

SA GOVERNMENT SUBMISSION
TO
THE INDUSTRY COMMISSION INQUIRY
INTO
INTERNATIONAL AIR SERVICES
FEBRUARY 1998



INTRODUCTION

- 1.1. The Industry Commission (“the Commission”) has invited the South Australian Government (“the Government”) to make a written submission to the Commission’s Inquiry into International Air Services. The Commission is to examine and report on:
- the effect of the current bilateral system of international air service agreements on competition, both in the global market and on Australia’s existing and potential aviation markets;
 - whether the International Air Services Commission allocation process provides net benefits to Australia’s existing and potential aviation markets;
 - the impact of the current arrangements on tourism, consumers, air freight and the aviation industry;
 - the importance of availability of airport infrastructure to negotiations in the trade of air services; and
 - the options for improving current arrangements, both within the bilateral system and outside the bilateral system.
- 1.2. Section 2 of this submission provides a summary of the key issues addressed in the submission.
- 1.3. Sections 3 to 5 provide necessary background about the development of international air services through Adelaide Airport, the characteristics of the South Australian international air passenger and freight markets, and the economic contribution of Adelaide Airport.
- 1.4. The remaining sections then provide comments on the Government’s particular interests in the issues under examination by the Commission in the context of this background.
- 1.5. The first point of contact for discussion of any of the issues contained in this submission should be:

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EXECUTIVE SUMMARY

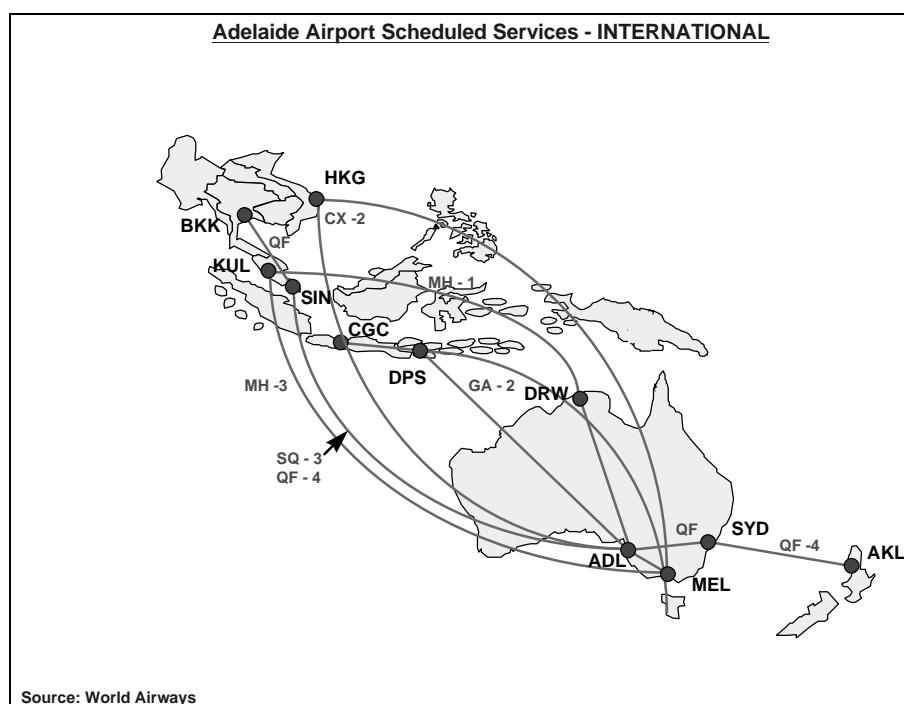
2. Key issues of this submission

- 2.1. South Australia seeks a mix of direct international flights through Adelaide and domestic connecting services to other hub gateways.
- 2.2. Core international direct flights provide benefits related to increased passenger spend at Adelaide Airport, export facilitation, investment attraction, niche tourism development and enhanced credibility of the State as an international destination and place to do business.
- 2.3. Because of the characteristics of the South Australian international passenger market which differ markedly from the national market, and industry changes taking place which favour primary hub gateways, direct international service growth is likely to be slow.
- 2.4. This difficulty is exacerbated by high opportunity costs of operating to secondary gateways inherent in the current regulatory system.
- 2.5. The Government is focussed on increasing international air access to Adelaide through a strategy of:
 - facilitating the removal of airport infrastructure constraints;
 - ensuring, through liaison with the Commonwealth, that an operator is selected for Adelaide Airport with the same focus;
 - working directly with shippers, forwarders and airlines (and the new airport operator when it is appointed) to demonstrate SA's potential passenger and freight markets;
 - offering cooperative assistance in the marketing and promotion of new services and otherwise working to increase destination passenger demand for Adelaide; and
 - seeking to influence the Commonwealth's adoption of policies in relation to international air service regulation which lower the opportunity costs of operating to secondary gateways and promote regional development.
- 2.6. The last of these is encompassed in the Commission's Inquiry and this submission suggests measures which could be implemented within the existing bilateral structure to liberalise capacity, enhance competition and encourage the spread of international services throughout Australia.
- 2.7. The submission suggests a number of measures are necessary because of the unlikelihood of more substantial multilateral reforms on GATS/WTO principles in the near term. These measures are:
 - streamlining of passenger and freight charter approval processes;
 - free exchange or granting of 3rd and 4th freedoms in freight services;
 - relaxation of cabotage to allow carriage of export air freight on some domestic sectors of international flights;
 - interim liberalisation of access, capacity and code-sharing to secondary gateways while retaining the current regime at primary gateways until more general liberalisation can be achieved;
 - consideration of a market solution to gateway access based on the purchase of landing slots.

