QANTAS

26 April 2005

Dr Kathleen Dermody
Secretary
Senate Foreign Affairs, Defence and Trade
References Committee
Suite SG.57
Parliament House
CANBERRA ACT 2600

Dear Dr Dermody

Re: Inquiry into Australia's Relations with China

I refer to your letter of 20 December 2004 to Qantas Airways Chief Executive Officer Geoff Dixon, inviting a written submission to the Foreign Affairs, Defence and Trade Committee's inquiry into Australia's relations with China.

Attached is a submission by Qantas to the Committee's inquiry.

As detailed in the attached, Qantas has a long history of involvement with China. Qantas first operated services to China in 1984, but has found it difficult to maintain commercially viable services in the market. However, even when Qantas did not operate direct services, we continued to serve China using our Hong Kong hub and through codeshare arrangements with Chinese carriers.

In December 2004, Qantas recommenced direct services to China. Although the route is not yet profitable, Qantas recognises the need to maintain a long-term commitment to this rapidly growing market.

Qantas has also taken advantage of recent air services liberalisation with China and introduced a number of freighter services operating through this market.

Qantas continues to investigate ways in which to further develop Australia – China air transport. In doing so, we face many challenges, but are optimistic about the future of aviation and tourism links between our countries.

We would be pleased to provide further evidence to the Committee if called upon to do so.

Yours sincerely

for J. McKeon

David Hawes
Head of Government and International Relations

QANTAS AIRWAYS LIMITED

SUBMISSION TO

THE SENATE FOREIGN AFFAIRS, DEFENCE AND TRADE REFERENCES COMMITTEE

ON

AUSTRALIA'S RELATIONS WITH CHINA

26 APRIL 2005

Introduction

China’s aviation industry has assumed an increasingly important role in recent years with demand for domestic and international air services fuelled by the country’s strong economic growth, rising living standards and rapidly expanding trade and tourism links with the rest of the world.

China’s economic growth has averaged around seven percent per annum over the past five years and is anticipated to continue, particularly with its accession to the World Trade Organisation. Increased air travel and airfreight movements have accompanied this growth, serving the needs of a vast population spread over an extensive and physically diverse land mass. With 43 cities in excess of one million people, China accounts for one third of all cities in Asia of that size.

China is set to become the second largest aviation market after the US, with passenger numbers forecast to grow at 8.4 percent per year over the next 20 years, compared with a global average of 5.1 percent. The World Tourism Organization predicts that by 2020, China will be the world's fourth largest source of tourists, with approximately 100 million Chinese travelling abroad each year. Australia is well placed to participate in that growth.

China will also be one of the most important markets for the world’s aircraft manufacturers. Over the next 20 years, Chinese airlines are set to purchase over 2000 aircraft, worth hundreds of billions of dollars. It would not be surprising, therefore, if China was to consider the establishment of its own aircraft manufacturing industry.

Over the past decade, China has gained prominence as a centre for aircraft maintenance and repair operations and other aviation related services. A series of partnerships involving Chinese carriers and investments by leading international airlines and original equipment manufacturers has established the necessary infrastructure and applied up-to-date technology, utilising China's highly skilled and low cost work force. Developments of this kind are expected to grow, with China assuming increased importance as a supplier of services to the global aviation industry.

China’s aviation policy

The rapid development of civil aviation in China over the past 20 years reflects the government’s recognition of its importance to continuing economic progress.

Industry re-structuring

Since 1987, concerted efforts have been made to separate government and commercial functions in the industry to create a more open and efficient air transport market.

By the late 1990s, state control and centralisation of aviation had been wound back and pricing was deregulated. A new administrative and policy framework for aviation and airports had been established, overseen by the Civil Aviation Administration of China (CAAC). However, the sector continued to be too fragmented and under-commercialised.

In 2001, in order to hasten the pace of reform, the government issued a plan for the future shape of the industry, reorganising 10 existing airlines into three larger groups, based on Air China, China Eastern and China Southern. The aim of this consolidation was to promote efficiency and sustainability, and prepare China's carriers for increased international competition.

Investment arms of the Chinese Government already hold significant stakes in Air China and Hong Kong-based carriers Cathay Pacific and Dragonair. There has recently been aviation media and industry speculation regarding a complex series of moves that could see major consolidation involving all three. Such a move would create the world's largest airline by market value. With a large customer base, and Greater China's most comprehensive route networks, such a grouping would be a formidable international and regional competitor.

