the current freight capacity allocation is 130 tonnes per week in each direction for PNG carriers on PNG-Australia route. Considering that Air Niugini is the only PNG freight carrier (using its wide-body aircraft), it is assumed that this capacity is being used up by Air Niugini and little is left for other PNG carriers, if any were considering entering the market. In a letter to the Commission dated 9th July 2012, DOT advised that as demand for service increase, that is factored into the level of capacity that is agreed upon for designated airlines to utilise. Hence as demand increases respective Governments review capacity entitlements accordingly. DOT further stated that capacity arrangements are made under a pooled arrangement where designated airlines are at liberty to utilise existing capacity. Any unused capacity is left in the pool for future use however allocated capacity which has not been utilised can be reallocated to another carrier.

---

6 Department of Transport letter dated 13 June 2012
The capacity grant of 35 tonnes to Qantas by the IASC and the introduction of independent services on the route would provide competition for Air Niugini absent the code share. This has particular relevance to the provisions of section 45(3):

“(3) In this part, unless the context otherwise requires, a reference to the lessening of competition includes a reference to the hindering or preventing of competition.”

From the above table, the combined share capacity allocated and utilised by Qantas and Air Niugini is very much greater than the shares of other players. Relative market shares are significant for strategic behaviour, as expressed in the HHI index. Hence their alliance could be argued to facilitate a cartel.

In the context of the operation of the code share arrangements, the additional capacity granted to Qantas would result in the two dominant players obtaining a bigger capacity share of the market than before. It could be argued that the two dominant players, Air Niugini and Qantas, are capable of lessening competition for air freight in PNG by co-ordinating their strategies to deter competitive entry.

In view of the above comments the Commission invites stakeholder’s comments and submissions on the following:

1) Given Qantas’ entry into the market independently for a period, if the authorisation is granted for this code-share application;
   
a) Would this severely limit the ability of other smaller carriers to effectively compete against the two dominant players in the market?

b) Do you think that there is high likelihood that Qantas and Air Niugini would operate a cartel?

c) What is your opinion about the likely effect on freight rates?

2) Would future independent entry by Qantas to operate additional capacity limit the ability of Air Niugini to vigorously compete on freight rates, given its reduced market share for the duration of independent entry by Qantas?

3) Although market share is not a sufficient factor in determining substantial lessening of competition, does high market share have greater significance when other competitors are relatively small players and are new operators in the relevant market?

4) Would future independent freight operations by Qantas reduce the bargaining power of Air Niugini in relation to the terms of the code-share agreement?

5) Could strategic coordination by Qantas and Air Niugini affect the competitiveness of other market participants in the context of separately operated services by Qantas?

6) Could the parties, under a scenario of both operating as freight carriers:
   
a) raise prices, in the expectation that smaller players, operating charter services, would ‘coat-tail’ in prices?
b) Discipline competing carriers who attempt to compete vigorously on price, by jointly increasing capacity and engaging in strategic conduct such as cutting prices to ‘punish’ aggressive competitors?

c) Is such a market environment likely to create a culture of ‘discipline’ that competitors may be unable or unwilling to challenge?

5.0 EFFICIENCY AND PUBLIC BENEFITS FROM RATIONALISATION

As indicated in the draft determination the Commission considers that the code-share is likely to lead to some productive efficiencies arising from rationalisation and consequent cost savings, which, if leading to profitable operations, is a public benefit. The durability and size of these benefits cannot be assessed at this stage in the context of possible independent entry by Qantas. An increase in the market share of Qantas from its independent entry is likely to have reduced the rationalisation benefits for Air Niugini, in terms of the unit costs of its operations from reduced volume as its share of the market had decreased during that period. If Qantas re-enters in its own right, it may use its freight operation to transport the major proportion of its cargoes and only use the code-share to carry a small proportion of its cargoes either beyond its dedicated freighter capacity or for exceptional cargoes of an urgent nature not fitting in well with its weekly freighter service. Consequently, it may become too costly for Air Niugini to continue providing freight services on the Brisbane route if there is a reduction on the load factor on the combined code-share services if the joint revenue from passenger and freight does not cover the total cost of the provision of passenger and freight services on the route, thus jeopardising its wide-body operation on the route.

Even if the wide-body operation by Air Niugini is continued, the ‘cannibalisation’ of its share by the Qantas dedicated freighter could be argued to reduce the rationalisation benefits which were argued to constitute the public benefit.

Recognising that profitability of ‘combo’ (combination freight and passenger) aircraft operations is gauged by both passenger and freight costs and revenues, the calculation of benefits lost by Qantas’s independent entry is complicated.

Air Niugini is yet to submit financial information on the package of routes which depend on the wide-body aircraft operating the code-share route. That will provide an indication of whether the package of routes depending on the code-share route results in losses or profits which determines whether sufficient efficiencies have been, or are being, achieved or not. From that position, an assessment is possible about the effect of any future independent freighter service entry by Qantas on the economics of Air Niugini’s wide-body operation on the code-share route and, hence, on the economics of operation of the package of routes dependent on the operation of the wide-body aircraft on the code-share route.

Significantly, losses to Air Niugini arising from reduction in rationalisation benefits reduces its competitiveness and, if losses are sustained, reduces the benefit to the public in terms of losses accruing to the public purse.

In this regard, the Commission invites submissions on the following:

1) Could reduction in rationalisation benefits for Air Niugini resulting from any ‘cannibalisation’ of the wide-body share of the traffic on the POM/Brisbane route lead to losses, which would be borne by the citizens of PNG?
2) Do you think that the Commission should include additional conditions to those in its draft determination, proposing to grant authorisation? If so, what additional conditions would be appropriate to minimise the public detriment resulting from lessening of competition or to ensure that the claimed public benefits are delivered by the freight code-share arrangement?

3) Interested parties are also invited to comment on any other matter that they wish to make on this matter.