BACKGROUND

3. International air services development through Adelaide Airport

- 3.1. Following a decision by the Commonwealth Government to develop Adelaide Airport as an additional international gateway, approval of expenditure to construct an international terminal was given by the Commonwealth Parliamentary Standing Committee on Public Works in March 1982. International flights to Adelaide commenced in November 1982 when Qantas and British Airways implemented a total of 9 flights per week.
- 3.2. Singapore Airlines commenced services in April 1984 and thereafter the number of international airlines serving Adelaide remained at three until 1989. Between 1989 and 1993 new services were implemented by Japan Airlines (jointly with Qantas), Britannia Airways (charters only), Air New Zealand, Malaysia Airlines, Garuda Indonesia and Cathay Pacific Airways.
- 3.3. These gains were offset by service withdrawals and frequency adjustments so that scheduled flights now number 19 per week by five airlines: Cathay Pacific (2), Qantas (8), Garuda (2), Malaysia Airlines (4) and Singapore Airlines (3). Present routes, airlines and frequencies can be mapped as follows:



- 3.4. The factors which resulted in certain service gains and losses are discussed in the body of this submission.

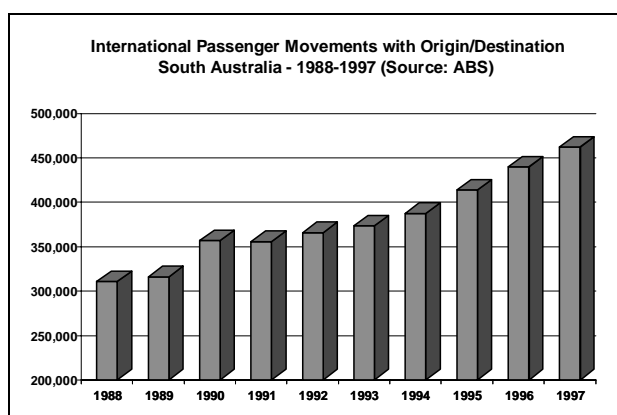
4. Characteristics of SA's international aviation market

Passenger market

- 4.1. In 1997 (year to September 1997) international passenger movements, at about 214,000, accounted for only 6% of Adelaide Airport's total passenger movements, and international aircraft movements 3% of total scheduled aircraft movements.
- 4.2. International passenger movements through Adelaide Airport over the past ten years showed strong growth during the period 1988-1993 when air service growth was greatest. Movements declined thereafter as a result of Qantas' policy to hub international traffic through Sydney made possible by the integration of Australian Airlines and Qantas, withdrawal of British Airways flights in March 1995 following its joint service agreement with Qantas, and withdrawal of Air New Zealand flights in April 1996:



- 4.3. However, the indirect movement of South Australian international traffic through other gateways accelerated after 1993:



