Australian Competition & Consumer Commission

SUBMISSION

TO THE

INDUSTRY COMMISSION

INQUIRY INTO

INTERNATIONAL AIR SERVICES

CONTENTS

1. Introduction

1.1. Role of the ACCC

The Australian Competition and Consumer Commission (the ACCC) began operation on 6 November 1995 as a consequence of reforms set out in the *Competition Policy Reform Act 1995.* Formed by the merger of the Trade Practices Commission and the Prices Surveillance Authority, the ACCC has the role of administering the *Trade Practices Act 1974* (the Act), State and Territory Application Acts and the *Prices Surveillance Act 1983.*

The ACCC is an independent statutory authority which seeks to improve competition and efficiency in markets, foster adherence to fair trading practices in well informed markets, promote competitive pricing wherever possible and restrain price rises in markets where competition is less than effective.

In seeking to prevent or limit anti-competitive conduct and to ensure adherence to fair trading principles, the ACCC takes action through compliance education programs, litigation or enforceable undertakings if necessary to overcome market problems.

It also: adjudicates on business practices (including merger proposals); arbitrates on access to essential facilities; enforces product safety standards; has functions under provisions of the Trade Practices Act which impose a liability on manufacturers for damages caused by defective goods; undertakes certain functions relating to prices surveillance, public inquiries and monitoring of goods and services under the Prices Surveillance Act; maintains a close liaison with Federal, State and Territory Governments, and regulatory authorities on current economic reform issues; and provides guidance to business and consumers about the Trade Practices Act and the Prices Surveillance Act.

Trade Practices Act

The object of the Trade Practices Act is to enhance the welfare of Australians through the promotion of competition and fair trading and provision for consumer protection. The ACCC's objectives in administering the Act are:

- to prevent anti-competitive conduct, with the aim of promoting economic efficiency and enhanced social welfare, including an improved choice for consumers in price, quality and service;

- to provide appropriate safeguards for consumers in their dealing with producers and sellers by fostering adherence to fair trading practices in well informed markets; and

- to promote competitive pricing wherever possible and restrain price rises in markets where competition is less than effective.

Price Surveillance Act

The Price Surveillance Act enables the ACCC to examine the prices of selected goods and services. The objective is to promote competitive pricing wherever possible and to restrain price rises in markets where competition is less than effective.

1.2. Scope of the submission

The terms of reference for this inquiry focus on the regulatory framework for international aviation, particularly the impact of the current system of bilateral air services agreements administered by the Department of Transport and Regional Development (DTRD) and the capacity allocation system administered by the International Air Services Commission (IASC).

There are many elements of the international aviation industry which have competition implications and are of concern to the ACCC. For example, the IATA accreditation scheme, code sharing, airline alliances, loyalty programs, frequent flyer schemes, market pricing practices, advertising standards, freight forwarding arrangements and computer reservations systems are of interest. However, many of these matters are not generally a result of the policy framework for international aviation and hence not relevant to the Industry Commission's inquiry as defined in the Terms of Reference. The contents of this submission address the issues which are impacted by the bilateral air services framework, primarily market access, capacity limitations, pricing, joint services and ownership/control issues.

It needs to be emphasised that international airlines, including foreign owned airlines operating in Australia, are subject to the Act and treated in the same manner as other companies operating in Australia. For example, airline conduct in relation to misleading advertising, agreements which may lessen competition and pricing practices are handled in the same manner as they would be for other industries.

Bilateral air service agreements are international treaties and, as such, exempt from the Act. They are of interest to the ACCC to the extent that they set the regulatory framework within which the airlines operate.

2. Competition issues

2.1. The current system

As noted in the Issues Paper distributed by the Industry Commission, the Government, through the Department of Transport and Regional Development, has pursued a policy of liberalising Australia's air services agreements. This liberalisation has resulted in:

- an increase in the number of air services agreements which include multiple designation;
- the negotiation of capacity entitlements well in excess of demand;
- virtually no restrictions on the ability of airlines to set air fares at market levels; and
- greater freedom for airlines of the contracting parties to engage in co-operative arrangements such as code sharing.

This liberalisation is consistent with the other competition reforms undertaken by the Government.

