AIRLINE COMPETITION

-- Note by Australia --

18-19 June 2014

This note is submitted by Australia to the Competition Committee FOR DISCUSSION under Item IX of the agenda at its forthcoming meeting to be held on 18-19 June 2014.
1. Introduction

1. As a geographically large island nation located some distance from the world’s major population and trading centres, Australia is reliant on airline services for the timely transport of passengers and cargo, both domestically and internationally. Efficient and competitive airline markets, and markets for the various inputs to airline services (including airport services), are therefore important to Australia’s economic performance and the welfare of Australian consumers. This submission outlines the key competition issues that have arisen in Australian airline markets since 2000 and how they are being dealt with by relevant agencies.

1.1 Overview of regulatory environment

2. Australia’s domestic airline markets (passenger and cargo) are reasonably liberalised by international standards. To operate domestic air services within Australia an airline must meet licensing conditions and ensure ongoing compliance with competition laws and industry regulation to address safety, security, liability and traffic congestion concerns. Domestic airlines may be 100% foreign owned, including by foreign international airlines. While there is state government regulation of entry and capacity on some thin intra-state routes, most intra-state and all inter-state routes are free of these restrictions. Airline access to airport landing slots and services at Australian airports is mostly unregulated, except at Sydney Airport. Prices for air traffic control services and rescue fire fighting services at Australian airports are regulated.

---

1 Subject to Foreign Investment Review Board approval.
2 Currently, bilateral Air Services Agreements between Australia and jurisdictions other than New Zealand do not permit cabotage (i.e. the right to operate between two or more points within another country). To operate domestic services in Australia, a foreign international airline that is not a New Zealand designated or authorised carrier must establish its domestic business operations under the structure of an Australian subsidiary.
3 Often this regulation is part of a Community Service Obligation and may be accompanied by subsidies to airlines operating services on routes that are otherwise uncommercial.
4 While there is provision under Part IIIA of the Competition and Consumer Act 2010 (third party access to essential infrastructure) for government to intervene in disputes over airport access, these powers are not currently in use for airports. Since July 2003 these powers have only been used once in a case involving demand for access by an airline to domestic airside services at Sydney Airport. The declaration of Sydney Airport domestic airside services, which obliged Sydney Airport to negotiate access with the airline, expired in December 2010.
5 Prices for air traffic control services and rescue fire fighting services at Australian airports are regulated.
6 Under the Sydney Airport Demand Management Act 1997 (Cth) and associated regulations, Sydney Airport is required to administer a slot management system. The regime controls the scheduled movement times of all commercial and private aircraft so that no more than 80 runway movements occur in any hour and guarantees a minimum number of slots for regional airlines. The hourly movement limit is intended to assist noise sharing and achieve a balance between the efficient use of the airport and broader environmental impacts. Additionally, there is regulation of the prices that Sydney Airport charges regional airlines for their use of airport facilities.
7 The monitoring regime encompasses domestic and international airport operations and is undertaken pursuant to Ministerial directions under Part VIIA of the Competition and Consumer Act 2010 (Cth) and under Parts 7 and 8 of the Airports Act 1996 (Cth). The regime aims to increase transparency and inform stakeholders, including access seekers, other users of airport services and policy makers. The regime does
3. The current state of play in terms of liberalisation of airline services to and from Australia (passenger and cargo) is mixed. This is largely a product of the bilateral system of Air Services Arrangements \(^8\) (ASAs) underpinning the provision of international airline services. Australia currently has 89 ASAs with other countries that impose varying degrees of restriction on trade. Two are ‘open skies’ agreements that place no restriction on the ability of designated carriers to operate services between the two jurisdictions. \(^9\) The remainder contain some degree of restriction on the number of airlines that can nominate to operate services, the number of flights that can be operated or passengers that can be carried, and/or the destinations that can be served between and beyond the two jurisdictions. \(^10\) Airlines may apply for unallocated capacity in order to access routes that are subject to restricted ASAs. \(^11\) In some cases, strict limits on capacity and frequency mean that airline demand exceeds allocated capacity, leaving applicants with no capacity or less capacity than they would prefer. Australian international airlines are also subject to restrictions on the level of foreign ownership. \(^12\) Acquiring landing slots is generally a formality at most international airports in Australia, particularly outside peak times. \(^13\) There can be significant impediments to acquiring slots at commercially attractive times at some of the world’s most congested international airports.

4. There is no government ownership of airlines in Australia. There is some government assistance for aviation in rural and remote areas, but not for operations on domestic trunk routes or international routes.

1.2 Recent developments in Australian airline markets

5. Against this regulatory backdrop, significant structural and behavioural changes since 2000 are impacting the way in which airlines compete within and to/from Australia. Key developments include:

- **Successful entry and expansion of Low Cost Carrier (LCC) model in Australia:** After some LCC failures in the 1990s (Compass I and II), Virgin Blue entered as an LCC in the domestic air transportation market.
passenger market in 2000 and quickly grew following the collapse of Australia’s second largest domestic airline, Ansett, in September 2001.\footnote{Virgin Group began operating international services to/from Australia in 2004 under the Pacific Blue brand.}

- **Adoption of dual Full Service Airline (FSA)-LCC brand structure by Australian airlines:** In 2001 Qantas Airways Limited\footnote{Former government owned carrier operating in domestic and international airline markets. Qantas was fully privatised in 1995, subject to foreign ownership limits and restrictions on business operations (e.g. makeup of the Board, the use of the name Qantas, the location of head office, place of incorporation, and the location of facilities that support international operations) which remain in place today.} acquired Impulse Airlines. These assets formed the basis of a separately branded LCC (Jetstar Airways) launched by Qantas Group in 2003 and deployed to complement the Group’s FSA service offering (Qantas Airways) in domestic and international airline markets.\footnote{Jetstar Airways is a wholly owned subsidiary of Qantas Airways Limited. In recent years Qantas Group has entered into joint venture arrangements with other airlines in the Asia Pacific region to create four Jetstar branded LCCs: Jetstar Asia (based in Singapore), Jetstar Pacific (based in Vietnam), Jetstar Japan and Jetstar Hong Kong.} In recent years rival Virgin Group has implemented changes to achieve a similar dual brand structure. Specifically, in 2010 Virgin Blue (later renamed Virgin Australia) announced its ‘game change strategy’ and began transitioning from a LCC to a FSA in order to compete more effectively with rival FSA, Qantas Airways, for business travellers. Then, in 2013, Virgin Australia acquired a 60% interest\footnote{Joint venture with Singapore Airlines.} in Tiger Airways Australia, a domestic LCC which had been financially distressed since it commenced operations in 2007.