- 4.4. That is, despite the decline in international passenger movements through Adelaide Airport, total South Australian international origin/destination passenger movements showed steady growth and reached about 462,000 in 1997. So, while international passenger movements through Adelaide Airport *declined* by an average of 2% per year over the last four years, total South Australian international origin/destination passenger movements *increased* at 5% per year.
- 4.5. The consequence of this is that the percentage of total international passenger movements with origin/destination South Australia using Adelaide as their gateway declined from a high of 63% in 1993 to only 46% in 1997.
- 4.6. Two further characteristics of the South Australian international passenger market need to be identified as background to the issues under examination by the Commission, before making specific comment on those issues:
- 4.6.1. The ratio of Australian residents to foreign residents on international flights through Adelaide Airport is roughly 60:40, while for Australia as a whole the ratio is reversed at 40:60. This means that South Australia at present relies disproportionately on a relatively fixed (and small) resident market to support international services. Visitor growth is now outstripping resident growth quite significantly so the South Australian market will conform more closely to the national mix over time. Until then, total international passenger movement growth is likely to be slower than the national average. Increased international passenger services through Adelaide consequently will be harder to achieve.
- 4.6.2. The other factor on which the South Australian market differs markedly from the national one is the origin and destination of its international passenger traffic. South Australia is extraordinarily dependent on the mature markets of Europe and on the UK in particular. Europe accounts for 46% of Adelaide's traffic while the equivalent figure for Australia as a whole is only 20%. North Asia traffic only contributed 13% of the Adelaide total, but fully 24% of the national total.
- 4.6.3. The UK is presently by far the State's biggest origin/destination market and constitutes 27% of international passengers uplifted and discharged at Adelaide Airport. All five international airlines serving Adelaide compete vigorously for this market and are to varying extents dependent on it. However, UK-SA origin/destination traffic growth over the last 5 years has averaged only 2% per year - which also suggests that Adelaide international service growth will be slow.

- 4.6.4. South Australia's weakness in the north Asian markets of Japan, Korea, Taiwan and China, which, until recent economic events fundamentally changed their air passenger market characteristics were contributing most of the growth in Australian air passenger movements, is a severe handicap in achieving direct air services between them and Adelaide. At the same time, the lack of direct air services will remain a significant impediment to the State achieving sustained visitor growth from those markets when economic conditions recover.

Freight market

- 4.7. A similar proportion of South Australia's international freight exports exit from other Australian gateways as has been demonstrated for the State's international passenger market. The situation is dissimilar, however, in that domestic flights from Adelaide to other gateways do not provide the alternative to direct flights that they do for passenger movements. Domestic flights between Adelaide and the primary freight gateways of Sydney and Melbourne are all operated with narrow-bodied aircraft such as the Boeing 737 and Airbus A320, neither of which is capable of carrying freight unit load devices for export.
- 4.8. In 1996/97, 56% of the State's air freighted export total of 20,400 tonnes was transhipped, mostly by road, to international flights out of other gateways. Only 6 major markets accounted for over 75% of the State's total air exports, and nearly 80% of exports to those markets consisted of 4 perishable product groups: seafood, meat, fruit and vegetables, all of which, to a varying extent, require fast market access to maximise their value.
- 4.9. Only 39% of products exported to the State's 6 largest markets secured space out of Adelaide Airport. 74% of products to Japan were transhipped, mostly via Sydney which requires a 20 hour road time from Adelaide, because of difficulty in securing air freight capacity to Tokyo out of Adelaide Airport. 4,300 tonnes of the State's total 6,300 tonnes exported by air to Japan in 1996/97 consisted of fresh chilled tuna.
- 4.10. Transshipment via other gateways imposes costs of the deterioration in market value of some products caused by additional transport time required to reach the markets. Transport SA, in consultation with industry, undertook case studies in 1995 of representative products exported from South Australia. The studies estimated that the cost per day of additional transport time is in the order 25% of FOB value for melons, 30% for cherries, 15-30% for fresh meat and 15% for fresh chilled tuna. This does not include any additional freight costs of transshipment. These are difficult to calculate because additional road freight costs may be absorbed by the carrier, or partially or totally offset by lower air freight costs prevailing at the other gateways as a result of excess air freight capacity available there.

- 4.11. Based on the FOB value of the quantities of these products transhipped by Melbourne, Sydney, Brisbane and Perth in 1996/97, and assuming that transshipment added an average of 1 day to total transport time, transshipment cost South Australian exporters of these products alone about \$9 million:

Time-Value Economic Cost of Transshipment of Representative SA Exports			
1996/97			
Product	FOB Value (\$)	Cost per Day	Economic Cost
	Transhipped	% of FOB(\$)	(\$)
Melons	94,148	25%	23,537
Cherries	102,910	30%	30,873
Fresh Meat	21,441,575	15%	3,216,236
Fresh Tuna	38,381,235	15%	5,757,185
Total	60,019,868		9,027,832
Source/ABS/Maritrade/Transport SA			
Assumes average 1 day additional transport time for transshipment			

5. Economic contribution of Adelaide Airport

- 5.1. The total contribution (direct and indirect) of Adelaide Airport to the State's GDP was calculated by Professor Michael Burns¹ in 1993 as about \$311 million, measured in 1989 prices, or about 1.3% of then State Product. He estimated the employment of 2,700 persons directly associated with the airport generated a further 5,700 jobs in the State, and that airport activity had generated more than 1,600 additional jobs in the local economy since 1989 when he had first estimated the airport's economic impacts.²
- 5.2. The importance to the State's economy of Adelaide Airport's contribution is self-evident from these figures. The Government has sought to maximise it by advocating policies to the Federal Government that aim to ensure the airport's most effective integration into the regional economy. These have included the facilitation of terminal and runway infrastructure necessary for the airport's efficient operation as an international gateway; advocating selection of a future airport operator with a single-minded focus on the development of the airport in its own right rather than as part of a national network; and systematically setting about facilitating better international air access to the State.
- 5.3. A mix of direct international air services through Adelaide Airport and connecting services to the much greater range and frequency of international services available out of other Australian gateways, is seen by the Government as essential. International air services provide direct market access for the State's air freighted exports, the ability to compete effectively in international tourism markets and they facilitate international investment in the State.

