

BRITISH AIRWAYS

SUBMISSION TO THE INQUIRY OF THE INDUSTRY COMMISSION INTO INTERNATIONAL AIR SERVICES

Introduction

This submission is made by and on behalf of British Airways Plc ("BA").

BA is a company registered in England. Its principal business is in the provision of domestic and international scheduled air services. It has significant share-holdings in a number of airlines, mostly in Europe but including a 25% share of Qantas.

The Industry Commission, in inviting submissions in respect of its inquiry, has asked particularly for information on four topics:

- the nature of existing arrangements governing international air services;
- the effect of these arrangements on competition both in the global airline industry and the Australian airline industry;
- the effects of these arrangements on various parts of the economy such as the Australian airline industry, passengers and users of freight services, tourism and hospitality service providers; and
- suggestions on how to improve existing international air services arrangements to generate net benefits for Australia.

Although British Airways has a significant and long-standing presence in Australia, it does not consider itself well placed to provide helpful comments in respect of purely Australian matters. This submission is largely confined, therefore, to general observations drawn from BA's own experiences. These comments tend to go across the topics generally, rather than focus on one at a time.

The merits and dangers of liberal bilaterals

BA believes that experience shows that the liberal workings of the marketplace are the best way of satisfying consumer demand in aviation as much as any other industrial sector.

This was really first demonstrated in the United States, where, prior to domestic deregulation in 1978, the CAB had sought to regulate the industry to ensure a good and well-priced range of services for travellers. This regulation included requirements for licensed airlines to maintain certain levels of service on particular routes and control of prices, to ensure no overcharging. Following deregulation, not only did very few routes lose service but fares tumbled. The CAB had simply been unable, through regulation, to emulate the achievements deregulated competition brought.

More recently we have seen the impact of deregulation in the European Union. For a number of reasons, not least infrastructural congestion, developments in Europe-have

been less dramatic than in the United States. The most obvious positive developments have been the introduction of competitive services in several domestic markets, most notably Germany, Italy and Spain; the recent growth in services by new low-cost competitors (for example, Debonair, easyJet and Virgin Express); and the cross-border acquisition of airlines (for example BA's acquisition of TAT and Air Liberte in France and KLM'S purchase of AirUK in Britain).

It is noteworthy that these recent developments have included the introduction of new low-cost competition in the UK domestic market. This is a market which was substantially deregulated some years before the wider EU liberalisation. But that deregulation had produced little significant development. The big change that EU liberalisation brought to the market was the opportunity for companies owned by citizens of countries other than the United Kingdom to commence services. Thus Irish-owned Ryanair and Greek-owned easyJet were able to enter the market and have done so. We see a similar pattern elsewhere with, for example, British Airways' subsidiary Deutsche BA providing competition in Germany and British-owned Virgin Express competing internationally out of Belgium.

Experience in liberalised markets shows the consumer benefits that removing regulatory constraints brings. This clearly raises the question of whether the best policy for a country to adopt towards bilateral agreements is not one of open skies. This is the policy that the United States would claim to espouse but its claim is disingenuous. Moreover the basis of its policy demonstrates the dangers there are in opening skies too freely.

The United States Department of Transportation has made clear its view that open skies, as it defines it, is beneficial to the country because it believes that in the competitive regime it brings about US airlines will be at a significant advantage in competition with others. In other words the policy is founded on an expectation that it will advance the interests and development of the US industry at the expense of others' industries. Although the DoT would not admit it, the likelihood of US airlines' success is strongly supported by the closed aspects of their 'open skies'

The US definition of open skies includes firmly closed domestic skies. Foreign airlines may not exercise domestic rights within the United States (nor may they get around this by obtaining significant ownership or control of a US airline since the United States limits ownership by foreigners in its airlines to 25% of the voting rights). This ensures that US airlines have a large competitive advantage. The size of this advantage can be seen in the comparative successes of UK and US airlines between the two countries. On routes where US and UK airlines compete the UK airlines attract over 50% of passengers whose air journeys start or finish at the US gateway but only 30% of passengers whose journey includes a domestic connexion within the United States.