- **Extensive alliance and code sharing activity:** The two largest Australian airlines, Qantas Airways and Virgin Australia, have each formed new alliances and code share arrangements that allow them to offer customers a more extensive ‘virtual’ network beyond their own metal, particularly in international passenger markets.

- **As end-of-line carriers, Australian international airlines face strong competition from mid-point carriers to carry growing numbers of passengers and cargo volumes to/from Australia:** Since 2000 annual air passenger traffic to/from Australia has almost doubled\footnote{16.5 million persons in 2000 compared to 31.3 million in 2013.} and air cargo tonnages to/from Australia increased by 30\%\footnote{Increase from 709 million tonnes in 2000 to 919 million tonnes in 2013.}. While the number of passenger and cargo airlines operating to/from Australia has been quite stable\footnote{In 2013 there were 49 passenger airlines (46 in 2000) and 54 cargo airlines (unchanged from 2000) operating to/from Australia.} since 2000, the share of passengers and cargo carried to/from Australia by Australian airlines is declining\footnote{Between 2000 and 2013, Australian airlines’ share of passenger traffic to/from Australia fell from 37\% to 32\% and share of air cargo tonnages fell from 27\% to 20\%.} while the share carried by Middle Eastern and Chinese carriers is increasing\footnote{For example, between 2000 and 2013 Middle Eastern airlines’ share of passenger traffic to/from Australia increased from 1.9\% to 12.3\% and share of air cargo tonnages increased from 3\% to 17\%.}.\footnote{18. Increase from 709 million tonnes in 2000 to 919 million tonnes in 2013. 19. In 2013 there were 49 passenger airlines (46 in 2000) and 54 cargo airlines (unchanged from 2000) operating to/from Australia. 20. Between 2000 and 2013, Australian airlines’ share of passenger traffic to/from Australia fell from 37\% to 32\% and share of air cargo tonnages fell from 27\% to 20\%. 21. For example, between 2000 and 2013 Middle Eastern airlines’ share of passenger traffic to/from Australia increased from 1.9\% to 12.3\% and share of air cargo tonnages increased from 3\% to 17\%.}
Technological change in the areas of Internet, software and mobile computing: This is facilitating rapid growth in online sales, rollout of self-service check-in and fully electronic ticketing and communications between airlines and customers.

New dimensions of non-price competition: There is increased competition between airlines in the supply of value added services (e.g. loyalty schemes, airport lounges, inflight entertainment and catering) and aircraft features (e.g. premium economy seating on international flights).

1.3 Enforcement and regulation of airline competition

6. The agencies responsible for enforcing and regulating airline competition in Australia — principally, the Australian Competition and Consumer Commission (ACCC) and, to a much lesser extent, the International Air Services Commission (IASC) — have been kept busy reviewing some of these structural and behavioural changes and addressing competition concerns. Both the ACCC and IASC are independent statutory authorities. Their roles are set out in legislation. Briefly:

- the ACCC enforces Australia’s competition, fair trading and consumer protection laws pursuant to the *Competition and Consumer Act 2010* (Cth). This includes taking action and/or accepting court enforceable undertakings to remedy breaches of:
  - the trade practices provisions of the Act such as anti-competitive practices that substantially lessen competition, the misuse of market power and cartel conduct, and mergers and acquisitions that have the effect or would be likely to have the effect of substantially lessening competition in any market; and
  - the consumer protection provisions of the Act, including misleading or deceptive conduct by businesses and misrepresentations with respect to price.

- the ACCC also has the power to ‘authorise’ airlines to engage in certain anti-competitive arrangements, including airline alliances, when it is satisfied that the public benefits outweigh the public detriment, including from any lessening of competition. Consistent with past decisions of the Australian Competition Tribunal, the ACCC gives the term ‘public benefit’ the widest possible meaning. Decisions about the public benefits and detriments likely to result from such arrangements are made by the ACCC following a public consultation process. To grant

---

23 Public benefit has been, and is, given a wide ambit by the Australian Competition Tribunal. In the language of *Queensland Cooperative Milling Association Limited, Defiance Holdings Limited* [1976] ATPR 40-012 (at 17,242), public benefit is ‘anything of value to the community generally, any contribution to the aims pursued by society including as one of its principal elements (in the context of trade practices legislation) the achievement of the economic goals of efficiency and progress. In *Re 7-Eleven Stores* [1994] ATPR 41-357 (at 42,677) the Tribunal added: ‘Plainly the assessment of efficiency and progress must be from the perspective of society as a whole: the best use of society’s resources. We bear in mind that (in the language of economics today) efficiency is a concept that is usually taken to encompass ‘progress’; and that commonly efficiency is said to encompass allocative efficiency, production efficiency and dynamic efficiency’. The Tribunal’s decision in *Re Qantas Airways Limited* [2005] ATPR 42-065 (at 185) made it clear that a “modified total welfare standard” should be used to assess public benefit: ‘In our view, the objective and statutory language of the Act, as well as precedent, support the use of a form of the total welfare standard as the most appropriate standard for identifying and assessing public benefit. We say a “form of” the total welfare standard because, as the passage cited from *Re Howard Smith* shows, whilst the Tribunal does not require that efficiencies generated by a merger or set of arrangements necessarily be passed on to consumers, it may be that, in some circumstances, gains that flow through only to a limited number of members in the community will carry less weight.’
authorisation, the ACCC must be satisfied that in all the circumstances: the benefit to the public outweighs the public detriments constituted by any lessening of competition that would likely result; and/or the public benefit is such that the conduct should be authorised.24

• the ACCC assesses notified price increases by Sydney Airport in relation to regional air services25 and by AirServices Australia26 in relation to air traffic control and aviation rescue fire-fighting services.