¹ Burns, M (1993) "Adelaide International Airport Socio-Economic Impact"

² Burns, M & Associates (1989) "The Socio-Economic Impact of Adelaide International Airport"

- 5.4. The Government's role in relation to infrastructure development at Adelaide Airport to make international air service growth possible has included taking the lead in demonstrating the need for terminal and runway development, leading discussions with the Commonwealth, Federal Airports Corporation and airlines to suggest design concepts and funding models, and, in the case of the runway extension, providing seed funding to expedite the commencement of works.
- 5.5. The Government anticipated early in the Commonwealth's airport leasing process the importance of securing a new operator for Adelaide Airport whose objectives coincided with those of the State. The Government has been proactive, and reasonably successful, in urging the Commonwealth to take account of regional economic development issues, and the bidders' delivery of programs that support regional initiatives, in its assessment of the bids.
- 5.6. The Government's focus throughout has been on facilitating increased international air access to Adelaide through these and more direct means. More direct efforts have included the demonstration of the potential passenger and freight markets to prospective airline operators, offering cooperative assistance in the marketing of new services and seeking to influence Commonwealth Government policies in relation to the provision of access and capacity to Adelaide in air service agreements with foreign governments.
- 5.7. The issues under examination by the Commission are integral to these efforts and therefore require comment by the Government.

ISSUES FOR THE INQUIRY

6. The Current regulatory framework

- 6.1. The bilateral system of air service agreements, to the extent to which they act to limit capacity and/or frequency which foreign airlines may operate to Australia, impose opportunity costs on those airlines operating scarce capacity to secondary gateway airports like Adelaide.
- 6.2. That is, as long as the capacity available to a foreign carrier is less than the amount of total capacity it wishes to operate to Australia, then the effect of that will be to concentrate the airline's services on the highest yielding airports. Scarcity of capacity will act to discourage airlines either from implementing new services to secondary airports, or expanding existing services to them.
- 6.3. The Government has therefore urged the Commonwealth Government, as long as the current regulatory framework remains in place, to treat secondary airports differently. The Government has advocated use of the regulatory framework as a means to deliver Commonwealth policy objectives of spreading the benefits of international air access more widely throughout Australia and thereby facilitating regional development.

- 6.4. This can be achieved in a number of ways, but most obviously by taking steps to lower the opportunity cost of using capacity at secondary gateways. This requires either removing limits on capacity generally, or, more achievably in an environment where the bilateral partner may be disinclined to reciprocate, making capacity available specifically for use at secondary gateways while demanding no or minor benefits from the bilateral partner in return.
- 6.5. That means a carrier, like Singapore Airlines, for instance, which operates a limited number of services to Adelaide but whose priorities are to expand services at the larger gateways, will be more inclined to maintain Adelaide direct services providing they deliver commercially sustainable yields. As long as sufficient capacity remains available for its expansion elsewhere, it will be less inclined to seek to redirect its Adelaide capacity.
- 6.6. Removing capacity restraints altogether would of course have the same effect except that secondary gateways would then be faced with an increase in the opportunity cost of scarce equipment (aircraft). An “open skies” regime, at least initially, would probably for this reason also result in a concentration of services at the larger gateways. Foreign carriers with a limited number of aircraft available for Australian operations and complete freedom to operate them where they chose, would be unlikely to seek opportunities at the secondary gateways, at least until congestion costs at the major gateways rose sufficiently to force them to (or until competitive pressures at the major gateways resulting from the operation of excess capacity had the same effect).
- 6.7. The Government maintains that Commonwealth objectives of achieving a wider spread of international air services throughout Australia require implementation of more proactive policies. It has consistently suggested that these must include lowering the opportunity costs of operating to secondary gateways through either of the means suggested above.
- 6.8. The Government has advanced this view by direct correspondence between appropriate Ministers, and through use of the existing consultative mechanisms. The Commonwealth Department of Transport and Regional Development’s Aviation Policy Division, which is responsible for the conduct of air service negotiations between governments, is scrupulous in seeking the views of the States and their stakeholders. It does so both directly through contact with State Transport Departments and indirectly through consultative forums such as the Tourism Aviation Group chaired by the Commonwealth Department of Industry, Science and Tourism which includes membership of State tourism and transport agencies.