Liberalisation of air services

With consolidation complete, liberalisation of international air services arrangements has been progressed to allow China's airlines to expand globally. Liberalisation has also been a vehicle for ensuring that the exponential demand for travel in China is met.

Privatisation of airlines and airports has occurred to some extent, with some foreign participation allowed, but Chinese Government involvement remains high. Intervention also remains significant through centralised fuel and aircraft purchasing, and the regulation of domestic route selection and domestic pricing.

Several aspects of China's aviation policy and the government's role in future industry restructuring bear watching. The scope for policy reversal was demonstrated in 2002 by the decision to reduce the permitted level of foreign ownership in Chinese airlines from 35 percent to 25 percent.

China's aviation policy has certainly become more liberal but not uniformly so. As CAAC Minister Yang Yuanyuan noted in February this year, it will be based on the needs of national economic and social development as well as diplomatic development, with CAAC defining the opening steps, models and pace towards different countries, different regions and different markets.

Additionally, CAAC Vice-Minister Yang Guoqing has described the approach to liberalisation as "west before east, cargo before passenger". This would see greater access granted to points west of China's key east coast gateways of Beijing, Shanghai and Guangzhou, and to routes used for the operation of freighter services.

China's recent decision not to allow international low cost carriers to operate to Beijing, Shanghai and Guangzhou, will impede the potential for airlines such as Singapore-based Jetstar Asia, in which Qantas has a 49 percent shareholding, to tap the strong growth in international traffic travelling to and from these major east coast centres.

That Chinese airlines do not operate under the same commercial or competition policy principles as apply to Qantas and many other carriers was evident in the announcement earlier this year that its four major airlines had agreed to cooperate on pricing because they were being hurt by existing competition on fares.

History of Qantas services to China

While Qantas has long recognised the potential of the Chinese market and offered interline connections via Hong Kong and other ports, the 20 year history of its direct operations to China has been marked by periods of failure and re-entry. The experience can be summarised as follows:

<u>1984 – 1987</u>

In February 1984, Qantas met with the CAAC to discuss the establishment of direct air links between Australia and China. This paved the way for formal government to government negotiations which resulted in an air services agreement in September that year.

Qantas commenced direct services to China shortly thereafter with a once weekly Boeing 747 service between Sydney and Beijing. At the same time, Air China commenced a weekly Boeing 747-SP Beijing-Guangzhou-Sydney service.

However, with low yields and highly seasonal loads dominated by Australian origin traffic, the route struggled financially from the outset and Qantas withdrew services in April 1987, leaving Air China as the sole operator.

<u>1995 – 2001</u>

Trade and tourism related traffic between Australia and China grew during the 1990s as China progressed with economic reforms, and Qantas decided to resume direct services in 1995, operating to Beijing with a once weekly Boeing 767 service from Sydney.

A further service was added in August 1996, and a call introduced at the burgeoning commercial centre of Shanghai. Qantas increased services to four per week from August the following year.

Although passenger loads were reasonably healthy, the route was characterised by low yields and the high cost of flying the Shanghai-Beijing extension. The situation was not assisted by the surge in capacity from

Chinese carriers and Ansett International in this period. Traffic growth expectations were also impacted by the delay in introducing Approved Destination Status (ADS) which had been announced in December 1997.

In an attempt to reverse losses on the route, Qantas reduced the level of service to three flights per week In October 1998 and cancelled the Beijing extensions in March 1999.

By 2000, Qantas' direct operations to China had accumulated losses in excess of $30 million. With fierce competition taking place in the Australian domestic market, Qantas decided it could no longer afford to fund such heavy losses on an international route and withdrew its services from May 2001 in favour of a code share relationship with China Eastern Airlines.

However, Qantas maintained a strong presence in the Australia – China market by carrying traffic over Hong Kong.

<u>2004 – present</u>

Qantas resumed direct operations to China in December 2004 with three services per week between Sydney and Shanghai using two-class 297-seater Airbus 330-300 aircraft.

The decision to re-enter the market was based on a number of factors, including deepening people-to-people links and the strong growth in merchandise trade (approximately 21 percent for exports and 26 percent for imports year on year between 2000 and 2004). The success and expansion of the ADS program, and the formalisation of the Government's Emerging Market Strategy, was also seen as providing a sound platform for growth in tourism.

The Shanghai – Sydney route was chosen because of the strong growth potential for business travel between Australia and China's principal commercial centre, and the fact that most travellers are destined for, or originate from, New South Wales and Victoria. A three per week service was chosen as a foundation on which to build up frequency.

