

BARRIERS TO GROWTH IN SERVICE EXPORTS
PRODUCTIVITY COMMISSION DRAFT REPORT



australia

SUBMISSION BY VIRGIN AUSTRALIA

SEPTEMBER 2015

The Virgin Australia Group of Airlines (Virgin Australia) welcomes the opportunity to comment on the Productivity Commission's Barriers to Growth in Service Exports Draft Report (Draft Report). We note that the Terms of Reference for the study require the Commission to focus on six key export sectors, one of which is tourism. Virgin Australia's comments below are directed to the Draft Report's analysis regarding Australia's air services arrangements. Virgin Australia would also refer the Commission to our submission to its recent Research Paper on Australia's International Tourism Industry (2015 Research Paper).

Tourism is Australia's largest services export and has been identified as one of five "super-growth" industries that have the potential to boost the nation's economic growth and prosperity in future years¹, particularly through opportunities presented by the continued expansion of Asia's middle class. Given Australia's relative isolation and vast land mass with geographically-dispersed population centres, aviation is a critical enabler of the tourism industry, bringing visitors to Australia as well as transporting people between domestic destinations. In this regard, it is important to recognise the significant contribution that Australian airlines make to tourism and the Australian economy more broadly, in terms of supporting trade, investment and employment.

The continued complementarity and consistency of the Australian Government's aviation and tourism policy settings will ensure that the combined economic output of both industries is maximised. Virgin Australia notes that the Australian Government's Policy for Aviation and Policy for Tourism both include the promotion of aviation liberalisation as a key objective, together with a recognition of Australia's potential as a prime tourism destination within the Asia Pacific region. These policies also state that global liberalisation will be pursued while protecting Australia's national interest, that strong support will be provided to Australian airlines seeking to access international markets and that air services negotiations will be prioritised in order to ensure that capacity available under Australia's air services arrangements is sufficient to accommodate future demand. By striking an effective balance between the interests of key stakeholders in the tourism and aviation sectors, these policies are capable of enhancing the overall welfare of the broader Australian community. Policy settings which remove this balance will limit the realisation of these benefits.

As stated in both the Draft Report and the 2015 Research Paper, Australia's international tourism industry has experienced strong growth over the past two decades, with the number of international visitors increasing from 3.2 million in 1993-94 to almost 6.7 million in 2013-14. This has been driven by a number of factors, including a significant drop in airfares in real terms. The effectiveness of the Australian Government's aviation policy settings, which have remained broadly stable since 2000, have played a key role in facilitating this growth by providing airlines serving the Australian market with regulatory certainty.

While some countries have explored different approaches to liberalisation over the years, in the vast majority of cases the ability of airlines to access new international markets or increase services on international routes continues to be governed by the complex web of treaties established under the global bilateral air services framework. Provided the requisite rights are available under the relevant air services agreements, growth of air services in any market will be determined on the basis of commercial considerations alone.

Against this backdrop, Virgin Australia is strongly opposed to Recommendation 8.2 of the Draft Report, which proposes that the Australian Government grant foreign airlines unrestricted access to all airports in Australia. If adopted, this recommendation would have a significant and far-reaching detrimental impact on Australia's aviation and tourism industries, with corresponding implications for the Australian economy. The proposed reform is not capable of delivering net benefits to the community, given its failure to take into account the

¹ Deloitte, *Positioning for prosperity? Catching the next wave*, 2013.

practical consequences that a unilateral measure of this kind would have within the confines of the existing bilateral system. Few benefits, if any, would be realised from such a reform and would be grossly outweighed by the associated costs. This has been explicitly acknowledged and accepted in the previous work of the Commission. The reasoning on which our views are based is outlined below in detail.

Impacts of unilateral liberalisation

Virgin Australia notes that both the Draft Report and the 2015 Research Paper concluded that, on balance, Australia's international aviation policy settings are "broadly working well" and "a wide ranging review of international aviation policy (such as the review conducted by the Commission in 1998)" is not warranted at this time. This conclusion is subsequently qualified in both documents with the suggestion that there may be further scope for liberalisation within the bilateral system, by granting foreign airlines unrestricted access to all airports in Australia on a unilateral basis. It is difficult to reconcile these statements, given that unilaterally opening up Australia's airports to foreign airlines would entail a fundamental shift in Australia's international aviation policy settings, notwithstanding that the effective operation of these settings has been explicitly accepted.

It would seem that the unilateral proposal contained in Recommendation 8.2 has been developed without regard to the Commission's 1998 International Air Services Inquiry Report (1998 Inquiry Report), which noted that a "fundamental principle of the bilateral system is that of bilateral reciprocity whereby countries exchange rights on the basis of 'equality of opportunity'". The 1998 Inquiry Report states that unilaterally opening Australia's airports to foreign carriers would have a significant detrimental impact on Australian carriers:

"For as long as the bilateral system is accepted and entrenched in the rest of the world, Australian airlines are likely to be severely disadvantaged by a policy of unilateral 'open skies'. They would be unlikely to share in market growth with increased capacity and frequency (except in the United States and New Zealand). Further, they would not be able to expand their networks to include new destinations".