- 6.9. Although significant changes, such as the negotiation of ‘development routes’ to secondary gateways, dual designation, separation of freight entitlements and general expansion of capacity ahead of demand in many agreements have occurred, the fact remains that the present bilaterally regulated system is unwieldy, expensive to administer and unable to respond quickly to the rapidly changing industry environment.
- 6.10. Although the remaining restrictions on capacity, frequency and route entitlements contained in the agreements are often “airline driven” in the sense that they attempt to anticipate market conditions and the capacity and route intentions of the airlines, because of the increasing rapidity of the rate of change in airline intentions, they may fail to keep pace. That failure may be, and often is, the fault of the bilateral partner rather than the Commonwealth.

7. Recent developments in international air services

- 7.1. The integration of Australian Airlines and Qantas in 1992 resulted in Qantas’ decision to rationalise its international services at Adelaide and to develop effective domestic connections to and from other gateways as its primary means of serving the Adelaide international market. Qantas has made virtually no change to its international schedule at Adelaide since then and its planned implementation of a fifth direct Singapore flight in August 1998 is the first indication of any change to its hubbing policy.
- 7.2. The decision to add the fifth flight may be partly a result of Qantas’ increasingly close commercial relationship with British Airways, which now includes the ability to code-share on each other’s flights. Although the rationalisation of schedules between Qantas and British Airways which followed the formation of its Joint Services Agreement in 1994 resulted in the withdrawal of British Airways’ twice weekly direct flights to Adelaide, the code-sharing of traffic between the carriers has been a factor in increasing traffic on Qantas’ direct Singapore flights to the point that increased frequency is justified.
- 7.3. However, the integration of Qantas and Australian Airlines and the formation of Ansett International which allowed both airlines to offer the Adelaide market a much wider range of flights and frequency to and from international markets than it could justify in itself, has done much to reduce the competitive disadvantage suffered by the State when interline add-on domestic fare sectors were necessary to reach Adelaide from other gateways.

- 7.4. Code-sharing in the absence of direct services has also reduced the competitive disadvantage. Such measures as Malaysia Airlines' code-sharing on Ansett flights to Melbourne and Sydney in order to increase the effective frequency it can offer, British Airways' code-sharing on Qantas flights which effectively allows British Airways to sell up to four flights per day to and from Adelaide, United Airlines and Air New Zealand code-sharing with Ansett, and probable future code-sharing between Singapore Airlines and Ansett, all work to increase international access to Adelaide and to increase demand for Adelaide as a destination.
- 7.5. So long as such measures ultimately work to increase direct international air services through Adelaide, they should be supported and encouraged. The Government is aware, however, of the significant risk that code-sharing and commercial alliances can have the opposite effect and lead to airlines withdrawing direct services in lieu of use of Qantas or Ansett domestic services to their flights at other gateways - as was the case with British Airways.
- 7.6. It is only through an adequate mix of direct international air services and domestic connections to gateway hubs that the State can have access to the significantly greater benefits that direct flights bring, including increased passenger spend at Adelaide Airport, export facilitation, investment attraction, niche tourism development and the general credibility of the State as an international destination and place to do business.

8. The nature of Australia's Air Service Agreements

- 8.1. Australia's geographical position has made it difficult to trade international air service entitlements on a reciprocal basis. The Asian carriers' access to 6th freedom traffic between Europe, North Asia, North America and even Africa and Australia has caused Australia to seek other benefits in Asian agreements than the reciprocal exchange of 3rd and 4th freedoms, for instance.
- 8.2. All four foreign airlines operating services to Adelaide airport compete aggressively for 6th freedom traffic, particularly to and from Europe. UK traffic forms an important component of each's total traffic.
- 8.3. The recognition of this and the Commonwealth's resulting success in achieving capacity imbalances in its favour and benefits of 'equivalent value' such as 5th freedoms between Asian countries have helped to mitigate the disadvantages of Australia's 'end of the line' geographic position. The exchange of like rather than reciprocal benefits, however, can only make the liberalisation of the regulatory framework more difficult to achieve on a comprehensive basis.

