FEDERAL EXPRESS

SUBMISSION TO THE INDUSTRY COMMISSION
OF AUSTRALIA

ENQUIRY INTO INTERNATIONAL AIR SERVICES

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SUBMISSION TO THE INDUSTRY COMMISSION OF AUSTRALIA

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CHAPTER 1

INTRODUCTION

Federal Express Corporation and Federal Express (Australia) Pty. Ltd. (together "FedEx") were invited by the Industry Commission of Australia to contribute a submission as part of their independent enquiry into international air services.

The Commission's aim is to improve the overall performance of the Australian economy.

FedEx share and support this aim and recommend that the Government of Australia promptly renegotiates the current Air Transport Agreement with the United States to introduce full regulatory liberalisation for air cargo carriers.

FedEx are finalising a study which will indicate the air cargo capacity which was made available by air lines to industries in Australia between April 1997 and March 1998.

The study will indicate the air cargo capacity which was available on freight aircraft during this period. The study will also indicate the air cargo against available at airports in Brisbane, Cairns, Darwin, Melbourne and Sydney.

This study will be compared to the figures prepared by the Australian government showing air cargo imports and exports during the calendar years 1995, 1996 and 1997.

Once FedEx have received and analysed these reports, a further submission will be presented to the Commission.

CHAPTER 2

EXECUTIVE SUMMARY

- Federal Express ("FedEx") is the innovator and the global leader in the air cargo transportation industry, offering a full range of integrated air and ground transportation services, logistics, customs clearance services, telecommunications and shipment handling technology in over two hundred and twelve (212) countries around the world.

- The FedEx service offers speed, reliability and ease of use at competitive prices.

- FedEx commenced operations in Australia in 1989 and now has over three hundred and forty (340) highly trained employees in five (5) cities using over one hundred (100) vehicles and thousands of shipments a month. FedEx also works with over thirty (30) alliance partners to ensure FedEx services are accessible to customers throughout Australia.

- In 1995, FedEx launched its AsiaOne operation, a regional network linking Asia to the rest of FedEx's global network through its Asian hub located at Subic Bay in the Philippines.

- Fourteen (14) Asian cities are connected to this hub, enabling customers access to an overnight intra-Asia service; and (for thirteen (13) of these cities) an overnight service to North America and Mexico City. Cities in Australia are not currently connected to the hub.

- **No other express carrier in the world can match FedEx's capabilities.**

- The U.S. – Australia Air Transport Agreement ("ATA") is a restrictive agreement as regards the rights of US cargo carriers.

- The air rights restrictions include:-

  - specific and complex routing limitations with specific intermediate and beyond points that cannot be combined;

  - prohibitions on carrying fifth freedom traffic on one of the three permissible routes, to points beyond Brisbane, Cairns and other international airports in Australia;

  - no seventh freedom rights; and

- a qualification that changes of gauge are only permitted if they conform to the capacity authorised.

▪ These restrictions severely restrict FedEx's flexibility to carry shipments between Australia, the USA, Asia and Europe. The restrictions make it difficult for FedEx to optimise the operations of its hub at Subic Bay, impeding FedEx's plan to connect Sydney to the AsiaOne network.

▪ Other regulatory restrictions include:

- cooperative commercial arrangements with other airlines cannot involve revenue pooling and do not expressly permit code-sharing, blocked-space or leasing arrangements;

- The Australian authorities must approve tariffs formulated by US carriers for the transport of shipments originating in Australia. The tariffs may be rejected and the authorities may direct that a different tariff be used; and

- there are no provisions expressly permitting inter-modal rights.

▪ The restrictions on commercial arrangements and tariffs limit FedEx's flexibility to offer customers in Australia a full range of services and prices. If FedEx publishes tariffs which are lower than tariffs offered by Australian carriers, they are likely to be rejected. In times of swift economic change, carriers must be given full flexibility to react immediately to the market conditions.

▪ The absence of inter-modal rights means that FedEx is unable to perform the pick-up and delivery operation in Australia under the same legal entity which owns the airline. This results in additional cost and the possible loss of tax benefits.

▪ On 1st October 1997, the Department of Transport in Australia submitted a draft amendment to the ATA to the United States Department of Transport ("US DOT") which proposed new restrictions on US all-cargo carriers.

▪ The new restrictions include:-

- a prohibition on all fifth freedom traffic between Japan and Australia and the People's Republic of China and Australia; and

- capacity restrictions on fifth freedom traffic enabling the Australian authorities to prevent FedEx from increasing the size of its aircraft or the frequency of its services to meet operational or market demands.

▪ These new restrictions were rejected by the US DOT on 27th July 1998.

- The current demand for air cargo services in Australia is approximately 204,000 tonnes per annum.
- The projected demand for air cargo services in Australia can therefore only be satisfied by the contributions of non-Australian carriers. A new open regulatory regime is needed to enable foreign carriers to meet this demand.

- The Australian government has shown itself to be supportive of free competition, recognising its benefits to customers.

- In 1996, deregulation permitted Ansett Airlines to carry cargo on international routes. This provided significant benefits for importers and exporters in Australia. Deregulation has also been introduced in other industries in Australia. The benefits of such deregulation have been obvious.

- Freedom of the seas and liberal ground transportation regulations in Australia has long been recognised as vital to support Australia's economy.