• the ACCC is also responsible for price and quality of service monitoring of the four largest airports in Australia (described above).

• the IASC assesses applications by existing and prospective Australian airlines for capacity available under Australia’s bilateral ASAs and for the use of allocated capacity for code sharing with foreign airlines. It is empowered to approve such applications on public benefit grounds.27 The IASC applies public benefit criteria set down by the Australian Government, of which competition benefits are the pre-eminent consideration. Parties that receive IASC approval are not exempt from general competition and consumer laws.

7. The ACCC continues to observe a variety of conduct in airline markets that raises competition issues, including: potentially anticompetitive mergers and acquisitions, alliances and code sharing arrangements; cartels and other horizontal agreements between competitors; alleged exclusionary conduct (abuse of dominance); and drip pricing (also known as component pricing).

8. The remainder of this submission highlights Australia’s recent experience in identifying and addressing these competition issues in airline markets, starting with a description of how we approach market definition in airline competition cases.

2. Market definition

9. Market definition is important for robust assessment of potentially anticompetitive conduct in airline markets, including cartel investigations, merger assessments and evaluation of airline alliances and code sharing arrangements. It defines the relevant field of inquiry for competition analysis by identifying the sellers and buyers that potentially constrain the commercial decisions of the parties engaging in the conduct at issue as well as the market participants that may be harmed by the conduct.

24 The Australian Competition Tribunal has the power to conduct merits review whereby it may: (i) authorise an agreement between airlines to engage in certain anti-competitive conduct where a person is dissatisfied with an ACCC determination regarding the same; or (ii) set aside an ACCC decision to revoke a notification of certain anti-competitive conduct. The Tribunal also has the power to authorise an airline merger. Applications for merger authorisation go directly to the Tribunal, not the ACCC (as distinct from merger clearance applications, which are reviewed, at least initially, by the ACCC).

25 In assessing such price notifications, the ACCC is required to have regard to the promotion of economically efficient investment and employment throughout the economy. The ACCC also is directed by the Minister to give special consideration to the Australian Government’s policy that caps total revenue-weighted price increases to growth in the Consumer Price Index over a three year period.

26 AirServices Australia is a government owned business responsible for providing the aviation industry with airspace management, aeronautical information, aviation communications, radio navigation aids and aviation rescue fire fighting services. It employs air traffic controllers and other staff at two major centres in Melbourne and Brisbane and at 29 towers at airports around Australia.

27 See the International Air Services Commission Act 1992 (Cth) and associated regulations.
10. In Australia market definition is viewed as a tool to facilitate robust assessment, not an end in itself. The ACCC therefore tends to invest in the market definition exercise to a point where it is satisfied that the product, geographic and functional space in which rivalry and competition takes place is sufficiently well specified to allow it to appreciate competition effects, without necessarily being exact about the precise boundaries of each relevant market.

11. We generally take a purposive approach to market definition, which means that we do not define a relevant market independent of the conduct at issue. The object of the exercise is to help determine the impact of the conduct at issue on competition, so it is important to have regard to the specific facts and circumstances of the conduct and current evidence from market participants about substitution possibilities. While decisions about market definition in previous, even similar, matters often will provide some guidance, they do not constrain the specification of relevant markets in subsequent matters.

12. In airline matters the ACCC is careful not to define the market so narrowly that it fails to take into account network-wide considerations that are relevant to the assessment of competitive effects (unilateral and coordinated). At the same time, the ACCC acknowledges that differing market conditions on each route often requires route-specific analysis. The way that it manages this is to recognise actual and potential future overlap routes as ‘embedded’ markets within a broader market that is defined by a set of routes. For example, in its 2010 assessment of an alliance between Virgin Australia and Air New Zealand, the ACCC identified a relevant market for air passenger transport services between Australia and New Zealand (trans-Tasman) and assessed competition effects both at the trans-Tasman level and at the individual (city pair) route level for all actual and potential future overlap routes.

13. When defining relevant markets in airline matters the ACCC is regularly confronted with issues such as:

- Are one stop and/or two stop services in the same market as non-stop services?
- Should air transport services from/to nearby points of origin/destination be included in the relevant market?
- Are FSA services in the same market as LCC services?
- Should transport services utilising alternative modes of transport (shipping, rail or road) be included in the relevant market?

14. The answer to these questions varies depending on the specifics of each case, particularly whether it involves cargo or passenger traffic, route distance and journey time, proximity of other airports, and customer preferences with respect to price and level of service on each city pair route. As a general proposition, if there is evidence that a significant proportion of customers regard the alternative as

---


29 ACCC Determination: Applications for authorisation lodged by Virgin Blue Airlines Pty and Others, Authorisation number A91227 and A91228, 16 December 2010, available on the ACCC public register.

30 In most Australian capital cities, the international and domestic passenger and freight terminals are co-located. In many cases there are long distances (often more than 1,000 kilometres) between cities and therefore major airports. However, this is not always the case. Where cities and major airports are reasonably proximate (e.g. Brisbane airport is approximately 110 kilometres from Coolangatta airport on the Gold Coast) the ACCC has recognised the potential for some demand-side substitution and competition.
a close substitute (or if suppliers would readily switch to increasing supply of the alternative in a timely manner and at low cost) the ACCC usually will include it in its definition of the relevant market. However, when such alternatives are included in the relevant market definition, the competition assessment generally takes into account that the alternative may not be regarded as a close substitute by all or even most customers and so the competitive constraint from the presence of alternatives may be limited.

15. Depending on the conduct being investigated, particularly in the case of airline alliances, there may be a number of relevant markets. For example, in the course of its assessment of an alliance between Qantas and Emirates, the ACCC considered the effects of the alliance on competition in the supply of:

- International air passenger transport services between Australia and each of UK/Europe, New Zealand, Asia (particularly Singapore, Thailand and Malaysia), South Africa, North America, South America and the Middle East and Northern Africa (MENA) region;
- International air cargo transport services, defined to include cargo services offered by international passenger airlines and dedicated freighter airlines and taking in all routes between freight location and destination, including via intermediate points in other regions, that are sufficiently substitutable;31
- Australian domestic air passenger transport services;32 and
- The sale of international travel services, which includes ticketing for air travel by airlines and travel agents.