The United States is inclined to argue that its definition of open skies is balanced since its partners also do not allow exercise of cabotage rights by foreign airlines and they generally restrict the nationality of ownership and control of their airlines. However,

such arguments are misleading. For example, US airlines, under their model of open skies would enjoy complete freedom to carry traffic between points in Europe, which in airline terms is the equivalent of domestic rights in the United States, which are denied non-US airlines. The United States, of course, argues that its open skies give foreign airlines unrestricted beyond rights (which are what US airlines exercise within Europe) but these rights are rarely of any value to non-US airlines because of the geography. And in respect of ownership and control, the United States applies an extremely narrow and strict test, compared with the often much more relaxed approach of other countries.

A danger which faces a country which decides to seek to liberalise its bilateral arrangements is that it will succeed with countries which expect to be at a competitive advantage, or to gain more in some way than they give away, but it will fail with countries where the competitive advantage would be likely to be with its rather than the other country's airlines. This would lead effectively to an exporting of aviation jobs and service provision.

Another danger, with the same ultimate consequence, is posed by the fact that many foreign airlines are state-owned and able, even encouraged, to act uncommercially. For competition to work properly all competitors should be motivated by the same commercial drive. If countries whose airlines are subsidised and/or behave without regard for an economic return on their activities are given unconstrained access to Australia, then the Australian industry will suffer.

Open skies will be successful without damaging the industry of one or more participants when the opportunities it provides to all parties are balanced and when the industries in all participating states are playing to the same rules. This is why deregulation in the domestic US market has been successful and why internal open skies within the European Economic Area have been substantially successful; the failures are due to the continued protection and subsidisation of their 'flag carrier' by some states.

Do these things matter if the result of opening skies is to give consumers a better deal? The answer to this question must depend upon the importance of aviation to the country concerned. The importance will include consideration of the direct and indirect impact on the economy of the travel generated by the air services provided and of the employment supported by the airlines. The more important aviation is to the country, the more important it is likely to be that its own industry is supported. It might be argued that this is not the case, since if the demand is there airlines will fill it whether they are national or foreign. However, consideration of recent developments in Korea should dispel too ready an acceptance of that hypothesis. Over the last few months, Korea has seen the withdrawal of many foreign airlines in response to its economic troubles. Thus Korea depends heavily on its own airlines to provide the services which it needs to aid its recovery. It can rely on them because they have no option but to struggle on and to make the best of the situation.

What the Korean example illustrates is the simple but over-riding fact that commercially driven airlines will place their assets where they will generate the best return. And their assets, aeroplanes, can be moved from one use to another almost overnight.

The needs of Australia

It appears to BA that aviation is of particular importance to Australia in view of both its geographic size and the relatively great distances from its neighbours. BA would expect, therefore, that Australia would wish to ensure that it retained a successful indigenous industry. At the same time Australia's geographic position makes it particularly vulnerable. Carriers such as SIA, MAS and Thai can provide services between Australia and Europe which are as good as anything that an Australian airline can do because non-stop services are not possible. And they can switch their aircraft to other routes at the drop of a hat if it suits them. These airlines have built up their business by bringing together many traffic flows and combining them to provide a level of service which the individual flows would not justify. Thus, for example SIA combines flows between a large number of places in southeast Asia and Australasia on the one hand and a number of places in Europe on the other, on routings through Singapore. It is easy for them to replace the Australian traffic if that becomes commercially attractive to them. Or, if business in one part of their network is soft, they may find it commercially attractive to dump seats in the Australian market, since the marginal cost of selling an empty seat on a flight which is going to go anyway is extremely small. In contrast an Australian airline because of its location is dependent almost entirely upon flows into and out of Australia and must charge economic rates for its seats. The relatively small size of the Australian market makes Australian airlines particularly vulnerable to the possible 'creaming off' activities of airlines which are substantially less dependent on the Australian market.

This means ensuring that liberalisation of Australia's bilateral air services agreements provides balanced opportunities which leave Australian airlines on at least an equal footing with others. Inevitably this will mean retention of traditional bilateral arrangements in respect of most of Australia's partners but that does not mean that the contents should remain the same. They should be liberalised as far as is possible, within the constraints of ensuring fair and equal opportunities for Australia.