- It's geographical position at the edge of Asia enables Australia to capitalise on Asia's extraordinary growth but only if Australia is able to offer a full range of competitively priced and efficient air transport services.

- Australia recognises that the growth industries of the next millenium such as: electronics, computers, pharmaceuticals, fashion, avionics, car manufacturing and financial services; are completely dependent upon transportation.

- Such industries will not set up or expand businesses in a country unless that country provides a wide range of competitively priced air services.

- As part of Australia's bid to compete with other territories in Asia to attract such growth industries, it is vital that carriers be given flexibility to adapt to the changing needs of customers. This is particularly vital at a time when currencies in Asia permit countries to export at ever more competitive prices.

- Just-in-time high tech. industries are reliant on the services of integrators like FedEx. Such services are not offered by the Australian national airlines. In order for such industries to invest and grow in Australia, integrators need full regulatory flexibility to operate.

- Twenty-eight liberal bilateral open skies air services agreements have been concluded with the US.

- These include bilaterals with countries such as Brunei, Malaysia, New Zealand, Singapore and Taiwan.

- Countries such as the Philippines and Korea already offer liberal regimes. The Philippines regime is so liberal that it permits FedEx and its competitors to operate hubs and Korea is currently negotiating a fully liberalised agreement with the US.

- Japan has recently agreed to considerable liberalisation under a new agreement with the US and there is an intention to introduce full liberalisation within a few years.

- Thailand announced in January that it will seek a fully liberalised agreement with the US.

- Vietnam recently announced a fully liberalised aviation regime with its neighboring countries.

- The EC introduced full liberalisation and the US has signed liberal agreements with European countries such as Germany as well as several Latin American countries.

- Australia must not allow itself to be left behind.

- Bilateral air rights restrictions constitute artificial barriers to free trade. By supporting them, the Australian government is imposing a competitive disadvantage on Australian industry at a time when they need assistance to compete in world markets.

- **FedEx therefore seeks a fully liberal regulatory air services regime in Australia.**

CHAPTER 3

THE HISTORY OF FEDEX

Origins

In the late 1960's, Frederick W. Smith conceived the idea of Federal Express.

A young businessman knowledgeable of the air transportation business, he discovered that the United States Federal Reserve Bank was in critical need of a method to transfer cheques among its thirty-six branches overnight.

The U.S. Mail Service did not offer this service, so FedEx was first created to provide the service.

It soon became obvious that the overall deficiencies in the nation's air cargo system were so great, that a large potential market existed for FedEx to provide a new and superior nationwide service.

FedEx developed a "hub-and-spoke" system which enabled more efficient use of an aircraft network. Aircraft from all over the U.S. would fly into a single airport (the "hub") and shipments would be transferred between aircraft which would fly them to their destination.

In April 1973, FedEx formally began operations serving 25 cities. The hub sort facility was completed in Memphis, Tennessee in May and by the end of the year, 44 vans were on the road and employees numbered 389.

During the next several years, FedEx expanded dramatically. However, expansion was hampered by restrictive federal aviation legislation which prevented FedEx from acquiring larger, more economical aircraft. FedEx led the effort to have the restrictions lifted and, in November 1977, U.S. President Jimmy Carter signed a new Airline Cargo Deregulation Bill.

In January 1978, FedEx acquired its first 727-100 aircraft, a plane carrying almost seven (7) times the payload of earlier aircraft. Other 727's soon followed. Today, the FedEx air fleet includes McDonnell Douglas MD-11's and DC-10's; Airbus A300's and A310's; Boeing 747-200's and 727's; Cessna 208's; and Fokker F-27's.

Further Growth and Technological Advancement

In April 1978, FedEx became a public company.

In 1981, FedEx introduced a computerised package tracking system (COSMOS), enabling it to track every shipment and tell its customers the exact location of their packages. FedEx also introduced the Digitally Assisted Dispatch System (DADS) which provides a computerised communication system for its couriers, enabling pick-ups within minutes of a call from a customer.

FedEx's growth was further assisted in 1984 with the expansion of its international operations, on a global basis, when it purchased Gelco Express International. The first of a number of international acquisitions, this gave FedEx an integrated global network serving more than 80 countries with its own offices in cities such as Hong Kong, Tokyo and Singapore.

Federal Express continued to increase productivity and improve the quality of its services by introducing a revolutionary tracking system using a device called the "SuperTracker". The "SuperTracker", a handheld mini-computer which scans a unique bar code on the air waybills, enables the position of shipments to be communicated by satellite to thousands of computer terminals across the globe. FedEx now gives its customers in Asia computers and software called "Powership", without charge, to enable them to print air waybills, track their shipments, calculate shipping charges automatically, store information and provide shipping management reports.

The International Air-Express Service

FedEx was named the official Air Express Carrier of the 1988 Olympic Games, signifying its emergence as a truly global logistics network. In the same year, FedEx flew its first aircraft to Japan.

In 1989, FedEx acquired The Flying Tiger Line, which was then the largest all-cargo airline in the world. Flying Tiger had operated an extensive route structure throughout Asia for many years.

Benefiting from Flying Tiger's unique and valuable collection of air rights, FedEx integrated Flying Tiger's business of transporting cargo between airports into the FedEx time-definite, technology intensive, door-to-door international express business.