16. While the ACCC ultimately did not identify competition concerns in several of these markets, careful market definition helped the Commission to reach this view early in the process so that investigation resources could focus on markets where there was potential for a substantial lessening of competition.

17. Market definition issues are central in the air cargo cartel case currently before the Federal Court of Australia. In 2008 the ACCC commenced proceedings against the first of 15 international airlines,33 alleging that they entered into agreements to fix the fuel and security surcharge components of the price of air cargo services to Australia during the period 2002 to 2006.34 Under competition law as it then stood, cartel conduct constituted a per se breach of Australian competition law if (i) the businesses involved were

---

31 The ACCC recognised that air cargo transport customers are more likely than passenger transport customers to regard the direct and indirect service offerings of alternative service providers as close substitutes, since the inconvenience of one or multi stop journeys generally is less of an issue for cargo than it is for passengers.

32 While the applicants’ operations did not overlap on domestic Australian routes, the ACCC was interested in whether the alliance could affect competition for the supply of domestic air passenger services by directing onward carriage (inbound) traffic or feeder (outbound) traffic to Qantas at the expense of the competitive position of other domestic carriers.

33 Air France, Air New Zealand, British Airways, Cargolux, Cathay Pacific, Emirates, Garuda, Japan Airlines, KLM, Korean Airlines, Malaysian Airlines, Martinair, Qantas, Singapore Airlines and Thai Airways International.

34 All but two airlines, Air New Zealand and Garuda, have settled. The proceedings against Garuda and Air New Zealand have been heard and are presently reserved before a Federal Court judge.
incorporated or carried on business in Australia and (ii) the conduct occurred in a ‘market in Australia’.  

18. The two airlines contesting the proceedings submitted that the ‘market in Australia’ hurdle had not been met. In essence, they contend that the geographic dimension of the relevant market is confined to the point of origin (which is at all times a point outside Australia, e.g. Hong Kong), or places nearby the point of origin, and does not extend to Australia because customers (freight forwarders) acquire air cargo services from suppliers located at or near the point of origin.

19. The ACCC argued that the relevant air freight services market(s) is a ‘market in Australia’ because the service demanded and supplied by airlines (the product) is the international transportation of cargo from an overseas point of origin to a destination in Australia. In the ACCC’s view, it does not make sense to restrict the competition analysis to the identification of suppliers and locations at which a transport service begins because, for both consignor and consignee, delivery to a destination in Australia on time and safely is important. Without delivery at a destination in Australia an air cargo service to Australia would have no value.

20. The same debate occurred in New Zealand. In 2008 the New Zealand Commerce Commission filed proceedings in the High Court of New Zealand alleging that eight international airlines had fixed fuel and security surcharge elements of the price of inbound and outbound air cargo services to New Zealand. On the issue of whether there is a ‘market in New Zealand’ for inbound air cargo services, the High Court concluded that a market does not have to be wholly in New Zealand and ruled that the market in New Zealand for air cargo services from an overseas country or region to New Zealand has a sufficient presence in New Zealand to constitute a ‘market in New Zealand’ under New Zealand competition law.

3. Mergers, alliances and code shares

21. The ACCC is empowered to authorise airline alliances and to clear mergers, and the IASC grants approval for capacity allocations involving code shares, where they confer (net) public benefits. The ACCC is also empowered to formally or informally assess and clear mergers and acquisitions in situations where the parties have not sought authorisation.

35 One of the airlines, Garuda, claimed foreign state immunity from Australian competition law due to its ownership by the Republic of Indonesia. Under Australia’s Foreign States Immunities (FSI) Act 1985, commercial transactions by government owned businesses are not immune from Australian competition law. The High Court unanimously determined that the ACCC’s regulatory proceedings concerned a commercial transaction and therefore the airline was not entitled to immunity under the FSI Act.

36 Under new cartel provisions introduced in July 2009, the requirement that the conduct occur in a ‘market in Australia’ has been removed.

37 See New Zealand’s Submission to the OECD on Airline Competition for the June Competition Committee Meeting at paragraphs 40-42.

38 Air New Zealand, British Airways, Cargolux, Cathay Pacific, Emirates, Korean Air, MASKargo, Qantas, Japan Airlines, Singapore Airlines Cargo and Thai Airways.


40 Merger parties may also apply to the Australian Competition Tribunal for authorisation of the merger. The Tribunal may grant authorisation if it is satisfied that the proposed merger is likely to result in such a benefit to the public that it should be allowed to occur.
22. Since 2000 the ACCC has reviewed a number of applications for authorisation of airline alliances and clearance of proposed airline acquisitions, while the IASC has considered various applications for use of capacity under code sharing arrangements. 41

23. It is well recognised that these arrangements between airlines have the potential to confer public benefits through, for example, enhanced products and services, cost savings, removal of double marginalisation, 42 and stimulation of competition and tourism. However, the realisation of such benefits usually depends on a number of factors, including:

- the degree of complementarity between the activities and service offerings of the airlines concerned. For example, if two airlines have operational bases in different countries they may be in a position to each offer the other better access to customers and inputs to airline services (e.g. customer support, engineering services) in their respective home countries. Through some form of partnership arrangement they may be able to mutually take advantage of such opportunities to increase their combined revenues or reduce their combined costs.

- how strongly the arrangement aligns the incentives of the parties so that they are driven to act in their joint interest. In arrangements where the parties’ incentives are fully aligned – to the point where each carrier is not concerned whether a passenger flies on their airline; a situation described in the literature as ‘metal neutrality’ – airlines tend to be very focussed on synchronising their operations and activities and sharing the financial rewards and risks so as to make their products and services as appealing as possible to passengers.

