PREFACE

This submission is the response by the Department of Transport and Regional Development to the draft Report on International Air Services by the Productivity Commission issued on 18 June 1998. It provides some further policy perspectives and suggests some amendments to specific elements of the draft Report.

Amendments to the Appendices to the draft Report are factual and will be provided separately.

GENERAL COMMENTS

The bilateral "system" used by Governments in the trade of international aviation rights does not operate independently of the aspirations of its participants.

It remains the method universally adopted by Governments to manage aviation relations between nations and is a collection of thousands of individual judgements, each based on an assessment of national interest.

This very powerful and continuing focus on national interest underlines the difficulty of modifying bilateralism or operating outside it. Even with its unique economic power in world aviation, the United States still pursues its preferred form of liberalisation from within the safety of bilateralism, but fully focused on maximising US national interest.

Those states that have concluded "open skies" agreements with the US, did so because their national interest was best served by that decision. Very few of those states have negotiated "open skies" in their air services arrangements (ASAs) with either each other, or with other states outside the US "open skies" family (New Zealand is probably the clearest exception, but with little to show for that). Most of Australia's major trading partners generally remain opposed to "open skies".

For several decades, growth in the global trade of goods and services, improvements in aviation technology, the increasing trans-national interdependence of production and GDP growth in developed and emerging economies has strongly stimulated demand for air travel.

States have responded positively and directly to the challenge of accessing and growing international markets by liberalising their approach to the management of air services. Some states are more successful at this than others. Australia has been particularly successful.

Within the bilateral "system", successive Australian governments have instituted far-reaching reforms to put Australia "in front of the game". This process has been driven by a clear view of the national benefits implicit in open and competitive aviation markets and from increasingly exposing our

airlines to competitive forces. As a result, Australia ***is*** a leader in liberalisation and economic reform in this sector.

The evidence for this lies in the key areas of each bilateral:

- We have two large "home" carriers serving a market smaller than that of most other countries with more than one "home" carrier;

- We have a process designed to ensure that capacity cannot be hoarded and entry prevented by a dominant incumbent carrier;

- Australia has the most liberal foreign ownership levels of any substantial independent sovereign state in the world (New Zealand *followed* Australia up to the 49% level);

- we have a standing policy on offer to all countries to negotiate capacity such that it does not impede new services being added at the drop of a hat;

- of our top 5 markets, New Zealand, Japan, United Kingdom, United States and Indonesia, only Japan is capacity constrained, and this is not a result of Australian Government policy;

- two of our top five markets, New Zealand and the US, have capacity regimes that are either open or based on market driven formula for increasing capacity;

- our standing policy is not to regulate prices irrespective of the contents of the relevant ASA, we prefer to negotiate double disapproval clauses in ASAs where our bilateral partners will agree;

- we do not use slot restrictions to prevent competition, as others may; and

- our approach to code sharing, a powerful tool for improved efficiency of airline operations in the bilateral environment, is again the most liberal approach possible, short of no restriction at all.

This perspective is simply not discernible at all in the Chapter of the draft Report (Chapter 5) which deals with these issues. The Department recognises that our perspective is not the only position that it is possible to have with regard to Australian policy but the legitimacy of these points above cannot fairly be avoided; yet they are rarely sighted and always given little credibility in the Chapter. A reader with little background in the area could be forgiven for believing, based on this Chapter, that Australia practised a restrictive air services policy, whereas the opposite is the case. We make a large number of specific comments on this Chapter later.

STRATEGY

The existence of bilateralism for some time in the future is recognised by the Commission. As a consequence, Australia must have bilateral strategies.

It is a fundamental tenet of bilateralism that States will trade into the packages of rights that best meet their national interest. Because competing and sometimes conflicting interests are often brought to the table, the package of rights may only be delivered in a long-term strategy, especially where synergies are not immediately apparent.

Australia negotiates to liberalise the total package of rights available in each market and needs leverage to deliver on medium and longer term strategies to achieve the end objective. It is a strategy that is noted with some approval on pages 36 and 186 of the report, but the short term consequences of its application are criticised at various points without reference to the longer term benefits.

Australia's strategy varies with the market or markets involved in the particular bilateral. On the mature, highly competitive routes to Europe, New Zealand, the US and South-East Asia, we favour the least possible restrictions on capacity and routes. There is no role here for what is often described as industry policy.

In more fragile markets, we may seek to encourage the retention and growth of services. South America is a case in point. Direct air services are fragile and unlikely to be able to sustain competitive entry without major growth in passenger and freight levels. Given the realities of low absolute levels of demand, long-haul routes and carriers without deep pockets, the most efficient way to nevertheless encourage growth has been not to saturate the market with capacity, but to encourage cooperative commercial arrangements to evolve. The hub philosophy, so effective in allowing thin domestic routes in the US to sustain services, is equally relevant offshore.

Traffic between Australia and South America now flows through three channels: over US points to/from Australasia; under commercial arrangements over New Zealand and Tahiti; and on the direct services. This approach has ensured that the maximum number of carriers, including US carriers, has continued to develop this market. Consumer choice is the greater. And, should the explosion in demand that some have forecast actually emerge, its presence will be demonstrable and the policies noted above (especially capacity ahead of demand) would accommodate it.

Yet this strategy has also provided the impetus for Qantas to consider entering the Argentine route in its own right later this year. This "aggressive bilateralism" has enabled Australia to participate in a market, which

nevertheless is not prevented from growing without any Australian carrier presence.

When taken across the whole of our bilateral partnerships, the policy approaches of recent years have enhanced the attractiveness of both Ansett International and Qantas as alliance partners in global networks, without preventing other carriers from competing.