- 8.4. However, in the meantime, the less that agreements are based on strict reciprocity, the greater the opportunity the Commonwealth has to use the existing system to encourage a wider spread of international services throughout Australia. There seems to be little reason for maintaining so many route restrictions in the agreements for instance. Although agreements with over twenty countries include specific or unspecific entitlements for their airlines to serve Adelaide, more than twenty others do not. The inclusion of access to the secondary gateways in all agreements as a unilateral policy measure independent of the airlines' intentions, would go a long way towards removing any possible constraint to improving access to them.
- 8.5. Usually the entitlement to the gateway must be included in the air service agreement before a foreign carrier can even operate code-shared services to it. Given the speed with which airlines are seeking new code-sharing agreements, this is most important for secondary gateways to which foreign airlines are unlikely to operate services in their own right. There seems little reason why Adelaide should be excluded either specifically or because the number of allowed points in an agreement are fully utilised, in agreements including those with Austria, Canada, Greece, India, Italy, Korea, the Philippines, China, South Africa, Taiwan and Vietnam, for instance.
- 8.6. Of the four foreign carriers which presently operate direct services to Adelaide, all are constrained in one way or another by their countries' air service agreements:
- 8.6.1. Although the Singapore agreement includes provision for stepped increases in capacity until April 1999, Singapore Airlines' expansion plans in Australia and the effects of its alliance with Ansett which will increase its access to regional feeder routes, may well result in pressure on its use of capacity to Adelaide. If this proves to be the case, Singapore Airlines' ability to use Ansett domestic flights on a code-shared basis to other gateways could result in the withdrawal of Singapore Airlines' direct flights to Adelaide. If capacity were to be unconstrained, then the opportunity for Ansett to code-share Singapore Airlines' flights out of Adelaide might result in enough traffic to justify additional direct flights instead.
- 8.6.2. Malaysia Airlines may seek to increase Adelaide flights and to operate beyond to New Zealand. Depending on the type of aircraft it chooses to use it may be constrained by its overall capacity entitlement and its Adelaide route entitlement in its freedom to add flights. There is no provision in the Adelaide route schedule for carriage of 5th freedom traffic and it is doubtful if the present regulatory system can deal quickly and effectively enough with the issues to maximise the chance of their realisation.

- 8.6.3. Cathay Pacific also operates close to the capacity limits in the Hong Kong agreement. Again, expansion plans elsewhere in Australia are likely to place pressure on its use of capacity to Adelaide and to increase its opportunity cost.
- 8.6.4. Garuda already fell afoul of the regulatory system when it implemented a third flight to Adelaide in March 1993. The air service agreement with Indonesia included a separate route entitlement to Adelaide and a two-flight frequency cap within its over-all capacity entitlement. Garuda was forced to withdraw the flight in May 1993. The Adelaide frequency limit has since been increased to three flights which could accommodate any immediate intention by Garuda to add a flight to the two it presently operates to Adelaide, but it is difficult to see any justification for the limitation of capacity to any secondary gateway in any agreement.
- 8.6.5. Cathay Pacific is permitted to carry own-stopover traffic between Adelaide and Melbourne and Malaysia Airlines between Adelaide and Darwin, but neither Garuda nor Malaysia Airlines is entitled to do so between Adelaide and Melbourne under the Malaysia and Indonesia agreements.

9. Access to airport infrastructure

- 9.1. The Government's role in ensuring the removal of infrastructure restraints at Adelaide Airport has been noted in Section 5.
- 9.2. The Government took this role because it saw development of airport infrastructure as crucial to the State's opportunity to export efficiently and competitively, and otherwise internationalise the State's economy. The FAC was required to make airport infrastructure investment decisions on the basis of the hurdle rates of return that the investments would deliver to the Corporation, and even when proposed investments at Adelaide Airport were demonstrated to meet these hurdles, capital rationing across the network ensured that investment was undertaken in the larger airports in projects delivering higher rates of return.
- 9.3. The Government was concerned that making investment decisions on this basis took no account of wider economic benefits derived from profits to businesses and the flow-on employment and consumption opportunities throughout the economy that they generate. So that while the cost of the runway extension at Adelaide Airport, for instance, would exceed the returns the airport operator could obtain, the Government demonstrated that it was justified because it did not exceed the total economic benefits it would deliver to the State.

- 9.4. These benefits are obtained not from the infrastructure itself of course, but from the additional air services that the infrastructure makes possible. The regulatory environment under examination by the Commission, as indicated elsewhere in this submission, is an import factor in the realisation of opportunities to increase air services at Adelaide.
- 9.5. Airport infrastructure constraints in Japan directly inhibit the achievement of air freight services between South Australia and Japan. Because of vertical integration of the tuna wholesaling and domestic transport industry in Japan, tuna imports into Japan are concentrated predominantly in Tokyo. Australian carriers are constrained in the amount of capacity they can direct to Tokyo by the availability of slots at Narita Airport, and their consequent value to the carriers precludes their use for freight flights.
- 9.6. This means that air freight between Australia and Japan is carried almost exclusively on passenger flights. Since South Australia has been unsuccessful in attracting passenger flights between Adelaide and Tokyo, South Australia's largest single air freight export market is almost devoid of any direct capacity and 74% of its exports are transhipped by road to passenger flights out of Sydney. The economic cost of this is suggested in Section 4.
- 9.7. Because of the amount of freight flowing in both directions between South Australia and Japan, without this infrastructure constraint, and given the right regulatory framework, freighter flights on a charter or scheduled basis would be commercially viable.