- whether the arrangement triggers a pro-competitive response from rival carriers or facilitates competition in other functional areas (e.g. marketing of passenger air services). For example, all else equal, hard block code share arrangements can create stronger incentives for code share partners to compete in the marketing and sale of air passenger services than free sale code share arrangements. Similarly, airline alliances that enhance the parties’ product and service offerings to business customers (e.g. by allowing customers of each airline to access more frequencies and at more convenient times and providing for better access to lounge facilities and other value added services) may trigger a competitive reaction from rivals operating on the same routes, which in turn may stimulate a second round competitive response from the alliance.

24. Notwithstanding their potential public benefits (including through potential pro-competitive effects), airline alliances and code share arrangements remove actual and potential competition between the parties in an airline market. The co-existence of potential public benefits and anti-competitive effects can present a challenge for competition regulators – should they deny the application, approve the application or approve subject to conditions and, if so, what conditions?

41 These reviews are conducted in accordance with the relevant statutory tests. The ACCC’s approach to evaluation of airline alliances is conducted in accordance with the statutory framework set out in subsections 90(5B), 90(7) and 90(8) of the *Competition and Consumer Act 2010* (Cth). The ACCC’s approach to evaluation of mergers and acquisitions involving airlines is conducted in accordance with the statutory test set out in section 50 of the same Act. When making a determination allocating available capacity, the IASC’s assessment is in accordance with section 7 of the *International Air Services Commission Act 1992* (Cth) and the Minister Policy Statement No. 5 dated 19 May 2004 issued pursuant to section 11 of the same Act.

42 Double marginalisation is a situation that occurs where suppliers of vertically related or complementary products each enjoy a degree of market power and independently charge a price which includes a mark-up above their costs and do not take into account the impact of such a mark-up on the other firm’s profit. The net result is both higher prices and lower profits and output than if the two firms coordinated their pricing.
25. Legislation provides the ACCC and IASC with some discretion to impose terms and conditions, including to mitigate competitive detriment, when authorising airline alliances or allocating capacity involving code shares. In merger review cases, if the ACCC forms the view that a merger or acquisition is likely to substantially lessen competition, the parties may decide to provide a court enforceable undertaking to address the ACCC’s concerns.

3.1 Conditional authorisation or clearance of arrangements between airlines

26. The IASC in the past has allocated capacity subject to conditions such as a requirement to begin using the allocated capacity within a short period or risk losing it or, in the case of code sharing, a requirement to operate a minimum number of frequencies per week.

27. The ACCC recently granted conditional authorisation for two (separate) airline alliances — Qantas-Emirates and Virgin-Air New Zealand — which were assessed as otherwise being likely to substantially lessen competition in the Australia-New Zealand air passenger transport market. In each case the ACCC was of the view that the alliance raised material (unilateral) competition issues on some overlap routes between Australia and New Zealand (trans-Tasman routes) due to the limited competitive constraint from rival carriers. The ACCC was concerned that post-alliance the airlines were more likely to find it profitable to reduce capacity, or limit capacity growth, to create a scarcity of seats on these routes and raise average fares. The alliance would gain from both the higher average fares and the lower costs from operating less capacity.

28. Rather than deny authorisation or carve out the routes of concern, which would also have denied the realisation of public benefits from the alliance associated with those routes, the ACCC sought to mitigate the competitive detriment by granting conditional authorisation which imposed a (structural) capacity condition on each alliance.

29. Broadly speaking, the condition requires the applicants to at least maintain an (aggregate) base level of capacity on the routes of concern for the term of the authorisation. The base level is informed by the capacity that the parties operated in the period prior to the alliance, adjusted for significant abnormal events. There is provision for an obligation on the parties to grow capacity on the routes of concern. The growth obligation is currently set at zero but may have a positive value in the future depending on

---

43 See section 91(3) of the Competition and Consumer Act 2010 (Cth) and section 15(1) of the International Air Services Commission Act 1992 (Cth).

44 Other options for the merger parties include not proceeding with the proposed merger or acquisition or proceeding and either defending court action or seeking a declaration from the Federal Court of Australia that the merger or acquisition is not likely to substantially lessen competition.


46 This includes public benefits arising in situations where the route forms part of a longer journey from/to points behind/beyond the origin/destination.

47 There are four routes of concern under the Qantas-Emirates alliance and six under the Virgin-Air New Zealand alliance.

48 The growth factor is currently set at zero, not because the ACCC does not expect to observe net capacity additions by the airlines on the routes of concern, but rather as an acknowledgement that the capacity condition is ‘lumpy’ in the sense that airlines add capacity by adding or upgrading aircraft, making it difficult to add capacity in small increments. Rather than prescribe a minimum growth factor for the bundle of routes of concern, the ACCC has opted to review the airlines capacity additions after two years and consider whether an increase in the minimum required capacity is warranted at that time.
alliance performance. As a safeguard for the airlines, the maximum value of any growth obligation that may be applied by the ACCC is capped in line with the rate of growth of either Australian GDP or total Australia-New Zealand passenger demand, whichever is greater. The parties are also required to provide information on key aspects of their performance post-alliance to assist the ACCC to ensure that the capacity condition is not excessive to its purpose and to enable the ACCC to monitor competition effects.

30. The objective of the capacity condition is not to bring about the same market outcomes that may be expected in a perfectly competitive market or the market absent the alliance. Rather, it is to mitigate (not eliminate) competitive detriment by placing a limit on the opportunity for each alliance to profitably raise fares or reduce service on the routes of concern. That is, the condition restricts, but does not entirely remove, airlines’ ability to exercise their increased market power on such routes post-alliance.

31. The ACCC is conscious that a capacity commitment may have the effect of deterring entry or result in the inefficient allocation of capacity. This has influenced the design of the condition. For example, the condition is confined to routes of concern. The capacity obligations are aggregated across the bundle of routes of concern so that the airlines have flexibility to reallocate capacity among the routes of concern in order to improve their operating efficiency. There also is provision for the airlines to seek, and for the ACCC to grant, a variation in exceptional circumstances or in the event of a material change in market conditions or material adverse financial performance. Virgin and Air New Zealand made such an application following the Christchurch earthquakes and were granted relief from the capacity obligation.