SUPPLY SIDE FOCUS

A number of submissions to the inquiry rely on supply side arguments to the virtual exclusion of other, but equally legitimate policy considerations. To the extent that the Commission has relied on some of these supply side arguments without exploring the balance of the case weakens a number of the key arguments supporting the report's draft conclusions. This issue is discussed in more detail throughout this paper.

The challenges for Australia in international aviation are complex and focus **not only on creating supply**, but also in meeting the challenges of maintaining liberalising policies across all aspects of the bilateral process with a very diverse group of trading partners. As noted above and elsewhere, there is also (whilst ever the process is bilateral rather than genuinely open market) a need to consider both **the demand side** of the equation and the **strategy designed to maximise benefit to Australia**.

International attitudes to the economic regulation of international air transport have reached the point where there can be a useful discussion on the future role of the GATS in this sector. However, a sophisticated approach to bilateralism remains the dominant requirement for now, if we are to maximise the benefits Australia generates from international aviation. The Commission needs to assess its thinking on short to medium term issues against this reality.

The Department suggests that the early chapters of the draft Report understate the complexity of bilateralism. In particular, there is often a strong presumption that the size and utilisation of 3rd/4th freedom capacity is central to judgements on the success or failure of competitive entry. The Department strongly disputes this and is supported in its views by the analysis conducted by the Australian Competition and Consumer Commission in authorising alliances involving Australian carriers. The can be much greater competitive forces created in key markets by third country and sixth freedom competition, than by the carriers of the two bilateral partners.

This is a weakness of analysis based on the table at 4.2 of the draft Report, which concluded:

> "The existence of capacity constraints reduces the ability for both Australian and foreign designated carriers to respond to rising traffic

> demand in those markets. It enables airlines with existing capacity to exercise increased market power."(PC draft Report p74).

This theme is extended throughout the draft Report, where narrow supply side benefits are simply assumed in comments on matters including market concentration, price competition, and tourism impacts and non-price effects.

The assumption of substantial capacity constraints also sits uncomfortably with the role played by fifth and sixth freedom carriers acknowledged at p 92 and p97 of the draft Report, but not critically examined or assessed for its true impact on capacity or competition.

Australia has actively encouraged competition by third country carriers by negotiating extensive fifth freedom rights and conceding sixth freedom capacity access to foreign airlines. In other words, if capacity had simply been negotiated with a view only to, implicitly, protecting its carriers and restricting capacity to third and fourth freedom demand, overall levels of capacity available (particularly in and via ASEAN markets) would be significantly lower, and competitive choices for consumers would be significantly smaller, than it is today.

Third country carriage is not just important in providing direct competition for designated carriers. Viewed strategically, capacity management under certain circumstances is an essential lever for obtaining increased fifth freedom rights for Australian carriers. The Commission at p186 of the draft Report concedes this point.

Of course, seeking fifth freedom rights usually means conceding something else. The presence or the threat of entry, from third country carriers on a route is a powerful agent for change today.

Using Singapore as an example, the combination of sixth freedom rights operated by Singapore Airlines, together with beyond and intermediate rights negotiated for Australian carriers through Singapore, intermediate rights for carriers whose country of origin is beyond Singapore, and interline and code share rights with carriers who operate to Singapore, but not to Australia, means that both passengers and freight have access to volumes of capacity far beyond that contained in any single ASA.

The deliberate policy of fostering access to hubs, particularly in South East Asia was commented on in the Department's original submission, which noted that 29 of Australia's 55 agreements provide access to foreign carriers over points in South East Asia. The traffic distribution at three major South East Asian hubs was covered at Attachment 11 to the Department's submission.

In its examination and citing of New Zealand policy as a model, the Department suggests that the Commission might also consider Australia's performance (and opportunities created) with that of New Zealand. While

New Zealand supports “open skies” agreements and has negotiated six in recent years, we understand that only 30 or so international airlines actually operate to New Zealand, and of those, roughly 9 do so only on a code share basis. The total number of carriers operating to New Zealand has actually fallen since the open skies policy was initiated. We understand that only three of New Zealand’s six open skies ASAs are active.

The Department supports the proposition that Australia must be willing and able to progressively liberalise its system of bilateral agreements with every policy weapon. At the same time, we need to apply judgement – given that markets are not able to function freely, for reasons beyond Australia’s individual control - on which weapon to use, and with what aims.
A too narrow focus on one path may actually slow the momentum of liberalisation and reduce Australia’s ability to tailor outcomes to meet the full and complex matrix that constitutes the national interest.

SPECIFIC COMMENTS:

CHAPTER 3: REGULATION OF INTERNATIONAL AIR SERVICES

3.1.1 Bilateral Framework

P36 The apparent assumption by Melbourne Airport, quoted by the Commission, that "equality of opportunity" is equivalent to a "one for one" reciprocity in the exchange of benefits is inaccurate. Australia has not taken such a simplistic policy approach for many years. A wide variety of recent and not so recent bilateral outcomes demonstrate this (eg Thailand, Germany, New Zealand, Malaysia, the UK etc).

The assumption leads to the *reductio ad absurdum* argument that, for example, Singapore would have access to only one point in Australia, as there is only one point for Australian operations to Singapore. Australia trades expanded opportunities for expanded opportunities, nothing less.

Australia, and almost all of its bilateral partners, look to exchange packages of rights rather than "one for one" trading, a point which is contrarily noted at pp75 - 76 of the draft Report.