This view continues to be highly relevant given that the bilateral framework remains the mechanism for the exchange of rights to enable airlines to undertake international air services.

In addition to its implications for airlines, the 1998 Inquiry Report also examines the effects of a policy of unilateral 'open skies' from a consumer perspective, noting that Australian airlines may lose the ability to access new markets, with the result that "consumers who prefer to use Australian airlines, but are no longer able to do so, would also bear the costs of having to use less efficient or less preferred carriers. As a result, both Australian producers and consumers would incur costs...The damage to the Australian airlines could be substantial, for little benefit of consumers".

The 1998 Inquiry Report also notes that Australia has undertaken most of its trade liberalisation on a unilateral basis for a number of reasons, including the fact that the trade barriers themselves were imposed unilaterally by Australia. In these particular circumstances, it was recognised that it was in Australia's interests to pursue unilateral liberalisation, rather than bear the associated self-imposed costs in the period while seeking to conclude multilateral negotiations. In contrast, restrictions within Australia's air services arrangements exist within a complex global bilateral system and have not been self-imposed. Accordingly, these bilateral arrangements are ill-suited to unilateral reform due to the significant costs that would be imposed on the aviation and tourism sectors as a result.

The views of the 1998 Inquiry Report regarding unilateral liberalisation were echoed in both the 2015 Research Paper and the Competition Policy Review Final Report released in March 2015. Virgin Australia queries the absence of any reference to the 1998 Inquiry Report in the Draft Report.

In its analysis of air services restrictions, the Competition Policy Review Panel recommended that the Australian Government adopts a proactive approach to air services negotiations as part of ensuring capacity remains ahead of demand, including through the pursuit of bilateral open skies agreements. It goes on to note that this will ensure that bilateral agreements do not act as barriers to tourism growth. There is no suggestion that limiting the amount of capacity that foreign carriers may operate to Australia's major gateways is, of itself, acting as such a barrier.

The 2015 Research Paper notes that unilateral reform as proposed by Recommendation 8.2 may lead to anti-competitive outcomes, whereby foreign countries would, over time, gain the ability to exclusively control the deployment of additional capacity on Australian international routes by Australian carriers, airlines of its country, as well as airlines of third countries seeking to serve Australia via another country. Consumers may be disadvantaged if this led to a reduction in choice and/or quality of air services on particular international routes. As a corollary, the paper states that the pursuit of further liberalisation within the bilateral framework has the greatest potential to deliver net benefits for the Australian community, while the Australian Government continues to explore opportunities for a multilateral approach to liberalisation in relevant international forums.

The 2015 Research Paper subsequently suggests, however, that it would be beneficial if foreign airlines were granted unlimited access to Australia's major gateways through the extension of the regional package. This position would appear to contradict the dangers of unilateral reform as previously outlined in the paper. Whether implemented through domestic reform, or within the bilateral framework by amending the rights available to foreign carriers under Australia's air services agreements with other countries, the practical effect and associated costs of giving foreign carriers unrestricted access to Australia's airports are the same.

Recommendation 8.2 would impose heavy costs on Australian airlines and consumers. These costs will stem from the Australian Government's loss of leverage that would have otherwise been used in future air services negotiations to obtain additional rights for Australian carriers. This is not a theoretical concept, based on Virgin Australia's observations as a member of the Australian Government delegation at these negotiations. The rights available to Australian airlines under Australia's bilateral arrangements would effectively be frozen in time, as long as the global bilateral framework remains in effect. It is highly probable that the bilateral system will remain in place for the foreseeable future, consistent with the International Civil Aviation Organization's views on liberalisation as noted in the 2015 Research Paper:

“...while momentum is building towards more open or even full market access between and among States, some States remain reluctant to endorse full liberalization of markets or to go beyond the bilateral approach towards a multilateral agreement for exchange of traffic rights. Some of the factors impeding liberalization include a lack of awareness of, or confidence in, the benefits of market opening, a lack of political will by some governments, and in some cases, the influence of some airlines over government decision making”.

In fact, some countries are retreating from liberalisation and seeking to introduce notions of “fair competition” into bilateral agreements, as noted in the Department of Infrastructure and Regional Development's submission to the Barriers to Services Exports Issues Paper.