It is this integrated airline and ground pick-up and delivery service which has revolutionised transportation in Asia and differentiates FedEx from freight forwarders, cargo airlines and courier companies and passenger airlines selling freight services.

In 1992, the company formed three (3) new divisional headquarters: the Americas, Europe, Africa and the Mediterranean; and, Asia Pacific and the Middle East.

With the creation of these new headquarters, FedEx moved corporate decision-making closer to international customers and ordered the expansion of its developing international business.

The Asia Pacific and the Middle East Division was subdivided into two (2) regions: the North Pacific and the South Pacific. The Divisional headquarters was established in Hong Kong, the North Pacific Region headquarters was established in Tokyo and the South Pacific Region headquarters was established in Singapore. In June 1995, the Middle Eastern countries became the responsibility of the Division in Europe in order to take advantage of the trade flows and close commercial ties between Europe and the Middle East.

In 1996, FedEx formed a new region for China, Hong Kong, Macau and Taiwan, the China Mid-Pacific Region, headquartered in Hong Kong.

In 1994, FedEx received ISO 9001 certification for all of its worldwide operations, the first company in the express courier industry to meet the ISO quality standard on a global basis.

On November 12, 1994, the Government of the Philippines and Federal Express signed an agreement to establish a regional hub at Subic Bay introducing the now famous FedEx hub-and-spoke system to Asia. FedEx inaugurated this unique service called **AsiaOne** in September 1995.

CHAPTER 4

THE FEDEX'S WORLDWIDE OPERATIONS

FedEx is the world's largest express transportation company. FedEx is the innovator and global leader in the air express service offering a full range of transportation, customs clearance, logistics, communications and tracking service across the globe.

Using more than 38,500 vehicles and 590 aircraft with a daily global lift capacity of 20.6 million pounds, FedEx's 140,000 employees deliver 3 million shipments to 212 countries everyday.

FedEx is **not** simply an airline, nor is it just a freight forwarder or courier company.

FedEx provides a unique integrated air-ground express service which includes:

- Guaranteed fast and reliable all cargo international transportation.
- Custodial control of shipments.
- Up-to-the-minute information on the location and status of shipments.
- Door-to-door pick-ups and deliveries of shipments regardless of size or weight.
- Customs clearance supported by state-of-the-art technology and express clearance procedures.
- The world's most advanced transportation, information and communications technology.
- Cutting-edge logistics expertise, product merging, remail, partsbank, repair and return and other just-in-time services.
- Internet tracking and tracing and other services.

All this and more are available to customers in Australia with a single telephone call or the touch of P.C. buttons.

See Exhibit 1 for further information on FedEx's services and worldwide operations.

CHAPTER 5

FEDEX'S OPERATIONS IN AUSTRALIA

FedEx began air services to Sydney's International Airport with charter services in the early 1960s as The Flying Tiger Line, Inc. FedEx has continued the charter services as Federal Express since 1989 and offered over one hundred (100) charter flights in 1997.

At Sydney International Airport, FedEx has thirty (30) ramp staff, including maintenance engineers, weights and balances experts, customs clearance staff and administrative staff.

FedEx employs over three hundred and twenty-four (324) staff throughout Australia and operates an international express pick-up and delivery service.

Our highly trained and motivated employees using one hundred and two (102) vehicles from ten (10) from locations in five (5) cities, in conjunction with over thirty (30) alliance partners, provide companies throughout Australia with a fast and efficient service.

FedEx provides proprietary technology and automation devices to hundreds of customers in Australia, enabling them to prepare shipping documentation and track and trace their shipments from pick-up to delivery.

FedEx works closely with Customs to provide state-of-the-art clearance processes and technology at Sydney International Airport.

CHAPTER 6

FEDEX'S OPERATIONS IN ASIA

FedEx and AsiaOne

In 1995, FedEx started operations of its first hub in the heart of Asia – Subic Bay, the Philippines. The FedEx facility in Subic includes a warehouse, a sorting facility, administrative offices, an aircraft maintenance facility and a transloading area on the airport ramp.

FedEx calls this unique Asia service:***AsiaOne.***

The Subic Bay International Airport serves 160 intra-Asia FedEx all-cargo freighter flights every week to 14 cities across Asia: Beijing, Bangkok, Hong Kong, Koahsiung, Kuala Lumpur, Manila, Osaka, Penang, Seoul, Shanghai, Singapore, Subic Bay, Taipei and Tokyo. It is intended that Jakarta and Cebu be connected to the hub in the near future.

Through Subic Bay, FedEx now offers its customers an overnight service in Asia and with an increased capacity in each direction across the Pacific, customers in Asia can receive **overnight** to cities across the United States, Canada and Mexico City. Combined with intra-Asia flights, FedEx operates 250 flights each week to and from Asia.

Taking advantage of later cut-off times for pick-ups and deliveries, Asia is now fully connected to the FedEx global network in North, Central and South America and Europe, Australia and Africa. Deliveries are made in two (2) to three (3) days.

FedEx is uniquely placed to offer customers in Hong Kong and elsewhere a competitive advantage in the Asian and the global marketplace, supporting Hong Kong's status as China's entrepot.

No other company can offer this service.