P36 The draft Report notes the role of ownership and control provisions as a restriction in bilateral arrangements, but does not discuss their function, or the willingness of the international community to modify existing ASAs.

The fear that foreign carriers might obtain unreciprocated access to local markets is why ownership and control is likely to remain an issue in air services arrangements until bilateralism itself is replaced. Even the arch advocate of bilateral open skies, the US, restricts ownership and control, more rigorously than many of its less reform-minded partners.

As our earlier Submission noted, ownership and control is the true restriction in bilateralism. Capacity is relevant but what keeps an ASA bilateral – and keeps out a potential competitor, who may otherwise enter through acquisition - is ownership and control. These comments also apply to the Commission's views on capital costs at 5.2.1 (pp 82 – 83) and to their views on operating costs at 5.2.3 (pp 85-86). It is one mechanism used by the US to protect its domestic market (the largest single market for aviation in the world) from foreign carrier entry.

3.2.1 Unilateral liberalisation

P43 The view of the Department of Industry, Science and Tourism (DIST) that the Asian economic downturn provides opportunities for bilateral liberalisation is problematic. It is more probable that the opposite will occur. The historically liberal ASA recently negotiated with Thailand is the result of years of painstaking offer and counter offer, designed to overcome previous misunderstandings and sensitivities.

More reflective of current market conditions, the downturn in Cathay Pacific's regional business fortunes is unquestionably the key factor in continued restrictions on Australian access. Historically, downturns are accompanied by calls for increased protection – and not merely in aviation.

As late as April 1998, the APEC Transportation Working Group failed to take early and decisive action on a package of measures designed to liberalise aviation regulation within APEC - a point noted by the draft Report at p49. Australia was a keen supporter of these measures.

3.2.2 Bilateral liberalisation

P44 The table 3.1 is misleading. The Australian template is only a guide to discussing the means of including elements in Box 3.3 in a new agreement. The template does not include route and traffic rights as these are negotiated separately.

CHAPTER 4: AUSTRALIA'S INTERNATIONAL AVIATION POLICY

4.2 Economy wide approach

P61 The comment from Aerolineas Argentinas that

> "… the interests of transport bureaucrats and the Australian airlines continue to take precedence over other equally important elements of the national interest.."

is inaccurate and offensive. We are surprised at its unquestioning acceptance by the Commission. The Department believes that the Commission, if it wished, could probably obtain many other such comments from aggrieved parties over the years, given the robust nature of negotiations. We are unsure what the Commission intended to prove, but it does not enhance the draft Report, given its lack of substance and obvious self-interest.

4.2.3 Public access to air services arrangements

P68 The Department concurs with the Commission that there should be a strong presumption in favour of disclosure and transparency of arrangements and, as the report notes, puts considerable effort into

ensuring information is available to the extent our bilateral partners will allow.

4.2.4 Government handling of negotiations

P69 The Commission claims that the practice of the Department leading negotiations differs from most other areas of trade. This is not correct. For example, the Department of Primary Industries and Energy has leads trade talks on fisheries. Other Departments which negotiate access arrangements on behalf of the Government include Treasury (double taxation), Health and Family Services (welfare benefits) and Immigration and Multicultural Affairs (refugees).

The Department of Foreign Affairs and Trade is present at every set of air services negotiations as an active member of the Australian delegation and provides comprehensive briefing as a part of the preparation for those negotiations.

P69 The Commission notes that the sectoral approach to trade in international air services may allow specific airline industry interests to influence trade in air services unduly. Government policy has, since 1989, dictated that national interest considerations be paramount to the narrower interests of any of the stakeholders, including the airlines. The critical nature of public comments made by Qantas and British Airways (in its role as investor in Qantas) on the nature of the policy approach under this Government (Qantas AGM, 1996) are not the remarks of a satisfied duopolist. The Department is aware of the dangers of capture and has no doubt that it is exposed to this claim, particularly when the process seems so simple from the outside.

The sectoral nature of air services negotiations is a universal phenomenon. The notion of broadening the field of trade negotiations to include air services, or to trade for comparative advantage across sectors including aviation, has not been embraced anywhere and would be difficult to effectively trade in the extremely valuable third country markets.

The Commission may wish to consider whether such a process is intended to allow aviation access to be *reduced* in return, say, for greater sales of wool; and if not, how it would recommend this invidious choice be avoided. It is the Department of Transport and Regional Development's understanding that this type of trade-off is consciously avoided by the Department of Foreign Affairs and Trade principally by negotiating multilaterally, and using WTO processes. But this option is not available in aviation.

Moreover, the deals here are done by hard bargaining for national advantage. There is little doubt that, having put "hard" rights in aviation on the table, a country seeking to maximise its competitive advantage overall may wish to reduce access for Australia's competent and competitive airlines in return for reduced tariffs on something peripheral to its interest but central to ours.

4.3 Responding to market demand

P71 The statement that capacity remains constrained on "many important routes" is inaccurate. North Asia aside, capacity is not limited on routes of significance. The crucial point made earlier at length about sixth freedom and third country carriage is relevant here. Australia would be more than happy to expand capacity with any North Asian country; and in Italy. The choice not to do so lies outside our control. The same choice would be made by our partners if we offered an Open Skies agreement.

P72 The effect of fifth and sixth freedom capacity on the conclusions that may be drawn on figure 4.2 have already been discussed as part of the Department's general comments on the draft Report. Charts which offer a "snap shot" of capacity are often misleading when applied to longer term arguments about capacity management.