It is important to note that such negotiating leverage is not used by the Australian Government to protect Australian airlines from competition. Rather, it is used to support the settlement of a package of outcomes capable of delivering the greatest benefit to the broader Australian economy. This includes securing rights which will allow Australian carriers to expand into new international markets, over both the short and long term. In this regard, we wish to highlight that Virgin Australia supports the liberalisation of Australia's air services agreements, in accordance with negotiating approaches which seek to balance short-term considerations in any particular market with long-term factors that have the potential to impact the sustainability of Australia's aviation and tourism sectors.

The Draft Report suggests that the loss of any leverage associated with restricting access to Australia's major gateways should not be overstated and notes that Australian airlines are currently not utilising capacity available under many of Australia's bilateral arrangements. This is a short-sighted view which fails to appreciate that global passenger and trade flows are constantly evolving and have shifted significantly over time, and that access to Australia's major gateways (including secondary airports such as Avalon Airport and the future Western Sydney Airport) is an extremely valuable right for foreign airlines. The emergence of the Middle East as a significant hub for passengers travelling to and from Australia over the past decade is a key example in this regard. To remain globally competitive, Australian airlines must have the ability to adjust their operations in response to these changes and this depends on the Australian Government having sufficient leverage, both now and into the future, in order to obtain the essential rights under Australia's air services agreements to support such services. While Australian airlines may not be using all of the entitlements available to them under these agreements at the present time, the dynamic nature of the global aviation market may see these rights utilised in the future.

While the Draft Report acknowledges that the Australian Government may seek to negotiate "other access rights" for Australian carriers, it would seem that the significance of such rights has been overlooked, as the document's analysis of further liberalisation is squarely focused on capacity. Other rights encompass traffic rights, which are fundamental to the commercial operation of any route as they specify an airline's ability to uplift and discharge passengers, including in connection with the exercise of fifth freedom rights at intermediate and beyond points. It is worth noting that Virgin Australia alone is using traffic rights under 53 of Australia's 94 bilateral air services arrangements and is seeking the negotiation of new or additional rights with 13 countries in order to support our commercial plans.

The sustainability of Australia's airlines depends on an ability to access new sources of growth in both the international and domestic aviation markets, which are inextricably linked and of vital importance to Australia's tourism industry. It should be noted that Australian airlines play a central role in facilitating domestic tourism, which contributes 70% of total tourism expenditure. Domestic air services not only facilitate visitation to Australia's major cities, but also regional centres, where around 46 cents of every tourism dollar is spent.² Accordingly, Recommendation 8.2 would weaken Australia's aviation and tourism sectors, both of which are significant sources of economic growth and employment.

Some of Australia's bilateral agreements include limits on the number of services that may be offered to any one of the major gateways, which acts as an incentive for airlines to consider the operation of flights to Perth in circumstances where capacity available to the major gateways on the east coast is fully utilised. In this way, the current policy settings can support a broader dispersal of economic benefits across Australia. Granting unrestricted

² Robb A (Minister for Trade and Investment), *\$66 million for regional tourism*, media release, 31 May 2015, viewed 18 September 2015
<http://trademinister.gov.au/releases/Pages/2015/ar_mr_150531.aspx>.

access to all the major gateways may see services to Perth scaled back if it would be more commercially attractive to redeploy aircraft on routes to Brisbane, Sydney or Melbourne.

The Draft Report acknowledges that benefits to be gained from providing foreign airlines with unrestricted access to Australia's major gateways will depend on the extent to which current bilateral arrangements are constraining market behaviour. Virgin Australia would highlight that there are currently no markets in which existing bilateral arrangements prevent airlines from introducing new or additional capacity to Australia. Under almost all of Australia's bilateral agreements, there is sufficient capacity available to support the introduction of new services to the major gateways – consistent with the Australian Government's policy of seeking to keep capacity ahead of demand. Accordingly, providing unrestricted access to all Australian airports, as proposed by Recommendation 8.2, will not boost competition nor simplify airlines' route network decisions. It is therefore difficult to understand how Recommendation 8.2 is capable of delivering any meaningful benefits. In practice, it would seem that maintaining capacity restrictions at Australia's gateway airports does not represent a barrier to tourism exports at all.

For almost all markets, an airline's ability to introduce new services to Australia will be determined by commercial factors rather than regulatory restrictions. Reforms which have the potential to boost the commercial performance of international air services to Australia, such as increased oversight of airport pricing and facilitating greater competition in jet fuel supply, are much more likely to deliver net benefits to the Australian community.

In Virgin Australia's assessment, Recommendation 8.2 is premised on a gross underestimation of the contribution that Australian airlines make to the tourism sector, as well as the broader economy. Its adoption would impose heavy costs on the community by jeopardising the economic benefits that Australia's aviation and tourism industries deliver, in return for almost no benefit. Recommendation 8.2 also fails to recognise that Australia's international aviation policy settings, which are among the most liberal on a global basis, continue to serve Australia's tourism industry well, by balancing the interests of all key stakeholders.