As a general rule, the ACCC would like to see a regulatory framework that facilitates competition between airlines. The key elements of the current regulatory framework which are of interest because of their impact on competition are discussed below.

Market access - multiple designation

Multiple designation facilitates entry to the market and may lead to increased competition as more airlines operate services. By comparison, a single designation agreement has at most two airlines (one Australian, one foreign) operating in the market and creates the potential for duopolistic pricing and scheduling.

While multiple designation is highly desirable from a competition viewpoint, it needs to be accompanied by sufficient capacity entitlements if it is to yield competition benefits (see below). To have multiple designation without sufficient capacity for each carrier to develop commercially sustainable services would be likely to result in fewer carriers operating than if capacity is unlimited.

The Commission considers that the policy of multiple designation should be continued.

Market access - fifth freedom carriers

The ability of fifth freedom carriers to access a particular market raises several possibilities. First, they may provide effective competition to the third and fourth freedom carriers. Second, the threat of their entry into a market may induce the third/fourth freedom carriers to behave in a competitive manner (ie contestable market theory). Third, it creates the possibility of marginal pricing by the fifth freedom carrier.

The ability of fifth freedom carriers to access markets depends on their ability to obtain the necessary route rights from the two countries concerned. Obtaining the right from only one of the countries is not enough. Their ability to enter a market at relatively short notice is limited unless the necessary route rights already exist and this may limit their ability to act as a countervailing force on the behaviour of third/fourth freedom carriers.

Examination of routes where fifth freedom carriers have operated would suggest that consumers are likely to benefit from their operations. For example, fifth freedom carriers on the Australia - UK route such as Singapore Airlines and Cathay Pacific have provided a credible competitive force to Qantas and British Airways. Even on the Australia - New Zealand route, fifth freedom carriers have provided strong competition (eg Continental Airlines in the 1980s). In these cases the fifth freedom carriers have provided a countervailing force to the third/fourth freedom carriers and been a significant determinant in setting prices.

The Commission considers that access to markets for fifth freedom carriers should be encouraged as the competitive effects are likely to yield benefits to consumers.

Capacity limitations

There are two principal types of capacity limitation: those which result from the bilateral negotiation process between Governments and those that are a result of infrastructure limitations (eg access to Narita Airport). Both types of capacity limitation have the potential to restrict competition and force prices up.

While the Government has succeeded in keeping capacity entitlements ahead of demand in most cases, there are some exceptions. Recent experience would suggest that in most cases where negotiated capacity entitlements become a limiting factor the Department of Transport and Regional Development has been relatively successful in negotiating additional capacity. Seasonal peaks in demand (eg Chinese New Year on the Hong Kong route) are catered for simply by approving supplementary flights. However, unlimited capacity entitlements would be preferable.

The existence of capacity limits creates the possibility that airlines will seek to "hoard" capacity entitlements to prevent other airlines from using that capacity, either

preventing competitors from entering the market or preventing existing operators from expanding. While a capacity allocation received from the International Air Services Commission (IASC) includes a condition that the capacity must be fully utilised from a specified date, this is not always enforced by the IASC (eg Fiji route). Similarly, the carrier with the allocation may never actually commence operations with that capacity or seek continuous deferral of the date by which it must use the capacity (eg Ansett to Malaysia, Qantas to South Africa, Australia World Airways to Greece). Such behaviour, if successful, may lessen competition by restricting competitors expanding their operations or new entrants establishing services. If there is ample capacity available then this incentive to "hoard" entitlements is eliminated.

Capacity limits created by infrastructure problems are less frequent and, with the exception of Tokyo, likely to be of little consequence. Furthermore, Australia's air services agreements usually include a clause which specifies that Australian carriers are to be granted access to facilities on the same basis as the carriers of the other country (including the same charges).

The Commission considers that unlimited capacity entitlements should be negotiated where possible.

Pricing controls

The ACCC notes that pricing controls are rarely used within bilateral air services agreements and the Government has pursued a "double disapproval" approach to air fare approvals. Where anti-competitive pricing practices within Australia are alleged the matter can be dealt with under the Trade Practices Act.