Appendix E has been revised at the request of the Commission and will be provided electronically. It shows increased capacity for Germany, Zimbabwe, Thailand and Taiwan. The Asian crisis has also impacted on the capacity available in a number of markets, including Korea.

From the information in the revised Appendix E, we have generated a new figure 4.2 to provide a more accurate guide to the proportion of capacity used relative to capacity available under these agreements, plus increased capacity in some agreements. The new figure 4.2 is at Attachment A.

P73 The claim made by the Commission that Singapore Airlines is relatively efficient compared with Australian carriers, based on capacity operated between Australia and Singapore, is not consistent with Appendix E, which notes that Australian carriers were using 36.7 B747 equivalent units of capacity between Australia and Singapore, and Singapore were using only 36.15 B747 equivalent units over the same route at 1 February 1998.

This claim also does not account for the fact that, while Singapore Airlines uses only one South East Asian hub to distribute Australian traffic, Australian carriers use considerably more, including some within Australia.

P73 The report notes a comment from DIST on seasonal seat availability on a range of routes. Leaving aside the obvious point that finite aircraft resources applied to peak periods of demand such as Christmas do result in pressure on seat availability, the distinction between seat availability and capacity constraint is often misunderstood.

Government policy allows airlines to operate whatever level of supplementary service is required to meet seasonal peaks. While the ability to operate such capacity is written into a number of agreements, it is unnecessary to do so – we have no policy of restriction on seasonal carriage.

In the case of Hong Kong, where capacity has been constrained by factors outside the best efforts of Australia, supplementary capacity is approved at the request of the airlines on both sides, to meet seasonal peaks.

Supplementary capacity is always permitted for longer periods where market requirements have made it desirable, for example, where bilateral discussions have been delayed.

The comment relating to the length of time taken to reach agreement on capacity with Singapore ignores a range of other extremely important issues attached to those negotiations. The basic reason for the time taken was the effort being made to remove restrictions, in an environment complicated by separate commercial negotiations between some of the interested airlines. The Department could be brutally efficient and achieve little; or address the complexities professionally. This criticism is disappointing, again showing an under-appreciation of the complexity inherent in these arrangements, a fact not likely to be removed by open skies options – as the current US-UK or recent Japan-US negotiations show.

P75 The conclusion that “the complex and time consuming nature of negotiations has contributed to emerging capacity constraints” is not supported by any evidence. Complexity does not create capacity constraints – unwillingness to agree does. This Commission seeks to make a policy point on a matter not of our making and not prone to any policy solution.

P75 The automatic provisions in the USA agreement do not constrain the ability of carriers to increase capacity. Both parties to the arrangements take an appropriately liberal view of the capacity provisions and have not applied them since 1994.

CHAPTER 5 ECONOMIC EFFECTS ON AIRLINES, USERS AND THE ECONOMY

5.2.4 Compliance costs

P88 The claim is made that "Australia's aviation regulations" create compliance costs. The implication is presumably based on the assumption that Australia could get rid of these regulations. The Commission elsewhere acknowledges the inevitability of the bilateral system and by extension at least some of its controls. These are not thus "Australia's" regulations. They are the international aviation environment. This misconception is repeated at other points in Chapter 5 (eg p79, p80, p99, p115 and p116). A far more accurate descriptor is that used in this reference – that there are compliance costs which go with being part of the *bilateral international aviation system.*

5.4.1 Market entry and competition

P93 The draft Report credits DIST's view that

> "Australia has rejected calls from New Zealand for an expansion of beyond rights on the basis that, inter alia, these rights are generally more valuable to New Zealand carriers because of New Zealand's location and because of the larger size of Australia's inbound and outbound markets…"

While the statement may be correct about the relative value of these specific beyond rights, it is not the grounds on which Australia would deal with this, or any other call for an expansion of rights. The single consideration that has been brought to this issue is and remains the longer term national benefit for Australia.

The Commission can confirm this from other sources including the Department of Foreign Affairs and Trade, which was more integrally involved in this matter than DIST. Again, we can see little in the quoting of this statement from the perspective of policy reform. Australia will continue to negotiate on the basis of national advantage, as does New Zealand.

P93 The Commission's assessment that, if available, seventh freedom rights may also lead to the entry of third country carriers and thus provide additional competition is probably correct. As the Commission also notes with fifth freedom rights, the negotiation of seventh freedoms for Australian carriers would be important for developing efficient networks.

Surprisingly, the draft report spends little time analysing th e central role played by the sixth freedom and the airlines that trade in this traffic. In reality, it is a far more significant issue than seventh freedom.

P94 European Union liberalisation has brought to the market a number of new carriers who have taken advantage of the new ownership and control provisions within the EU. However, until the EU negotiates as a bloc with other states, these new carriers will be unable to operate to and between states outside the EU without specific concessions to their ownership and control status from those states. The potential cost of these concessions was discussed at p6 in the Department's original submission.

P95 Code share rights increase the scope for both Australian and foreign carriers to enter new markets and to minimise costs. Australia has actively pursued it at every opportunity.

Code share is a relatively recent phenomenon, particularly in Asia, where Australia has pioneered code share as a means of accessing markets and has negotiated code share arrangements into 26 of its ASAs. This has meant that code share is merely absent at this time, rather than deliberately omitted from, the remainder of Australia's ASAs, which are either older, or less active, or are held with States that are not currently interested in code share arrangements.

P96 The Report uses Herfindahl-Herschman indices to indicate that there is a high degree of market concentration on routes to and from Australia without providing a comparison on market concentration on similar routes outside Australian markets. It is therefore not clear whether market concentration is a universal characteristic of international aviation, or whether Australian policy has contributed to Australia having more or less concentrated markets than other states.