See Exhibit 2 for further information on FedEx's hub at Subic Bay

FedEx Regions in Asia

- Asia Pacific Division – headquarters in Hong Kong

- North Pacific Region – headquartered in Tokyo, covers Japan, South Korea, Guam and Saipan.

- China and Mid Pacific Region – headquartered in Hong Kong covers China, Taiwan, Hong Kong and Macau.

- South Pacific Region – headquartered in Singapore, covers the ASEAN countries, Australia, New Zealand and a number of South Pacific island nations.

The Federal Express Commitment to Asia

In addition to our hub sorting facility at Subic Bay, FedEx also operates an aircraft maintenance facility, an express distribution center, a repair and return facility, a remail facility, a logistics support office and an administration office at Subic Bay.

FedEx has over 4,500 employees in Asia at over 75 locations to provide the unique FedEx services alongside FedEx's exclusive agents in 30 countries across Asia.

FedEx provides service to Asia using its own dedicated aircraft, MD-11's, A310's and DC-10's, for maximum service reliability and space availability.

FedEx uses its own handlers in Asia to ensure safety, security and reliability and to ensure that FedEx has full custody and control over shipments.

FedEx services in Asia allows customers to take advantage of both later pick-up and delivery times. Customers do not have to worry about connecting with several planes, different airlines or linking with a different courier to ensure timely delivery.

FedEx provides a network of regional air route authorities connecting Asia's nations to one another and to the world, with more daily lift capacity across the pacific than any other all-cargo carrier.

FedEx is the only U.S. all-cargo airline with aviation rights to China.

Federal Express Services in Asia

FedEx offers reliable, time-definite, overnight distribution services for the shipment of documents, boxes or heavy cargo to, from and within Asia.

Connecting Asia to the World

FedEx offers fast, time-definite distribution from Asia to points around the world by providing:

- Overnight service from Hong Kong, Kaohsiung, Osaka, Seoul, Taipei and Tokyo to points throughout the United States, Canada and Mexico City.
- Overnight by 10:30 a.m. to the western United States from Singapore, Kuala Lumpur, Manila and Penang.
- Two to three business day service between Asia and Europe, South America and most destinations worldwide.
- "Back in time" flights department from Osaka's Kansai Airport in the early A.M. and arriving in Oakland late the previous evening.
- Connectivity to over 212 countries using our fleet of 590 aircraft, 38,500 vehicles and 140,000 employees worldwide.

CHAPTER 7

THE US-AUSTRALIAN AIR TRANSPORT AGREEMENT RESTRICTIONS

The US-Australian Air Transport Agreement ("ATA") comprises of a number of documents.

These documents include:-

1. A main Agreement, executed on 3rd December 1946 and Annexes setting out the route descriptions;

2. Memoranda of Understanding on Tariffs and Charters executed on 23rd May 1980; and

3. Memoranda of Understanding concerning Capacity executed on 23rd March 1989.

A copy of these documents is set out in Exhibit 3.

The ATA provides a restricted regulatory environment for US all-cargo carriers.

Route Restrictions

There are three alternative routes which carriers are obliged to use. Points on these three routes cannot be interchanged (see Exhibit 3).

This route description is so complicated that it is difficult for airlines to interpret.

For example, there may be some uncertainty as to whether the Philippines is a point which can be served using the South Pacific route description. Unless the Philippines is a point on this route, FedEx will not be able to connect Australian cities to the FedEx hub at Subic Bay.

Further, the restrictions reduce flexibility to route aircraft in a commercially and operationally optimum manner.

This artificially limits the types of aircraft and the frequency with which they fly.

Industries in Australia therefore have a limited choice of services and have to pay higher prices.

Fifth Freedom Right Restrictions

The route description also prevents fifth freedom traffic on flights originating in Brisbane, Cairns and other points in Australia to international destinations.

Exhibit 4 briefly sets out a description of fifth freedom rights.

Again this limits consumer choice and provides a monopoly or “franchise” to airports in Sydney, Melbourne, Darwin and Perth from which international fifth freedom exports are permitted.

By limiting the air transport options available to industries in Australia to these industries’ largest and most lucrative markets, the Australian government is imposing on them an artificial competitive disadvantage.

Australia’s geographic position, being on the edge of Asia, should provide a competitive advantage provided that a full range of flexible, efficient and competitively priced air transport services are made available.

At a time when currencies in Asia are falling, thereby making Asian exports more competitive, it is important for the Australian government to remove artificial barriers and assist its industries to compete rather than hinder their access to world markets.

Seventh Freedom Right Prohibitions

The ATA offers no seventh freedom rights to US all-cargo carriers and the text makes it clear that carriers cannot exercise such rights.

These rights are often called “hubbing” rights because they provide carriers with the flexibility needed to operate hubs in an optimum manner.

Exhibit 4 explains why hubs are so vital to the economies of the world and what regulatory freedoms are required to operate them.

The global demand for increased air transportation services with faster transit times at lower costs can only be fulfilled using a system of globally connected hubs.

Exhibit 5 sets out the Boeing World Air Cargo Forecast 1996/97 and the 1997 IATA paper on “Asia/Pacific Air Traffic Growth and Constraints”. These reports indicate the phenomenal demand for air cargo services in Asia and elsewhere.

In order to operate such hubs, liberal air rights are needed.