3.2 Dealing with uncertain and changing competitive harm

32. In some cases it may be difficult for the competition regulator to anticipate the competitive harm that may result from an airline alliance or code share arrangement beyond the short to medium term (e.g. due to uncertainty about the likelihood of new entry in the event that the parties raise price or reduce service). One way that the ACCC and IASC deal with this is by varying the term of regulatory approval, generally within the range of 2 to 10 years. While a longer term provides the parties with greater regulatory certainty, a shorter term may provide an opportunity for the regulator to review the applicant’s performance under the arrangement and reassess longer-term regulatory approval in light of that information.

33. The competitive detriment from an alliance or code share arrangement is likely to change over time as markets evolve. Arrangements that may confer public benefits initially may cease to do so sometime in the future if they crowd out more competitive arrangements. The code sharing arrangement between Qantas and South African Airways (SAA) approved on several occasions by the IASC from 2000 until 2014 is a good example of this. Under this arrangement, Qantas and SAA agreed that SAA would code share on Sydney-Johannesburg services operated by Qantas and Qantas would code share on Perth-Johannesburg services operated by SAA. The code share was a hard block arrangement whereby the marketing carrier was required to pre-purchase a fixed block of seats (40%) and was not permitted to hand any back to the operating carrier. The marketing carrier was to bear the loss if it did not sell enough seats to cover the cost of the pre-purchased block. Since 2000 Qantas has been the only airline operating direct

49 For example, in 2010 the ACCC initially granted conditional authorisation of the Virgin-Air New Zealand alliance discussed above for three years. In 2013 the ACCC reauthorised the alliance for a further term of five years. In contrast, in 2012 the ACCC granted 10 year authorisations for alliances between Emirates and FlyDubai and between Etihad and AirBerlin.

50 Published IASC Determinations relating to the Qantas-SAA code share arrangement are available from the IASC website: http://www.iasc.gov.au/determinations_decisions/South_Africa.aspx
services between Sydney (East coast Australia) and Johannesburg and SAA has been the only airline operating direct services between Perth (West coast Australia) and Johannesburg.  

34. The IASC maintained short-term periods of approval (one or two years at a time) because of concerns that the code share may not be of benefit to the public over a longer period. In its reviews in 2007 and 2008 the IASC recorded its concern about high air fares and rising load factors on the direct services. The constrained capacity meant that there was little incentive for the two code share partners to compete strongly through their code share blocks because aircraft were already full. In a later (2012) review, the IASC expressed concern that the code share arrangement may not achieve outcomes that are materially different than those achieved absent the arrangement. While, in theory, the code share could create some incentives for duopoly competition between Qantas and SAA in the marketing and sale of direct services, in practice these were likely to be limited and, in an environment in which the carriers are able to routinely achieve high load factors, there is little pressure on either carrier to offer fares materially below the monopoly price.

35. In its (final) 2012 Determination, the IASC explained that it considered that the future without the code share arrangement was changing over time, which had significant implications for its assessment of public benefits. In particular, beyond 2014 the IASC considered there was a greater prospect of two carriers offering parallel direct services on one or both routes or possibly on another city pair route. In a situation where it may be economic for two carriers to operate competing direct services, the Commission considered that the code share arrangement could hinder, rather than promote, competition by deterring or delaying the introduction of competing services and increasing barriers to entry. For these reasons the IASC did not approve the code share beyond December 2014.

36. In February 2014 SAA and Qantas announced the end of their code share arrangement. SAA continues to operate Perth-Johannesburg services and has entered into a new code share agreement with Virgin Australia to allow SAA passengers to travel on Virgin operated services within Australia to/from Perth. Qantas continues to operate Sydney-Johannesburg direct services.

3.3 Financial distress as a ‘mitigator’ of competitive harm

37. From time to time the ACCC receives an application for authorisation of an airline alliance, or reviews an airline merger or acquisition, in which the parties rely on failing firm arguments to claim that the arrangement is not likely to substantially lessen competition.

38. In assessing the competitive detriment (and public benefits) likely to flow from an airline merger, acquisition or alliance, the ACCC compares the likely ‘future with’ the arrangement to the likely ‘future without’ the arrangement. Typically, under a failing firm argument, it is claimed that absent the arrangement at least one of the airlines involved would exit the market or, alternatively, compete less effectively in the market. Under this counterfactual scenario the arrangement gives rise to less

---

51 For a brief period, between March 2010 and February 2011, V Australia (now Virgin Australia) operated direct services between Melbourne and Johannesburg.  

52 The IASC was concerned that the intensity of competition in this duopoly environment, with repeated interaction, was greatly limited by the basis on which the operating carrier charges the marketing carrier for its block of seats, the limited competitive constraint imposed by third country carriers on the code share carriers, and each code share partner’s knowledge that if it discounts fares too aggressively it might destabilise the arrangement.

53 In merger reviews, as distinct from merger authorisations considered by the Australian Competition Tribunal, the ACCC does not consider public benefits. The ACCC considers only whether the merger or acquisition has or would be likely to have the effect of substantially lessening competition in any market.
anticompetitive effect than would be expected under a scenario in which both airlines are vigorous and close competitors.

39. In its recent application to the ACCC for authorisation of an alliance with Emirates, Qantas claimed that its international operations were in “terminal decline” and that this decline would be “arrested” by the alliance. Qantas claimed that for many years its international operations have been supported by other profitable Qantas businesses but its losses continued to grow. Qantas submitted that it is unable to compete effectively or operate profitably as a result of ‘embedded structural cost disadvantages’ compared to other international carriers which benefit from more favourable geography, more favourable tax regimes, lower labour costs and government funded infrastructure.