A rough calculation by the Department shows that the Open Skies routes between the US and Europe are more heavily concentrated than any Australian route. United Airlines/Lufthansa held 57% of the seats sold US-Germany in the year to June 1998. United/SAS held 100% of the seats sold US-Denmark. US –Austria: 100% of seats held by the single alliance. US-Switzerland: 89%. US-Belgium 88%. Figures are not available to the Department on US-Netherlands but we believe the results are similar. The Commission might wish to look further at this matter (as we suggested in our evidence and subsequent correspondence). At minimum, the index results should be put in context. The source of these figures is an American Airlines presentation, defending its similar attempt to dominate US-UK routes.

P99 The Commission has overstated the role of charter operators in having an effect on competition and air fares at the bottom end of the market. Australian policy has encouraged the operation of these charters, but to date their overall effect on the market as a whole has been small.

For example, the largest single charter program to Australia is operated by Britannia, which carried 2% of the Australia – UK market

in the year to November 1997 (see Attachment 11 of the Department's initial submission). The main contributors to price competition on the route were the sixth freedom carriers, another sector of the market encouraged by the Australian Government's approach to the bilateral system.

P99 (footnote) The Department is astonished that the Commission would quote unquestioningly the views of a single industry sector, apparently unconcerned that their customers could be exploited by (literally) fly-by-night operators. A history of such operators is easily uncovered (the Commission may wish to contact the New Zealand Serious Fraud Office). The cost of consumer protection for individual passengers is relatively low and the Department has allowed for considerable flexibility in the way in which consumer protection for individual passengers can be provided.

There is no evidence to date that the consumer protection measures have had anything other than a positive effect. Reputable operators would seem to have little to fear. Passenger complaints to the Department number zero.

5.6.2 Availability of freight services

P103 No evidence is provided to support the claim that the combination of low value outbound freight and access to fifth freedom sectors decreases overall load factors and leads to higher inbound freight rates.

P106 The draft report suggests that the granting of cabotage rights to foreign airlines would have the effect of improving yields on Australian freight runs. It is unlikely that tax exemptions for international carriage would still fully apply for aircraft engaged in cabotage. The Commission may wish to take advice from the appropriate tax authorities on this matter and assess the possible implications for its proposal.

Since the Department's original submission, three more unrestricted freight agreements have been signed with Singapore, Germany and Taiwan, in addition to the original ASA with Luxembourg.

98 B747 equivalent units of dedicated freight have been added to our freight markets outside those covered by these unrestricted ASAs since March 1996.

Perhaps some mention of the freight capacity available could be made, given the very substantial weight the remainder of the report, and many Submissions, give to simple expansion of capacity as the single most important reform issue.

5.7 Regional effects

P108 The apparent assumption made in this section, that foreign carriers view Australian points as competing directly with each other for their services is probably not sustainable. In practice, Regional destinations in Australia compete with all points available to an international carrier on all of its routes. This means that Australian points compete with Los Angeles or Paris or London or Tokyo as much as they compete with Sydney, Melbourne, Brisbane and Perth.

It simply cannot be assumed that when opportunities at these points have been exhausted, the next highest-ranking choice for the airline is in regional Australia and not elsewhere on its international network.

5.8 Effects on the Australian economy

P111 The claim that previous sections of the report have shown that constraints in ASA's have led to higher airline costs and prices and restricted competition needs to be reconsidered against the admission that relatively little information is available to the Commission on the effects of ASAs on airline costs. We are not aware of any clear evidence to this effect, other perhaps than for markets where our bilateral partner has negotiated more liberal arrangements.

P112 The Department regrets that it is characterised as not in favour of "more frequent, more competitively priced services". These are exactly the objectives the Department has been pursuing over the past decade. Prices have fallen and frequencies have increased.

P115 Many ASAs include a range of mechanisms such as expressing capacity in terms of seats or providing a range of aircraft substitution options that give airlines complete freedom to introduce aircraft of choice. Again, it would be helpful to the impression left to the reader if the Commission acknowledged that Australia seeks to remove restrictions on aircraft substitution but cannot do so unilaterally.

CHAPTER 6: CAPACITY ALLOCATION AND THE INTERNATIONAL AIR SERVICES COMMISSION (IASC)

6.3.3 Market approach

P 124 Perhaps the Commission may wish to note that the market approach to allocation of capacity by definition adds costs of its own (the bids, the framing of bids, and the assessment of bids). In the Department's significant experience with bidding processes, these costs are not cheap nor is the process simple. A consumer might well ask, why must I pay for the (sole) carrier's bids, which were designed to exclude my choice of another carrier?

6.4.1 Objectives of the IASC

P127 The draft report suggests that the current objectives of the IASC Act could be simplified to one overarching objective; to

> "enhance the welfare of Australians through the promotion of greater competition and economic efficiency in the provision of international air services"

This amendment is unlikely to simplify the task of the IASC. Ansett provides a good illustrative example. Ansett could be claimed to be a less "efficient" carrier than Qantas, incurring losses and without the benefits of economies of scale or scope. However, as the Commission acknowledges elsewhere, it is demonstrably an agent of competition. The conflict created can be addressed in guidelines or policy statements. In the Department's view, this matter is not prone to simple change.

6.5.1 General capacity allocation criteria

P129 The complexity of the allocation process should surprise no one who is familiar with administrative law and the review processes associated with it (regardless of whether the decision is simple or not, the process must address the full range of judgement options). The Department is accountable to the Minister for these processes and does not intend to leave itself open to legal review to any greater extent than is necessary. Melbourne Airport is not a user of these criteria.