These rights are needed in countries even if hubs are not situated in those countries, if the industries there are to enjoy the full benefits afforded by hub operations.

Change of Gauge Rights

Exhibit 4 demonstrates that hubs require unlimited change of gauge rights.

Unfortunately, the ATA impose restrictions on change of gauge rights by including a qualification that changes of gauge are only permitted if they are in conformity with the capacity authorised (see Exhibit 3).

No other provisions of the ATA impose capacity constraints on air cargo carriers. This qualification to the change of gauge rights could be construed as introducing an independent right by the Australian government to impose a capacity constraint.

The AsiaOne Hub

The routing restrictions, restrictions on fifth freedom traffic, the lack of seventh freedom rights and the restrictions on change of gauge rights, make it difficult for FedEx to optimise operations using our hub in Subic Bay.

They effect the commercial viability of linking cities in Australia to the FedEx hub.

Without such a link, industries in Australia will not be able to take full advantage of our unique AsiaOne service.

Exhibit 2 sets out details of the Subic Bay hub and Exhibit 1 sets out details of the FedEx AsiaOne service.

No other transportation company in the world can offer the same service as the FedEx AsiaOne service which enables customers to enjoy overnight intra-Asia transport and overnight transport throughout North America and Mexico City from the thirteen (13) largest centers in Asia.

A majority of the growth industries of the next millenium rely on time definite, express, door-to-door integrated air and ground transportation services.

Just-in-time Manufacturing

Manufacturers also require the advanced communications and tracking and tracing technology offered by integrated carriers. This on-line transport and customs clearance information can be integrated into manufacturers' ordering, inventory and invoicing systems, enabling them to reduce the supply chain cycle times.

Only integrated carriers like FedEx can provide these services.

Manufacturers in the smallest towns in Australia could receive or place orders from customers and arrange shipping with FedEx through the Internet. This gives them the ability to compete on a equal footing with manufacturers in Asia, North America or Europe.

By impeding FedEx's ability to offer the AsiaOne service, such manufacturers may not be able to compete with even the smallest manufacturers in cities such as those in China, Malaysia, Taiwan, Thailand and Hong Kong, which <u>are</u> connected to our hub. Australian industry will fall behind even these modest competitors.

<u>Commercial Arrangements and Tariff Restrictions</u>

The ATA imposes restrictions on commercial arrangements with other airlines by prohibiting the pooling of revenues. Further, the ATA offers no express right to codeshare or to enter into blocked space or leasing arrangements (see Exhibit 3).

This restricts FedEx's ability to offer customers optimum transport solutions at the lowest commercially sustainable prices.

The ATA also permits the Australian government preventing FedEx from changing its tariffs. Further, the government can direct FedEx to charge a tariff which the government imposes (see Exhibit 3).

This removes FedEx's ability to charge tariffs which Australia's national carrier believe to be too low or too high.

It reduces the incentive for such carriers to compete by lowering their operating costs or improving their services and enabling them to lower their own prices.

Industries in Australia will be unable to secure the same year over year transport cost reductions which industries in other countries can rely on. This imposes on Australian industry a further artificial competitive <u>disadvantage</u>.

Competitive pressures provides a sufficient check on carriers raising prices without a compelling commercial justification.

Complete price flexibility is needed to enable carriers to quickly react to the changing economic conditions, to ensure that services to customers are not disrupted and long term investment plans remain unaffected.

<u>Intermodal Rights</u>

The ATA does not expressly contain intermodel rights.

FedEx operates an extensive ground transport network through its subsidiary in Australia, Federal Express (Australia) Pty. Ltd.

If intermodel rights are given, FedEx could merge its airline and ground transport business into one company.

The costs and tax savings would be beneficial and could be passed on to customers in the form of improved services and more competitive prices.

CHAPTER 8

THE AUSTRALIAN MOU PROPOSAL

Recently, rather than identifying and removing artificial barriers in the face of growing competition from Asia as a result of the currency devaluation, the Australian government has sought to impose <u>new</u> competitive <u>disadvantages</u> on Australian industries.

On the 1st October 1997, the Department of Transport in Australia submitted a draft Memorandum of Understanding ("MOU") to the United States Department of Transport ("US DOT") which imposes <u>new restrictions</u> on US all-cargo carriers (see Exhibit 6).

New Fifth Freedom Right Restrictions

The proposed MOU includes a new prohibition on fifth freedom traffic between Japan and Australia and China and Australia.

There seems little justification in preventing Australian companies from exploiting these important markets by depriving them of a full range of air cargo transport services at the most competitive prices.

New Capacity Restrictions

The proposed MOU also introduces new capacity restrictions on all cargo carriers.

These restrictions enable the Australian government to prevent cargo carriers from increasing the size of their aircraft or increasing the number of flights serving the Australian market.

There seems little justification in depriving carriers of unfettered operational flexibility needed to meet the demands of the market.

It is well understood in the aviation industry that when market demand results in a certain percentage of the aircraft hold being filled on a consistent basis, a new aircraft is needed.

It is also well understood that once the new service is inaugurated, there may be a <u>temporary</u> period during which the percentage of the hold filled with freight may be too small to support the operating costs of that service.

Airlines are willing to take this commercial risk.

They believe that market demand will expand to fill the aircraft and make the service profitable.