40. Ultimately, the ACCC did not accept or rely on Qantas’ claim that Qantas International was in terminal decline and unable to compete effectively or operate profitably. It considered that the scope of Qantas’ international operations in the likely future without the alliance would not be materially different to the likely future with the proposed arrangement. More specifically, the ACCC accepted that Qantas is likely to be at a competitive disadvantage in its operations between Australia and the UK/Europe compared to mid-point carriers based in the Middle East and Asia as a result of its inability to achieve the same economies of scale and density and comparatively higher labour costs. However, the ACCC considered that Qantas was likely to rationalise its Australia-UK/Europe operations in both the future with and the future without the alliance. The ACCC also did not accept that Qantas’ other international services faced a net structural disadvantage or were in terminal decline. In all other areas of Qantas’ international operations, the ACCC considered that any structural disadvantages were likely to be largely or entirely offset by Qantas’ strength in other areas, including in Australian domestic aviation and Qantas’ customer loyalty through corporate contracts and frequent flyer program.

41. While the ACCC was not persuaded that a failing firm defence mitigated the competitive detriment arising from Qantas’ alliance with Emirates, it was persuaded in another case involving Virgin Australia’s proposed acquisition of a 60% stake in LCC, Tiger Airways Australia (Tiger). The ACCC had particular regard to Tiger’s particularly poor financial and operational performance in Australia. In six years it had never made an operating profit and its losses were large. These losses were a substantial burden on the Tiger Group. The ACCC tested the likelihood of Tiger’s performance being improved by either its current owner or other potential shareholders or joint venture partners if the proposed acquisition did not proceed. It considered it unlikely that Tiger’s performance would be turned around under any of these scenarios to provide vigorous competition as an independent operator. Instead, its key assets (aircraft) would very likely be redeployed into the Asian operations of its parent company.

42. The ACCC ultimately assessed that the acquisition was unlikely to lead to a substantial lessening of competition in the Australian market for domestic air passenger services because Tiger was unlikely to remain in the domestic market if the proposed acquisition did not proceed. Since it was highly likely that Tiger would exit the market if the acquisition did not occur, blocking the acquisition would not serve to protect competition.

43. The finding that Tiger was likely to exit in the event the proposed acquisition did not proceed was a critical factor in the ACCC’s decision to approve the acquisition. Absent this conclusion the

---

54 See ACCC 2013, Determination: Applications for authorisation lodged by Qantas Airways Limited and Emirates in respect of a Master Coordination Agreement to coordinate air passenger and cargo transport operations and other related services, 27 March, A91332 and A91333.

55 ACCC 2013, Public Competition Assessment: Virgin Australia Holdings Limited - proposed acquisition of 60% of Tiger Airways Australia Pty Ltd, 31 July available on the ACCC Public Register (Mergers Register).
acquisition raised considerable competition concerns. In particular, the ACCC held concerns that the proposed acquisition may increase the likelihood of airlines coordinating their pricing, capacity or related commercial decisions (i.e. give rise to ‘coordinated effects’) by:

- reducing the number of airline groups within Australia from three to two and making those groups more similar in that each would be comprised of a FSA and a LCC in the domestic market;
- removing Tiger as an independent LCC and instead aligning its incentives with those of Virgin Australia; and
- reducing the threat of further entry by a new airline.

44. The ACCC also held concerns with the elimination of direct competition between Tiger and Virgin Australia (i.e. unilateral effects). While post acquisition Tiger would remain a separate brand in the market, it would be under the control of Virgin Australia and would therefore take into account, and act in, the interests of Virgin Australia, which would be likely to affect the airlines’ decisions as to fares, service quality, capacity and/or network.

4. Cartel and horizontal agreements other than mergers, alliances and code shares

45. Australian competition law prohibits businesses from engaging in cartel conduct – that is, making or attempting to make agreements with their competitors to fix prices, rig bids, share markets or restrict output. Cartel conduct is prohibited per se and may give rise to criminal or civil liability. The law also prohibits contracts, arrangements or understandings between competitors that substantially lessen competition in a market, even if the conduct does not meet the strict definition of cartel conduct. Anti-competitive horizontal agreements that do not fall within the definition of cartel conduct may give rise to civil liability only.

46. Investigation and prosecution of cartel conduct is a high priority at the ACCC. A number of structural and strategic factors conducive to cartel formation are present in Australian domestic and international airline markets, including relatively small number of players, multi market contact, high barriers to entry, relatively homogeneous products and numerous relatively small transactions.

47. The most prominent cartel case in Australia involving airlines to date is the air cargo cartel case mentioned previously. This is a significant competition case in Australia by almost any metric – number of airlines involved (proceeded against 15), amount of pecuniary penalties (AUD $98.5 million to date), and resource demands and cost to litigate (the ACCC investigation commenced in 2006 and the cases against the last two airlines is still before the Court). As noted previously, the conduct at issue involves individual airlines giving effect to agreements with other major airlines in relation to fuel and security surcharge on freight they transported to Australia. The understandings arose following a resolution to

56 Excluding intra-state airlines and charter services.

57 The relevant provision [1.44ZZRD.30] refers to fixing, controlling or maintaining price or a discount, allowance, rebate or credit in relation to the supply or acquisition of goods or services.

58 Division 1 of Part IV (Restrictive Trade Practices) of the Competition and Consumer Act 2010 (Cth).

59 Without the need to establish a substantial lessening of competition.

60 Section 45 of the Competition and Consumer Act 2010 (Cth).

61 AUD $1 = US $0.9293 as at 2 April 2014.
impose such surcharges adopted at an International Air Transport Association (IATA) meeting. In the ACCC’s view, the case serves as a reminder of how the combination of multi-market contact and regular industry meetings can facilitate the reaching of agreement between competitors, with or without written communication.

48. Another recent case involves attempts by one of Australia’s largest travel agencies to fix international airfares. In March 2012 the ACCC instituted proceedings in the Federal Court of Australia against travel agency, Flight Centre Limited, for attempting to induce three international airlines (Singapore Airlines, Malaysian Airlines and Emirates) to agree to stop directly offering and booking their own international airfares, including over the internet, at prices less than Flight Centre offered. The ACCC alleged that the internal sales divisions of these international airlines provided booking services to the public and distribution services to the airline in competition with travel agencies. No allegations were made against the airlines.

49. By way of background, Flight Centre offered a ‘Price Beat Guarantee’, whereby it undertook to beat a cheaper airfare offered by its competitors by AUD $1 plus a AUD $20 Flight Centre voucher. As a result of that guarantee, Flight Centre was obliged to match cheaper web fares of its airline competitors. From time to time, the airlines offered lower airfares on their websites which travel agents such as Flight Centre did not have access to. Flight Centre was obliged to match these cheaper web fares, as a result of its Price Beat Guarantee, which caused Flight Centre to forgo commission.