P131 The role of the IASC is to allocate capacity ent itlements, which requires judgements concerning which entity is best placed to advance the national interest by using the available capacity. It is therefore reasonable to seek assurances from applicants that they are reasonably capable of actually using the resource to be allocated by the IASC.

The cost of meeting CASA requirements is irrelevant to the costs of the IASC allocation process. The Department sees this matter as being well outside the Commission's terms of reference. Moreover, safety is not a 'compliance' cost - in the view of any reputable airline.

P132 The Commission suggests that general consumer protection laws prevent deceptive advertising. Our experience differs from that of the Commission. It is standard for new carriers to claim 'government approval' or 'government approval pending' in advertisements. The issue here is one of moral hazard. The Government by definition must advise the IASC that a carrier allocated capacity is likely to be a designated Australian carrier; moreover, the Government must so indicate to foreign governments. If we licence someone, we must

satisfy ourselves that they are capable of doing what they hold out to less well-informed parties they will do (and from whom they take large amounts of money in advance). The general protection laws do not take this issue into account. We recommend that the Commission does.

In addition, the provision of business plans to the IASC, as part of the viability test, should not be an unreasonable or costly requirement. They are usually prepared by carriers in any event as a part of prudent business practice.

Even with the "use it or lose it" principle strictly applied, there will still be a substantial delay in the reallocation and eventual use of capacity that had been allocated to a failed carrier. The Commission is effectively choosing delay cost over consumer protection.

6.5.2 Start up provisions

P139 The draft Report maintains that, while the IASC should encourage competition on all routes to and from Australia, the start up provisions currently do this in an arbitrary way. There is no doubt that, if capacity was sufficiently ahead of demand on all routes, there would be no need for start up provisions to apply.

Where capacity is constrained under an ASA, start up criteria do at least provide a "one off" chance to introduce Australian competition on the route through allocating an initial new entrant a level of capacity appropriate to the development of efficient, commercially sustainable services. While Ansett has extinguished start up on many routes through South Eastern and Northern Asia, routes in Europe, South America, Africa and the Pacific remain open to a new entrant, whether it be Ansett or another Australian carrier.

CHAPTER 7 ACCESS TO AIRPORTS

7.1 Australia's international airports

P154 Box 7.1: the FAC will be wound up by the end of September 1998, not July 1 as stated.

7.3.1 Pricing regimes

p158 The Minister for Transport and Regional Development approved the FAC's proposed Determination 13 for prices at Sydney Airport on 30 June 1998.

The new prices for Sydney Airport, which we understand the new Sydney Airports Corporation Limited will apply from 1 October 1998, are:

- General landing charge = $2.92 per tonne maximum take off weight (MTOW) pro rata, subject to a minimum charge per landing of $100. This is a decrease from the previous general landing charge of $5.72 per tonne MTOW and an increase from the previous minimum charge per landing of $27.50;

- International terminal charge = $7.92 per tonne MTOW pro rata, up from $2.48 per tonne MTOW;

- Parking charge = $350 per day or part thereof for aircraft parking in designated aviation parking areas (passenger aircraft start paying from the day following their arrival). There was no previous charge for this type of aircraft parking. For aircraft parked in a designated general aviation parking area for a period in excess of two hours, the charge remains $11.00 per day or part thereof; and

- Peak period charge and shoulder period charge = $0, down from $250 per landing and take off for all aircraft during peak periods and $200 landing and $100 take off for non-RPT aircraft during shoulder periods.

The new price determination affects the analysis from pages 159 to 161 as indicated below.

P159 The peak period landing and take-off charges on all aircraft will be removed from 1 October 1998.

P159 The shoulder surcharge currently in place at Sydney Airport only applies to non-RPT aircraft.

P159 Paragraph 4 is affected by the price changes to be implemented from 1 October 1998 as a result of Determination 13. The peak surcharge of $250 during the peak period will no longer apply, although the minimum landing charge has increased from $27.50 to $100.

P160 The landing charges in table 7.2 and the notes are affected by Determination 13. The minimum landing charge will be $2.92 per tonne MTOW pro rata with a minimum charge of $100 from 1 October 1998.

P161 The commentary on parking charges in paragraph 2 is affected by the price determination. The statement that Sydney charges $A11 per day is incorrect in any case as this fee only currently applies to aircraft using general aviation aircraft parking areas. From 1 October 1998, aircraft parking in designated aviation parking areas will be charged

$350 per day or part thereof (except passenger aircraft which commence paying from the day after arrival). Parking fees in general aviation parking areas remains at $11 per day or part thereof (fee applies when aircraft are parked for longer than 2 hours).

P160 The Department would also like to comment on the analysis of landing charges at international airports around the world in the last paragraph on page 160 and Table 7.3 on page 161. The analysis only includes general landing charges and peak period surcharges at the selected airports.

An aircraft operator using these airports will be influenced by the entire package of prices they face in using an airport. The analysis in the report ignores the fact that many airports levy significant terminal fees, some of which include peak and off peak variations. The analysis would be more robust if it included international terminal fees at each of the selected airports (including peak and off-peak variations).

P162 Aeronautical charges have been capped at major privatised airports (see Attachment B) (no caps apply at the privatised smaller RPT and general aviation airports). Attachment C contains a press release and Declarations 83 and 84 and Directions 13 and 14 which create the prices oversight regime for privatised airports. The prices oversight regime will be administered by the Australian Competition and Consumer Commission (ACCC).