Airlines deploy sophisticated marketing and financial models in order to judge whether a new service or a larger aircraft should be operated.

Airlines are motivated to undertake a thorough analysis in order to make the correct commercial decision because they stand to lose money if their capacity is increased too soon.

What benefits can be derived by the Australian government intervening in this efficient commercial process?

The Australian government does not have the commercial skills, the marketing information nor the financial models which would result in a more effective business decision. The Australian government does not have access to the rapidly changing economic forecasts and marketing intelligence for countries outside Australia.

The Australian government will simply defer to the opinion of the Australian national carriers.

There is no motivation for these national carriers to undertake an objective analysis of the investment plans and business decisions of their US competitors.

Further these national airlines have no access to the confidential commercial information of the US carriers nor are they likely to have the same investment criteria. The business of an integrated carrier like FedEx bears little relation to the business of a passenger carrier like Qantas.

The Australian airlines would simply be motivated to frustrate their competitors efforts for fear that they will lose market share.

Nor will they undertake an independent analysis of the loss which Australian industry may suffer as a result of the capacity increase being prevented.

The Australian industry’s plight will go unmeasured and therefore ignored.

Further, there can be no truly accurate measure of the loss suffered by the Australian economy from industries which <u>would</u> have invested in Australia <u>if</u> the full range of transport services at optimally competitive prices were available.

This inability to measure the total loss to the national economy has enabled national airlines to put their economic interest before the economic interest of their own nations. There is simply insufficient evidence to weigh the two interest in an objective manner.

Common sense would however dictate that the economic losses of national carriers could not justify frustrating the investments of the biggest growth industries of the next millenium.

Suppose that the Australian government sought and the national airlines provided, a detailed and objective account of the likely losses they, as airlines will suffer as a result of permitting an increase in capacity. Such an account would have to be based on assumptions concerning the new pricing and service improvements offered by competing US carriers (if any).

They would have to argue that the increased capacity will either result in a loss of their market share or result in a fall in prices and that if they compete at those lower prices, they will suffer a material loss.

Assumptions on prices and improved service can only be accurate if they are based on confidential information available only to their US competitors. As this information will not be available to them, their analysis will be flawed.

Even if the analysis is reasonably accurate, the Australian government does not have the resources to independently verify the assumptions of the Australian national carriers and undertake an independent analysis.

Further, assuming the analysis does demonstrate material losses, by what criteria could these losses be said to be “bad” for the national carrier?

Such losses are likely to motivate changes which will <u>strengthen</u> the airlines. Qantas made material reductions in operating costs as a result of the deregulation exposing it to competition from Ansett on international routes.

The more national airlines are protected from the discipline of full competition, the more difficult it becomes for them to compete. There is no doubt that they will have to face free competition at some point. The economies of the world are moving towards deregulation and open competition. It is therefore in their interest to embrace liberalisation and fair competition as soon as possible.

There may be a temporary period in which the national airlines downsize and employees are made redundant. However, the other airlines are likely to offer them employment as the market grows. Employing already qualified airline staff only makes good business sense.

Further, the employment opportunities opened up by the new high tech. and other companies which are attracted to invest in Australia, are likely to far outweigh redundancies by the national airlines.

In communist countries, we have seen the poor economic results which results from governments trying to take hold of the “invisible hand of capitalism”.

The US government recognised that the restrictions imposed by the proposed MOU were unacceptable and rejected them in a letter dated 27 January 1998.

CHAPTER 9

THE CHICAGO CONVENTION AND THE BILATERAL SYSTEM OF AVIATION REGULATION

Those unfamiliar with bilateral aviation treaties may be forgiven for wondering why there is a restrictive air rights regime at all. Why is transport by sea and land free of similar restrictions? What makes it necessary to control aviation?

The answer lies in the genesis of the bilateral treaties regime.

The concept of using bilateral treaties to govern aviation was born in 1944 at the Chicago Convention.

At that time, the founding fathers of the Convention were considering only passenger traffic and the concepts of national sovereignty in the context of the post World War Two political era.

They came to the political conclusion that each country should be permitted to retain control of their own air space for passenger transport.

There was no such thing as a dedicated commercial air cargo transport service in 1944.

There were mailbags, which were transported by air and of course airline passengers' luggage. But that was all.

Think how surprised these founding fathers at the Convention would be if we told them in 1944 that today forty percent (40%) of the world's goods (by value) are transported by air and that by 2015 there will be over two thousand two hundred (2,200) aircraft dedicated wholly to transporting air cargo across the globe (see Exhibit 5).

They would have been equally amazed to hear about the new industries which drive the demand for these air services:-

- Computers and computer chip manufacturers
- Pharmaceutical manufacturers
- Aeronautics and automobile manufacturers
- Fashion industries
- Distributors of food and other perishables

Perhaps they would find it incomprehensible that technological advances like the Internet, satellites and other communications technology, huge long range aircraft and inexpensive short range aircraft would enable a small manufacturer in Penang, Malaysia to receive an order in the afternoon from a North American customer and have the goods delivered to that customer overnight.

How could they have predicted that these mega industries - perhaps the fastest growing industries of the next millenium - could not exist without rapid air transport?

Some electronic products may have a shelf-life of only two months. If the manufacturer does not receive the orders and deliver the shipments within a matter of days, he will be out of business.