50. In December 2012 the Federal Court of Australia found that Flight Centre had on six occasions between 2005 and 2009 attempted to enter into arrangements with airlines which sought to eliminate differences in air fares so as to fix, control or maintain Flight Centre’s retail or distribution margin. Logan J found that Flight Centre competed not just with other travel agents but also with the airlines in relation to the distribution to and booking of available flights for would-be passengers. The Court imposed a pecuniary penalty of AUD $11 million and accepted a court enforceable undertaking from Flight Centre that for a period of three years it would not attempt to prevent an airline from offering international passenger air travel services direct to the public at a lower price than it makes fares available to Flight Centre. Logan J made it clear there is nothing preventing Flight Centre from merely requesting that an international airline make an airfare available to it. Flight Centre has since filed an appeal against the Federal Court’s ruling and penalty. The ACCC has cross-appealed on penalty.

5. Abuse of dominance

51. Under section 46 of the Competition and Consumer Act 2010 (Cth), a firm with a substantial degree of power in a market must not take advantage of that power (in that or any other market) for the purpose of eliminating or substantially damaging a competitor, preventing entry, or deterring or preventing competitive conduct.

52. The ACCC has not initiated proceedings against an airline operating in Australia alleging misuse of substantial market power, including through predatory conduct, since 2002.

53. When investigating a complaint of predatory conduct by an airline with substantial market power, the ACCC typically focuses on whether the conduct is likely to foreclose actual or potential competition in

---

62 ACCC v Flight Centre (No 2) [2014] FCA 292.
63 ACCC v Flight Centre (No 2) [2014] FCA 292 at 112.
64 ACCC v Flight Centre (No 3) [2014] FCA 292.
65 ACCC v Flight Centre (No 3) [2014] FCA 292 at 3.
the relevant market(s). This often involves the application of a price-cost test to determine whether the alleged predator’s prices under the conduct fall below an appropriate measure of its costs. The appropriate measure of prices and costs is determined through case by case assessment. If we find that the airline is charging airfares that do not fully recover its (appropriately defined) costs, then the ACCC generally will be concerned that the conduct is not commercial other than as part of a broader predatory strategy to induce competitors to exit (or not enter) the relevant market(s).

6. Drip or component pricing

54. Since 2000 the ACCC has been concerned that various online booking systems, including airline online reservation systems, are being used to mislead consumers and distort competition by sequentially revealing components of the total price and not revealing the full price until the end of the reservation process, a phenomenon known as ‘drip’ or component pricing.

55. In a typical scenario, an airline’s website may specify a ‘headline’ airfare that many consumers consider represents good value. As consumers who wish to take up the offer progress through the online reservation process, a number of mandatory additional fees and charges are disclosed as well as charges for optional services. Optional services may be pre-selected by the airline even though their price is not included in the headline price. In such cases customers usually can avoid additional charges by de-selecting the pre-selected option, but they may not be aware that they will incur an additional charge unless they do this. The final price for the service, after all additional mandatory and optional charges are included, can be substantially higher than the initial headline fare.

56. When price information is framed this way airlines that offer the best total price and value may not necessarily prosper over airlines that advertise the lowest headline price and mislead consumers or exploit their behavioural biases. This is because, firstly, drip pricing can reduce the extent to which consumers shop around for the best offer, since identifying and comparing full price offers across airlines is made difficult and time consuming. Secondly, drip pricing may allow airlines to influence consumers to pay more for the service than they need or accept offers that are not the best match for their preferences. For example, some consumers may ‘anchor’ to the headline airfare and then fail to adjust their perception of the value of the offer as more components of the total price are revealed. Some may not realise that pre-selected options are not included in the headline price. By the time the total price is revealed some consumers may be frustrated by the amount of time they have invested in the transaction and, even though it is more than they had expected to pay, may be unwilling to begin the process again with another airline, particularly if they expect that drip pricing is widespread in the industry.

57. Under Australian consumer law, businesses that choose to advertise a part of the total price of a particular product or service must also prominently specify a single total price. Additionally, businesses...

---

66 Taking a purposive approach to market definition (discussed earlier), we have found in the past that the relevant market for the purposes of assessing the competitive effects of alleged predatory conduct often is a single city pair route or a set of city pair routes.

67 Some measures of price that may be relevant in airline matters include the average airfare or freight charge and/or the effective airfare or freight charge. Some measures of cost that may be relevant include average avoidable cost, average variable cost and/or long run incremental cost.

68 For example, government taxes, airport charges, fuel surcharges, security surcharges, and/or booking and service fees including payment card surcharges.

69 For example, seat selection, meals, baggage allowance, inflight entertainment and/or travel insurance.

70 Section 48 of Schedule 2 of the Competition and Consumer Act 2010 (Cth).
must not, in trade or commerce, engage in conduct that is misleading or deceptive or is likely to mislead or deceive.71

58. To date the ACCC has had some success in improving airline compliance with the law in these areas. For example, after identifying potential breaches, the ACCC accepted court enforceable undertakings from a number of domestic and international airlines to not exclude mandatory charges from their advertised airfares. In 2012 the ACCC took action in the Federal Court of Australia against a foreign owned LCC operating services to/from Australia for not displaying airfares on its website that were inclusive of all mandatory charges in a prominent way and as a single figure.72 The Court found that the airline was in breach of the relevant Australian Consumer Law provisions and imposed a pecuniary penalty of AUD $200,000. The Court also accepted from the airline a court enforceable undertaking restraining the airline from engaging in similar conduct for three years.

59. Notwithstanding these successes, the ACCC remains concerned that some airlines are using drip pricing practices to mislead consumers and distort competition. Improving compliance in this area is an ACCC priority.

---

71 Section 18 of Schedule 2 of the Competition and Consumer Act 2010 (Cth).

72 ACCC v Air Asia Berhad [2012] FCA 1413.