At this stage, China is an emerging market that has yet to contribute profits for Qantas. Nonetheless, the new operations are attracting reasonably strong loads and a good mix of traffic. With continued efforts to sell and market services, underpinned by strengthening economic links between Australia and China, Qantas remains confident that the market will become profitable in time.

Australia – China Passenger Air Services

In addition to Qantas, three carriers offer direct passenger services between Australia and China, equating to 6,489 seats each way each week:

- Air China operates nine services per week with 2,450 seats to Shanghai and Guangzhou with onward connections to its Beijing hub;

- China Eastern Airlines serves Australia daily with 2,009 seats from its hub in Shanghai; and

- China Southern Airlines serves Australia daily with a total of 2,030 seats from its hub in Guangzhou.

In 2004, the three Chinese airlines carried 33 percent of Australia-China traffic. Qantas accounted for 26 percent, with most of its traffic connecting to and from services over Hong Kong.

Indirect operators accounted for the remainder of the market. The main indirect operators are Singapore Airlines with 13 percent of the total market, Cathay Pacific with nine percent and Japan Airlines with four percent:

- Singapore Airlines operates 86 weekly services to Australia and is able to offer connections on 64 flights per week between Singapore and Beijing, Shanghai, Guangzhou, Shenzhen, and Nanjing. Also, its wholly owned subsidiary, Silk Air, operates between Singapore and Xiamen, Kunming, Fuzhou, Chongqing and Chengdu;

- Cathay Pacific serves Australia 46 times per week from Hong Kong, providing connections to China on both its own services and on Dragonair; and

- Japan Airlines operates 21 services per week to Australia with good connections over Tokyo to and from Beijing, Shanghai and Guangzhou.

Dragonair, which has indicated its intention to commence services between Australia and Hong Kong later this year, will provide further indirect services between Australia and China.

Australia – China Passenger Market

The Australia – China air passenger market is currently Australia's fifth largest by volume of origin/destination traffic. Growth in both inbound and outbound travel has outstripped Australia's other major origin/destination markets over the past 10 years. Prospects for continued growth, particularly in inbound traffic, are healthy.

<u>Inbound Travel from China</u>

More than 250,000 Chinese travellers visited Australia in 2004. There has been an average annual increase of 25 percent over the past 10 years.

In the mid 1990s the Chinese Government introduced the Approved Destination Status (ADS) facility, greatly easing the ability of Chinese nationals to travel to selected foreign countries.

Australia was the first Western country to receive ADS with the status granted in April 1999. This allowed Chinese citizens from Beijing, Shanghai and Guangdong Province to apply for special short stay tourist visas as self-funded group leisure travellers to Australia.

At this time, the mix of traffic, which had previously been dominated by Australian residents, reversed, and inbound visitors have increasingly outnumbered outbound travellers.

In October 2003, a further six Chinese regions were added following an agreement between the Australian and Chinese Governments. This will be implemented in several phases. Further expansion of the program will eventually cover the whole of China. ADS status provides Australia with effective access to 31 percent of China's 1.3 billion people, in areas with significantly higher disposable incomes and GDP per capita than the national average.

Many Chinese visit more than one destination when travelling to Australia. New South Wales receives the highest proportion with 68 percent, and Victoria registering 46 percent. Queensland, which captures 50 percent of the Chinese market, recorded the highest growth rate by State between 2000 and 2004, although it is not serviced with direct flights.

The Australian Tourism Forecasting Committee's (TFC) 10-year projections for growth in inbound traffic from China are the highest of any market. In 2004, Chinese visitors accounted for five percent of the total inbound market to Australia. The TFC forecasts that in 2013, over one million Chinese will visit Australia, representing over 12 percent of the inbound market

Outbound Travel to China

The number of Australian residents travelling to China has grown by an annual average of 15 percent over the past 10 years. In the 12 months to December 2004, approximately 170,000 Australian residents travelled to China, predominantly for business, or to visit friends and relatives.

Clearly a destination of significant promise in its own right for Australian business and leisure travellers, China also has potential as an aviation hub for Australian carriers. Chinese cities offer a stopover alternative to traditional Asian hubs and a chance for Australian airlines to tap into the sizeable China-Europe market.

If the Australian Government could secure the necessary China – UK traffic rights under the Australia-UK Air Services Agreement, Qantas would give serious consideration to the potential to operate Australia - London services via a Chinese port such as Shanghai.