In particular, the bilaterals should recognise the growing role of international alliances in the provision of air services. The growth of these alliances has been accelerating. This is because they provide consumers better with what they want: the ability to deal with, effectively, one single airline for a wide range of journeys. The US DoT, which is the regulator which has investigated these alliances to the greatest extent, has concluded that they enhance consumer welfare and consequently, unless there have been serious competition law concerns, they have approved them.

The industry has moved to meet consumer demands by the formation of alliances and other commercial agreements, rather than the more traditional internal growth or

merger, in large part because of the restrictions placed in the way of cross-border ownership. However, even avoiding that problem, there are uncertainties about the extent to which arrangements fit within the bilateral agreements. For example, some states consider that a code-sharing arrangement should be considered as though it comprised two operations, one by each of the partners, and each operation must be available within the agreed bilateral; others require only the operating carrier's service to be within the bilateral. It is important to the successful development of network airlines of a country that the bilateral agreements to which their government is party should provide them with the flexibility to enter into code-share and other partnership arrangements with any airline of their choice, subject only to normal application of competition law.

Distribution of bilateral rights between airlines

The effectiveness of a country's bilateral arrangements are also dependent upon the effectiveness of any internal arrangements for allocating the available capacity.

As a general rule, a country is likely to be best served by trying to ensure that sufficient capacity is available to meet the needs of all its airlines but that is not always possible. Where it is not possible, it will be necessary to allocate the available capacity between airlines. In these circumstances regulators are often tempted to allocate the capacity in a way which they think will bring about a particular, desirable market structure. BA believes that this is a mistaken approach which ultimately can damage, maybe irreparably, the state's industry. The past practices of the UK's Civil Aviation Authority (the CAA) illustrate this well. The CAA believes that consumers will be best served by a UK industry that is competitive within itself and with others. It has thought it necessary to try to support and to nurture the smaller airlines in order to foster such a situation and has therefore given them preference in the allocation of limited rights. The effect of this has been to disadvantage BA in its efforts to compete with its foreign competitors without actually achieving what was sought. Several of the favoured few have fallen by the wayside (for example, British Caledonian, Air Europe and DanAir) while other airlines, such as Virgin and British Midland, have thrived without special succour. It is best for regulators to make their choices by considering which airline will provide the best satisfaction of consumers needs and best strengthen competition with foreign airlines by being given the capacity at issue.

The administration of bilateral rights in Australia

As a last, specific point, BA would like to mention an experience it has had with Australian regulation which to BA appears to act against the best interests of both Australian airlines, their commercial partners and consumers.

In order to improve the efficiency and quality of service between Australia and the United Kingdom, BA and Qantas concluded a commercial agreement between them which included *inter alia* arrangements for code-sharing on each other's services. To be able to give effect to these arrangements, the two airlines needed changes to be

made to the Australia - United Kingdom bilateral agreement. They asked their respective governments for the changes, which both governments, having considered the airlines plans, agreed to. Because Qantas and BA operate their services between Australia and Europe in accordance with an agreement which has been authorised by the (then) TPC, they sought confirmation from the ACCC that implementation of their new agreement would not alter the situation with regard to that authorisation. The ACCC raised no objection, although it reserved the right to intervene later if developments required it. Notwithstanding the bilateral agreement, which permitted the code-sharing without impact on the capacity available to Australian airlines under the agreement, and the acquiescence of the Australian competition regulator, the IASC decided that it should also consider the matter. Not only did it do so but it came to a preliminary finding that the arrangements were against the public interest and should not be allowed. Although the ultimate finding reversed this position, the implementation of the agreement was delayed with adverse impact on service to the public and on the airlines involved.

It is British Airways' understanding that the IASC's primary function is to determine the allocation of capacity between competing Australian airlines. However, in this case, the Qantas application was not contested by any other Australian airline. Nor did Qantas' application raise real capacity issues; the code share arrangements are of a 'free sale' nature with no protection or blocking of seats.

In reality the regulatory approach actually disadvantages Australian airlines and their partners as if identical arrangements had been initiated by two foreign airlines, also with the appropriate bilateral rights, they would have been able to implement them immediately without any reference to the IASC.

It appears to BA that under these circumstances it was wasteful and unnecessary for the IASC to examine the agreement which had been specifically allowed for in the changes to the bilateral negotiated by the Australian government and which had the acquiescence, and was under the future oversight, of the Australian competition authority.

British Airways Plc