10. The role of the International Air Services Commission (IASC)

- 10.1. The Government believes that the IASC's criteria and procedures for allocating capacity between Australian carriers as set out in the Federal Minister's Policy Statement have resulted in efficient and effective outcomes.
- 10.2. The Government supports the change to the Policy Statement that allows freight services to benefit from start-up phase provisions previously applying to passenger services only.
- 10.3. However, it is clear that the process of capacity allocation, while imposing some competitive discipline on Qantas as the major Australian international carrier, also offers it substantial advantages. This is because the IASC is required to assess the allocation of capacity on a route by route basis while the ability of a new entrant to operate commercially sustainable services may depend on allocation of capacity on several routes.

- 10.4. So even though the “*pre-eminent consideration is to introduce competition on the route through allocating to an initial new entrant a level of capacity appropriate to the development of efficient, commercially sustainable operation*”³ in the start-up phase of a route, that level of capacity is considered in isolation. Commercial sustainability on a single route may require a much higher level of frequency than that required in the context of a wider network.
- 10.5. Further, the incumbent airlines have other significant advantages over new entrants relating to the costs of entry on a route which suggest that a commercially sustainable allocation of capacity will be lower for the incumbents than for new entrants.
- 10.6. A single route consists of “*All the combinations of origin, destination, intermediate and beyond points available to Australian carriers under the bilateral arrangement*”⁴. That is, although capacity is allocated on a country-pair basis by the IASC, the benefits competing applicants attempt to demonstrate to justify allocation of capacity to them may be based on proposals to operate specific city-pairs.
- 10.7. The Government does not suggest that compelling successful applicants to operate specific city-pairs would constitute sensible commercial practice. It would be unlikely to result in efficient allocation of capacity and would not necessarily enhance competition. Nevertheless, if the IASC’s allocation is made on the basis of claimed benefits to be generated through the operation of a specific city-pair, then there is certainly a case to be made for the capacity to be allocated to that city-pair. If, for competitive or other reasons the applicant then wished to operate the capacity over a different city-pair, the IASC could require return of the capacity as “shelf capacity” or could compel the applicant to re-justify its allocation on the basis of the benefit to be generated over the new city-pair(s).⁵
- 10.8. Another suggestion is that if a carrier withdraws from a route with no shelf capacity it should return its capacity to the shelf prior to the expiry of its determination. The capacity could then be advertised. If the withdrawing carrier wished to re-enter the route and no other carrier had applied for allocation of the capacity in the meantime, then it could do so under its original determination.

³ International Air Services Commission Act 1992 Section 11 Policy Statement 23 April 1997

⁴ International Air Services Commission Act 1992 Section 11 Policy Statement 23 April 1997

⁵ An example of this was the initial allocation of Kansai capacity on 1993 to Qantas and Ansett. Both sought to demonstrate regional benefits of operating Darwin flights in their applications. Neither implemented Darwin flights after award of the capacity.

11. Options for reform under the bilateral system or multilaterally

- 11.1. Professor Christopher Findlay has summarised a range of policy options suggested in recent reports and papers in a paper prepared for presentation to the Institute of Southeast Asian Studies APEC Roundtable 1997⁶.
- 11.2. The options include policies which could be implemented both within the existing bilateral structure, and on a multilateral basis.
- 11.3. Multilateral reform through inclusion of air services in the General Agreement on Trade in Services (GATS) or on World Trade Organisation (WTO) principles would clearly be the most complete means of removing constraints on airlines' freedom to compete with each other across borders by entering new routes, constructing new networks and optimising their costs. However, it is also clear that some APEC members will continue to oppose this degree of liberalisation so that it is unlikely to be achievable in anything but the very long-term.
- 11.4. It appears more likely that present trends towards inclusion of air services in regional multilateral trade liberalisation will continue instead, but regional liberalisation of trade in air services in isolation risks capture by anti-competitive airline interests. Findlay suggests that this, and the fact that some APEC members are unwilling to proceed as rapidly as others with liberalisation, makes it important that any regional liberalisation bloc allows entry of new regional members on the same basis as foundation members. This would allow pro-reform countries, including Australia, to proceed unconstrained by countries which oppose reform while at the same time placing pressure on the latter to accelerate reform programs and join the bloc at a later date.
- 11.5. In view of the long period likely to be required for substantial multilateral liberalisation, the Government has focussed on the reform options available within the existing structure that can be implemented by the Commonwealth either bilaterally or unilaterally as steps towards more substantial reform:
 - 11.5.1. The Commonwealth has already taken steps to liberalise the approval of passenger and freight charters which is reflected in its amendment to the Air Navigation Act 1920⁷. Section 15D of Schedule 1 of the Amendments lists public interest matters which the Secretary must have regard to in considering approval of charter flights, including the promotion of trade and tourism and whether the charter program includes a wide range of places that will be served in Australia.