Most of all, the founding fathers would have been astounded that the complex bilateral treaty regime they created for passenger airlines should be applied to air cargo transport.

If they had the benefit of a crystal ball, we believe they would have applied a quite different regime for air cargo transport. One that would have enabled a free movement of goods by the air just as the free movement of goods was permitted on the high seas in 1944.

Instead, carriers are obliged to work within the complex confines of over three thousand (3,000) bilateral treaties. These treaties set out a host of different restrictions which change from time to time depending on political winds, social policies and economic developments.

Why do governments continue to exploit these archaic bilateral system to impose restrictions on aviation transport?

Usually to protect national airlines and to secure an adequate local transport infrastructure in times of national emergency. These issues are discussed more fully in Chapter 11.

We do not however advocate that the bilateral process be immediately abandoned now that it has been in place for some fifty-four years.

There will for some time remain a number of countries which, for political or other reasons, do not wish to introduce liberal air rights regimes.

Any attempt to substitute a multilateral approach will result in multilateral agreements which are acceptable to the most <u>restrictive</u> countries. They will contain the "lowest common denominator" of rights and this will slow the progress of full liberalisation.

The true power of global hubs is that once a critical mass of countries are connected to them, other countries are obliged to join or risk falling behind their competitors. Gradual bilateral liberalisation provides a strong "river", the pressure of which will eventually break the "dam" of restraints on Open Skies.

Chapter 10

FULL LIBERALISATION – THE BENEFITS

FedEx recommends that the government of Australia renegotiates the ATA with the U.S. government and enters into a bilateral treaty in the form attached as Exhibit 7 with one modification. FedEx recommends that the treaty include seventh (7^{th}) freedom rights. Malaysia has entered into a similar treaty and a copy is attached as Exhibit 8 by way of an example.

The benefits of full liberalisation have been well documented.

Europe

Countries in Europe which adopted the liberal aviation regimes have seen a 35% growth in air traffic, while those who did not have grown by a mere 3.5%. Schipol airport in Amsterdam saw a growth of 500% between 1992 and 1996, while Charles de Gaulle in France saw a decrease of 16%.

U.S.A

What's more, the U.S. domestic market deregulation experience, though a disruptive one for the airlines, demonstrated the benefit which the tremendous power of competition provides to consumers. Low prices, multiple routes served by a choice of inter-connecting hubs, diverse services and high aviation safely records.

Canada

U.S. Transportation Secretary Slater said in June 1997 at the International Aviation Club:

"In our hemisphere, in 1994, we liberalised our transborder aviation relationship with Canada. Let me share what that has accomplished: 28 per cent more passengers are flying; 17 cities that did not have non-stop service to Canada now do; and fares are down more than 20 per cent."

<u>CHAPTER 11</u>

<u>FULL LIBERALISATION – THE CONTRARY ARGUMENTS</u>

Governments imposing restrictions on aviation in bilateral treaties use a number of issues to support their case.

These issues include:-

- Protection of National Carriers;
- Anti-Trust/Competition Abuse;
- the Dominance of US Carriers;
- National Security; and
- Inadequate Infrastructure

<u>Protection of National Carriers</u>

There is no doubt that governments have a very difficult balancing act to perform. They have a number of different interest groups to consider. Issues such as inflation, unemployment, currency (and currency speculation!), and social policies all bear heavily down upon them.

However, we believe that competition enables the consumers and <u>consumers alone</u> to drive the services and the prices, and that consumer, acting in a freely competitive market, will enable airlines to produce the best service at the best prices.

Optimum economic growth requires a willingness to take well-considered business risks and to impose accountability for mistakes or mediocre performances.

Human nature being what it is, if we do not suffer the consequences for our actions and if we are not rewarded for our achievements, we will not do our very best. Competition provides the consequences and the rewards.

We do not believe that by somehow artificially restricting competition from foreign cargo carriers, a national airline's cargo business and its captive industrial customers will grow and flourish.

There is no doubt that state ownership of airlines and protectionism has met with little success.

There is also no doubt that national airline like Singapore Airlines, working in open and competitive environments have provided tremendous benefits to their shareholders, consumers and their national economies.

Nor do we believe that the government <u>can</u> somehow instill "partial" competition and ease national carrier into the free market.

There is either competition or no competition.

If we examine the realities of "partial competition" type markets where limited freedoms are offered to foreign carriers, we question whether the difficult and important issues such as inflation, unemployment and social policies are really being methodical and thorough examination and judicious weight by the governments.

It might be valuable to examine for a moment the dynamics of "partial competition" in air cargo aviation.

Let us suppose that a country permits foreign carriers to serve the market but the number of frequencies they are permitted are limited to a certain number each week and that the size of the aircraft are also limited.

If a customer comes to the foreign carrier and requests more air services, in reality, that foreign carrier has to persuade the local carrier to support the foreign carrier's increased frequencies.

There is no motive for the local carrier to support their competitors. Quite the reverse is true. They would want to frustrate their competitor's efforts.

Even if the local carrier is unable, for operational, commercial or other reasons, to provide the additional air services requested by the customers, that local carrier could simply be a "dog in a manger".