The Declarations and Direction 13 set up the CPI minus X price cap on declared aeronautical services at privatised airports. The 'X' values are: 4.0 per cent for Adelaide Airport; 3.0 per cent for Alice Springs Airport; 4.5 per cent for Brisbane Airport; 1.0 per cent for Canberra Airport; 4.5 per cent for Coolangatta Airport; 3.0 per cent for Darwin Airport; 3.0 per cent for Hobart Airport; 2.5 per cent for Launceston Airport; 4.0 per cent for Melbourne Airport; 5.5 per cent for Perth Airport; and 1.0 per cent for Townsville Airport.

In addition to the price cap, a number of aeronautical related services will be monitored by the ACCC. The list of aeronautical related services to be monitored is set out in Direction 14.

P162 Non-privatised Federal airports were transferred from the FAC to new Commonwealth owned airport operator companies Sydney Airports Corporation Limited (and its subsidiaries Bankstown Airport Limited, Hoxton Park Airport Limited and Camden Airport Limited) and Essendon Airport Limited in early July 1998. Similar to privatised airports, the Treasurer has declared aeronautical services at Sydney Airport for surveillance by the ACCC. The ACCC will also monitor charges for aeronautical related services at Sydney Airport. The press release and Declaration 85 and Direction 15 by the Treasurer covering Sydney Airport are at Attachment D for information.

P162 The draft Report states that quality-enhancing investments may be constrained as the costs of these investments cannot necessarily be recouped through higher (permitted) prices. This statement ignores the provisions in the prices oversight regime for pass through of new investment. The criteria to be used by the ACCC in assessing applications for passing the costs of new investment through the price cap are set out in Direction 13 in attachment B and include quality of service issues.

P163 The report states that price-capped airports may be constrained in their ability to use pricing strategies to solve congestion problems. The price cap on declared aeronautical services does not prevent airport lessees from restructuring their prices within the price cap. It would be possible for airport lessees to put in place a price differential between peak and off peak movements. Direction 13 (section 2) also allows congestion charges employed as part of a demand management scheme under the *Airports Act 1996* to be passed through the price cap.

P163 The report states that after the five-year transitional period, the Commonwealth will need to examine the nature of future regulation which may be required. The Government has already taken an in-principle decision and committed to lessees to implement it, establishing the parameters of this review at the time the prices oversight regime was created. The review guidelines given to the ACCC are set out in the press release at attachment B.

7.3.2 Slot management

P163 The draft report makes reference to a cap of 80 movements per hour during the period 7-8 am Monday to Friday. This cap applies to the full operating period of the airport outside curfew, seven days a week.

P164 The draft report discusses the general difficulty new entrants have in gaining slots. It should be noted that the slot scheme applying at Sydney Airport provides greater access to slots for new entrants than the IATA rules referred to in the draft Report.

The slot scheme for Sydney provides for any available slots (through operators giving up slots or losing them through the use – it – or – lose – it provision to be divided equally between new entrants and incumbent operators. IATA rules allow incumbents the first opportunity to access a slot by allowing them to swap an existing slot for one that has become available. This denies a new entrant access to the more highly sought after slot.

7.4.1 Airport access regimes

P169 Paragraph 3 and footnote 8 should note that the Minister may only issue one Declaration for each core regulated airport under section 192 of the *Airports Act 1996* and that each Declaration must include an expiry date (subsection 192(3)). Although Declaration under the Airports Act may occur, all privatised core regulated airports will become subject to general competition laws on the expiry of the section 192 declaration or access undertaking.

P170 The ACCC has not accepted airport access undertakings by any of the three Phase 1 airport lessees (Brisbane, Melbourne or Perth). All three of these airports are to be declared by the Minister for Transport and Regional Development under section 192 of the *Airports Act 1996*.

P171 The reference in paragraph 2 should be to Federal airports still owned by the Commonwealth (as the Federal Airports Corporation no longer runs any airports).

P171 Section 192 of the *Airports Act 1996* has been amended. The amendments [which have not yet received Royal Assent] allow the ACCC to make written determinations that a specified service, or a specified use of a specified facility, at an airport is taken to be an airport service for the purposes of section 192.

CHAPTER 8 TOWARDS FURTHER LIBERALISATION

8.1 The liberalisation agenda

P174 The Department agrees that the bilateral system is both robust and capable of accommodating more liberal economic regulatory arrangements. It is also a robust and universally understood tool for delivering both change and substantial national benefits. Australia has driven a substantial reform agenda precisely to ensure that the opportunities, defined as pressures by the draft report, are available within Australia's structure of bilateral arrangements to deliver the benefits defined on p175.

8.2.1 Nature of production and trade in international air services

P176 Worldwide, it is acknowledged that ASAs prevent states from using their right in customary international law to complete and exclusive sovereignty over the air space above their territory to veto access to the carriers of their bilateral partners.

Bilateralism therefore helps prevent abuse of this element of customary international law by allowing states to agree to a form of access that is the best fit between their respective national interests.

P178 The claim that very few international airlines have gone out of business in the past 50 years is not correct. The history of

international aviation since the Chicago Convention is littered with international airlines that have either failed or been absorbed into larger entities. Pan Am, Laker, British Caledonian and Eastern come to mind. However, *State flag carriers* have remained largely immune from failure. This immunity, in many cases was provided either through direct subsidy, or though protection under restrictive bilaterals, or through a combination of the two.