⁶ Findlay, C (1997) "The APEC Air Transport Schedule"

⁷ Aviation Legislation Amendment Act (No. 1) 1997

- 11.5.2. However, charterers continue to criticise the length of time necessary to gain approval of their programs under this legislation which suggests that there is scope for the Commonwealth to streamline its procedures. Charterers cite specifically the onerous requirements that passengers be indemnified against failure of the charter operator (Section 15C(2)), and the fact that the charter operator rather than the charterer must make application for approval of a program (Section 15B(1)).
- 11.5.3. The Commonwealth has also already taken steps to expand the negotiation of separate freight entitlements within bilateral agreements. This could be extended to include free exchange of freight 3rd and 4th freedoms, or granting them on a unilateral basis to encourage the operation of freight services free of capacity limits or the requirement to convert passenger entitlements to freight.
- 11.5.4. The Commonwealth could consider lifting cabotage for the carriage of export freight over certain domestic sectors. For instance, any unused freight capacity on the Adelaide-Melbourne sectors of foreign carriers' flights could be utilised to tranship export freight to other carriers in Melbourne. The national carriers are not equipped to carry unit load devices (freight containers) on this route. Similar consideration could be given to other city pairs such as Cairns-Brisbane or Darwin-Cairns.
- 11.5.5. The Commonwealth could grant free availability of own-stopover rights for foreign carriers between ports in Australia. This would facilitate joint tourism product packaging between States, augment traffic on international flights at secondary gateways and encourage foreign carriers to operate to a wider range of gateways.
- 11.5.6. "Open skies" could be permitted at secondary airports. Retaining the current regime for hub airports while liberalising code-sharing rules and introducing more liberal availability of capacity and route entitlements to secondary airports has been suggested by Professor Tae Hoon Oum of the University of British Columbia⁸ as a short-term measure in the long-term achievement of an open-skies regulatory environment. While this suggestion was made in the context of discussion about the need for intra-Asian aviation liberalisation, it is more-or-less the policy that the Government has urged the Commonwealth to adopt for some time⁹.

⁸ Tae Hoon Oum, (1997) "Challenges and opportunities for Asian airlines and governments, Pacific Asia Transport", Institute of Southeast Asian Studies

⁹ See Section 6

- 11.5.7. Lastly, Findlay has suggested phased introduction of a landing slots-based system called “landing slots plus” (LSP)¹⁰. The system would be based on the purchase and sale of landing slots at airports to approximate a market solution. This would ensure that scarce airport capacity is ultimately used by the most profitable (and hence most efficient) carriers. Findlay suggested safeguards against monopolistic behaviour in his model.
- 11.6. By applying the LSP system at all gateways, the Commonwealth could use it as a means to encourage wider distribution of international air services among the gateways, while at the same time ensuring that carrier decisions remain commercially based. By “grandfathering” slots for existing services and auctioning additional slots, both the level of congestion (and hence scarcity of available slots) and the commercial value of access to each airport would be reflected in the price of the slots. Secondary gateways, so long as they had sufficient infrastructure, might have slot prices approaching zero.
- 11.7. Or, as a matter of policy, secondary gateways (which might be defined as all gateway airports, other than Sydney, not included in the first tranche of airport lease sales - ie, all gateways other than Brisbane, Sydney, Melbourne and Perth) might have slot prices set at or near zero according to their commercial value on particular routes to the carriers. This, in conjunction with liberalisation of capacity, would have the same effect as applying “open skies” to secondary airports suggested by Oum.
- 11.8. It is difficult to see this system operating usefully as a redistributive mechanism, however, in the absence of free availability of total capacity. If capacity remained constrained, while the opportunity cost of using capacity to secondary gateways would be reduced by an amount equal to the difference in the slot prices of the secondary gateway and the preferred gateway, this would be unlikely to be enough to change carriers’ gateway preferences.

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¹⁰ Findlay, C; Hufbauer, G & Gautam, J (1997) “Aviation Reform in the Asia Pacific”