The local carrier may fear that if a foreign airline were given the additional rights to satisfy the customer'' demand, the customer may start using the foreign airline more than the local airline simply because the foreign airline was more flexible to the customer's wishes. Alternatively, local carriers may think that having used the foreign airline, the customers will come to the conclusion that the foreign airline has better services and more competitive prices.

Even if the local carrier agreed to additional frequencies, it would have to persuade the government that this was a good thing for the country.

Can you, for example, imagine any local airline or any department of government funding an expensive economic review to confirm how much the additional frequencies or other freedoms given to foreign carriers will benefit the overall economy?

Will the government vigorously champion the needs of the consumers with detailed statistics and visionary commercial insight? Or will it simply look to its national carrier for answers to these important issues?

We believe that it is wrong to assume that protecting a local carrier's cargo business can be made without cost to local industries.

We believe that if the maths is done correctly, the harm to the export economy of expensive and inadequate air cargo transport will in every case far exceed the short-term benefits of protecting a national airline. Particularly if that airline's business is primarily focused on passenger transport, not cargo, which is commonly the case.

Chapter 8 raises further issues on this subject.

Further it seems wrong to prevent **integrated carriers** from operating freely in the name of protecting local airlines.

The fact is that there are only 3 integrated carriers in the world.

National carriers in Australia simply do not provide these services. We do compete in the airfreight markets of combination and passenger carriers. But that is not our core business.

Our strategy is to fill the aircraft with door-to-door express shipments and the more freedom we're given to do this, the less we'll be competing in the ordinary airfreight, airport-to-airport market.

Liberalisation also means greater opportunities for all carriers including local carriers.

It not only opens up huge markets like North America, it also provides new opportunities to transport shipments between the local gateways and interior points. As technology develops, markets on different continents become ever more accessible.

Anti-Trust / Competition Abuse

There is a belief that not all competition is good competition.

Competition also creates monopolies and oligopolies which, over time, tend to limit consumer choice, erode quality and increase prices.

United Airlines, Virgin Airlines and others point out that the British Airways and American Airlines alliance in Europe will effectively place BA and AA in an unassailably dominant global position.

Will open regulatory regimes simply feed these monopoly monsters?

The European Community's experience in introducing full liberalisation is useful because it shows us that there is no conclusive evidence that monopoly monsters are created or that oligopolies materially decrease consumer choice, erode quality or increase prices.

On the contrary, competition abounds in Europe and while some small airlines and routes may die, new airlines and other routes grow and flourish (see also Chapter 10).

In those limited areas where objective judgment may be required to curb some of the worst excesses of market dominance, perhaps a multilateral approach involving a multitude of pressure groups, consumers and the airline industry would achieve a better result.

The solution should not be to allow such important decisions to be made by self-serving national airlines or governments without the resources or commercial tools to objectively assess the nature and scope of the problem and implement and monitor a balanced solution.

The Dominance of US Carriers

Critics of competition say that U.S. carriers can afford to compete internationally.

They have the huge North America market to build a cash flow "war chest" to fight a price battle overseas.

They also have their economies of scale, a huge North America customer base and the profits to fund substantial aviation R&D.

How can local carriers in small countries ever hope to compete?

The answer is they cannot unless they are in open competition.

Does a small market stop Singapore Airlines from being one of the most successful airlines in the world?

Competition drives the economic forces which create profits, which in turn create economies of scale which in turn create large loyal customer bases.

National Security

Governments are concerned to ensure that in times of armed conflict, riots and natural disasters, they can secure sufficient air transport.
They assume that carriers owned by companies or people who are foreign nationals, would simply fly the aircraft to their home state and refuse to provide the transport. Alternatively, they may charge unreasonably high prices or provide a poor service.

The carriers may be owned by companies incorporated in what suddenly becomes an enemy state.

For these reasons, governments may wish to protect national airlines so that their services and equipment is maintained to an adequate level.

Our view is that by exposing national airlines to competition, they become stronger, more efficient, more able to invest for the future and capable of providing a greater range of services.

Protecting national airlines simply makes them weaker.

There may come a time during an armed conflict or natural disaster when the government can no longer afford to support them. They may then be exposed to bankruptcy at a time when their nation most needs them. This scenario poses a much greater threat to national security.

If national security demands a strong airline, then competition should be introduced without delay.

Inadequate Infrastructure

A number of countries have claimed that limited infrastructure mean that airlines that hold on to slots and parking spaces can exploit them in an anti-competitive manner. For them, liberalisation simply does not create competition in the market place so airport infrastructure bottlenecks occur. Liberalisation will simply feed the dominant position of the carriers with slots and parking.

That proposition does not bear up to close examination.

Taking Narita in Japan as an example, Japan's answer to the slot bottleneck has been to introduce competition for slots.

Airlines have long held on to the slots they don't use, preventing their competitors from expanding their services. Regulations have now been introduced which force airlines to release slots unless they are used 80% of the time.

Even if this open competition for slots doesn't provide enough capacity to meet demand, following liberalisation, competition is still the answer.

If Japanese carriers were truly competing in the Asia market against the U.S. carriers and they were deprived of much needed slots at Narita, the second runway project at Narita may not have taken so long to emerge.

If there is open competition tomorrow, there is a good chance that the second runway would be operational within 12 months and not in two (2) years or three (3) years.

The power of competition simply makes the infrastructure available. Like the power of water, it eventually finds a way through the most formidable obstacles.