Where subsidies were, and in many cases still are, provided it was because the state in question judged that the benefits to the economy outweighed the cost of state assistance. These benefits included subsidised import of high technology equipment and skills, employment of skilled labour, income multiplier effects and a potent symbol for a modern state as well as providing cheap global advertising. The Australian Government does not endorse this approach but it is nevertheless consistent with practice in international trade in other commodities to provide subsidies as a preferable (more transparent) form of protection than volume restrictions or tariffs.

The most fundamental reason for many states to subsidise a national carrier is that it provides a guarantee of service on a particular route, even if that route is not one profitable enough to attract services by foreign carriers, or to be operated without subsidy.

8.3 Designation of airlines

p178 The act of designation is an executive act and any state can designate any carrier under an ASA. It is up to the state receiving the designation to accept it or not. In most ASAs, the lack of substantive ownership and effective control by nationals of the designating state is one of the grounds for rejecting or revoking a designation. Designation is therefore linked to ownership and control by the actions of the state receiving the designation, not the state making the designation.

Australia, for example, continued to accept the designation of Aerolineas Argentinas even when it was demonstrably not owned or effectively controlled by Argentine nationals.

While SAS is owned and effectively controlled by shareholders from three Scandinavian countries, SAS is still designated under an arrangement that limits the benefits of the market between the bilateral partners to nationals of those partners. This will also be the ultimate outcome of liberalisation of ownership and control provisions within the EU, as it may allow the EU to negotiate with its bilateral partners (which will eventually include Australia) as if it were a single state.

P180 The Commission notes that New Zealand is using criteria other than substantive ownership and effective control for designation. Air New Zealand notes in its submission that the control element is retained

even in New Zealand's open skies arrangements, and that these are exceptions to their general policy. Moreover, the key factor here is that these are 'reserve powers'. No country can unilaterally revoke ownership and control restrictions, lest they risk bilateral access – as Aerolineas found with the US.

In most of its ASAs, New Zealand has adopted the same ownership and control criteria as Australia. In a recent statement to the APEC Air Services Group, New Zealand stated that

> "Until such time as partner states concerned have relaxed their own policies, the New Zealand Government maintains the policy of requiring its designated airlines to be at most 49% owned by non New Zealand nationals. This is to ensure that the traffic rights secured by the Government will continue to be available for use under existing bilateral ownership clauses."

8.5.2 Bilateral "open skies"

P187 The draft Report states that

> "to the extent that Australia is able to negotiate "open skies" agreements, third and fourth freedom carriers would be increasingly subjected to the threat of entry of fifth and possibly seventh freedom carriers."

As the Department observes in its general comments, it would be preferable if this statement reflected the most significant source of additional competition (under any policy regime) which is sixth freedom carriers.

P188 The draft Report suggests that Australian negotiators need not be constrained by notions of strict reciprocity in trading for a more liberal aviation environment. As noted at our comments on p36, **Australian governments have not negotiated on this basis for at least 20 years.**

P189 The suggestion that Australia has relatively modest fifth freedoms in most of its agreements is not correct. In the international aviation environment, Australia has had considerable success in negotiating fifth freedom rights with states that have extraordinary sixth freedom leverage. This success has been due to a preparedness to negotiate sophisticated packages of rights on the basis of equality of opportunity

rather than of strict reciprocity, together with a willingness to deliver third country access to the Australian market.

It is possible that, across the majority of Australian ASAs, open skies could well be a barrier to increasing fifth freedom rights. Any third country that does not have an open skies agreement with an Australian "open skies" partner is hardly likely to give Australian carriers superior (fifth freedom) access to that market than is available to its own carriers.

P190 A possible lack of access to domestic terminals may have been only one of a number of influences on Air New Zealand's decision not to set up its own domestic service in Australia. It is also possible that Air New Zealand did not enter the domestic market because, since deregulation, there has been a significant welfare shift from airlines to consumers as well as failure of new entrants and low profit margins.

P192 Answers to the question as to why many of our bilateral partners would be reluctant to enter into bilateral "open skies" agreements with Australia can be found in the precedent it creates for their relations with other countries, the efficiency of Australian carriers relative to others, and the generally threatening nature of alliances with carriers such as British Airways and Singapore Airlines, creating an even stronger presence for Australian carriers in third country markets.

The result is that the combined strength of Australian carriers represents a far greater threat to regional and global competitors than Air New Zealand on its own.

P201 The view of a common market with New Zealand raises a number of issues. The Commission may wish to seek advice on whether the proposal contradicts New Zealand's expressed unwillingness to liberalise their ownership and control arrangements until it is generally acceptable to do so (see comments on p180).

It is also an issue that has been rehearsed in the European Union, where flag carriers have not taken advantage of the new EU rules for cross ownership, despite well publicised needs for additional capital. New carriers that have taken advantage of the EU cross ownership rules have had little success in extending their operations beyond EU boundaries.

P203 The claimed benefits for New Zealand under its open skies agreements need to seen in a broader perspective.

The Department understands that New Zealand has signed six ASAs that it regards as "open skies", only three of those are active two of the active ASAs are with the United States and Singapore, both of whom Australia also has liberal ASAs which do not restrain market

development. We understand that New Zealand has approximately 33 ASAs overall, all of which, with the exception of the SAM and the open skies ASAs, are conventional agreements.

There is no evidence presented in the draft Report at there has been any increase in capacity operated on these routes since the “open skies” ASAs were entered into by New Zealand. The assumption that the “open skies” ASAs so far negotiated by New Zealand have either increased competition or increased tourist flows in ways not possible under other ASAs is not substantiated in this draft Report.

Claims that New Zealand has obtained benefits that have been denied to Australia through the lack of “open skies” agreements are not supported by evidence in the draft report, or from any other source that we are aware of.