Qantas Freight Services to China

Australia was an early beneficiary of changes in China's international aviation policy and concluded substantially more open bilateral air services arrangements in July 2003.

Qantas has been swift to take advantage of these opportunities with respect to air freight. Seven weekly dedicated cargo services have been introduced from Australia to Shanghai to connect the US, Europe and Asia, using wet leased Boeing 747-400 freighter aircraft.

Qantas carried approximately 470 tonnes of freight between Australia and China in 2004 and is currently seeking additional rights to operate beyond China to Europe, where the rate of growth in air freight is amongst the highest in the world.

While air freight movements between Australia and China have grown significantly in recent years, the level of freight remains low and services terminating in China could not be operated viably at this stage. Hence, as for passenger services, Qantas attaches importance to the Government's ability to secure traffic rights to markets beyond China.

Qantas Representation in China

Qantas has Regional Managers located in Beijing and Shanghai, with staff totalling eight and 10 respectively.

However, overall responsibility for Greater China rests with Qantas' General Manager in Hong Kong where approximately 40 staff are engaged in sales, reservations, marketing and finance.

Qantas Engagement with China

Qantas' long and continuing engagement with China has included close involvement with Chinese authorities in developing the L888 routing through Chinese airspace for services from Singapore and Bangkok to Europe. This routing was introduced in May 2000 and saves 53 minutes on previous flying time, providing consumer, environmental and cost benefits.

Qantas also continues to work closely with Chinese authorities to further develop modern air traffic management procedures.

Qantas has previously trained pilots from major Chinese carriers, most recently Hainan Airlines.

Qantas also works with a number of Chinese carriers in serving the Australia-China market, in particular, China Eastern Airlines with whom cooperative arrangements commenced in October 2000. The commercial relationship between the two carriers has not been affected by the resumption of Qantas services to China. Qantas is able to supplement its three services per week and offer a daily service by code sharing on four weekly China Eastern flights.

Qantas also works with Dragonair to connect regional China traffic into its Hong Kong hub, and with Air China to provide domestic connections within Australia and on to New Zealand.

Australia – China Free Trade Agreement

Qantas can see benefits in the further development of Australia's trade and economic relationship with China and, on this basis, supports the exploration of a Free Trade Agreement (FTA). However, Qantas believes that, consistent with the approach taken under Australia's FTA's with Singapore, Thailand, and the USA, aviation market access issues should continue to evolve within the bilateral air services arrangements already in place.

Qantas believes the potential gains from more open trading arrangements with China could be impacted by the extent of any exclusions and exemptions from FTA coverage, in particular for measures affecting the marketing and selling of aviation services.

Qantas has encountered obstacles in some aspects of its activities in the China market, principally in the areas of distribution, representation, staff recruitment, and government procurement. Some of these impediments arise from the broader framework and regulations governing foreign companies doing business in China, while others apply more narrowly to aviation. Lifting these restrictions as part of an FTA would yield substantial revenue benefits to Qantas.

Qantas' Future in China

China will become an increasingly important market for Qantas, as it will for Australia more broadly.

Qantas remains optimistic that it can build on its three Sydney-Shanghai services, and anticipates increasing the level of frequency by the end of 2005. It is also closely monitoring the market with a view to providing services between other points in Australia and China.

Hong Kong will remain an important element of Qantas' China strategy. The Qantas Group operates 29 services per week between Hong Kong and the five Australian gateways of Cairns, Brisbane, Sydney, Melbourne and Perth. Neither Shanghai nor Beijing airport provides an ideal hub solution for domestic connections. In Shanghai, for example, the connection time between the domestic and international airports is four hours, which leads to most of the regional traffic travelling via Hong Kong.

While Qantas is committed to maintaining a presence in China, its services will need to be commercially viable if they are to be sustained over the longer term. Substantial volume growth in the market is virtually assured. However, Qantas' success in the market will be heavily influenced by competition, both from other airlines and other destinations. Increased support for tourism marketing, and the ability to secure traffic rights to operate services beyond China will be important to Qantas' efforts to develop the Australia – China market.

Nonetheless, the outlook for growing and strengthening aviation and tourism links between Australia and China is, in Qantas' view, positive. The re-introduction of Qantas services to Shanghai in December 2004 reflects the burgeoning trade and investment flows between the two countries, and the enormous potential of closer bilateral relations, to which an FTA will undoubtedly give further impetus.