Of greater concern is the potential for duopolistic pricing in situations where access and/or capacity are limited. In such circumstances prices may be higher than they would be in a more competitive market, to the detriment of consumers. To illustrate, consider the Sydney - Port Moresby and Sydney - London routes (see table below). On the former route there are only two airlines operating (Qantas and Air Nuigini) while on the latter there are numerous airlines operating. The fare per kilometre flown on the London route is between 48 and 62 per cent of the fare for the Port Moresby route.

Discount fare type	Return fare with Qantas ($)	Great circle distance (km)	Fare/km
Sydney- London			
Low season (1)	2099	17,036	6.16
High season (1)	2899	17,036	8.51
Sydney- Port Moresby			

Low season (2)	703	2,750	12.78
Hiqh season (2)	766	2,750	13.93

(1) "Take-Off Fare'' code LLSS and LHSS, price applicable as at July 1997. Even cheaper fares are available on other airlines.
(2) Discount code WLIT30 and WHIT30, price applicable as at July 1997
Source: Qantas. Fares from Australia. Issue no.80, JULY 1997

While the economics of operating the two routes will differ for a number of reasons (eg aircraft type, distance flown in foreign airspaces, landing charges) they are unlikely to account for all the difference. Results from the BTCE's Aerocost model for a B747-400 on the London route and a B767-300 on the Port Moresby route suggest that the London route would be approximately 20 per cent cheaper to operate on a cents per kilometre basis. Thus only half the air fare differential between the routes can be accounted for as a result of cost differentials.

The Commission considers that the current policy of minimal intervention in pricing should be continued.

Ownership and control

Air services agreements normally include a condition that an airline designated by a country be substantially owned and controlled by that country. This condition prevents, say, Australia designating United Airlines as an Australian carrier on the Australia - Japan route and is aimed at ensuring that the rights negotiated are only utilisable by airlines of a specific country.

Because the test of what constitutes substantial ownership and control is not clearly defined, it has resulted in arrangements which may be less than optimal to ensure compliance. Following Air New Zealand's purchase of TNT's shares in Ansett Australia, the ownership of Ansett International was changed to ensure Australians owned at least half of the airline. This ensured majority ownership by Australians of Ansett International so that it would not violate the ownership requirement in air services agreements. However, the question of substantial control is less clear, with Ansett International heavily dependent on Ansett Australia for operational support, a close interlinking of operations and the existence of a Deed of Guarantee and Indemnity provided by Ansett Australia to Ansett International.

It has also been argued that the ownership and control requirements of air services agreements have been a contributing factor to the proliferation of airline alliances. With takeovers, buyouts and mergers effectively prevented by the substantial ownership and control clause, airlines have resorted to alliances to try and achieve objectives similar to that which a takeover would achieve.

Should further relaxation of air services agreements be pursued, perhaps the ownership and control clause could be varied to require ownership and control of designated

airlines to be consistent with general foreign investment laws of the country designating the carrier.

Market dominance and misuse of market power

One of the original rationales for bilateral air services agreements was to ensure equal opportunities for carriers of the different countries. However, while opportunities for each country may be similar, the ability of designated carriers to take advantage of them differ. Large airlines with extensive networks and distribution systems have an inherent advantage and are better able to endure competitive pressures. They can, for example, feed domestic traffic to their international services and cross-subsidise between routes if necessary.

It needs to be acknowledged that there is the potential for large carriers (or alliances) to dominate markets in a liberal environment. While such dominance could be mitigated by allowing fifth freedom carriers to enter the market (particularly if the fifth freedom carrier is a major airline), it would also be desirable if both countries party to the bilateral agreement have strong competition laws.

Joint services

Many air service agreements now permit joint services between the third/fourth freedom carriers and, in some instances, with fifth freedom carriers. The most common type of joint service is code sharing.

While code sharing can generate public benefits, particularly on thin routes where competition would not otherwise exist, it has the potential to create adverse competition effects. There are two general types of code share operations: where the operating carrier sells seats to the non-operating carrier; and where both carriers operate on the route and "swap seats" on each others flights without exchanging any consideration.

In the case of an operating carrier selling seats to a non-operating carrier, such arrangements may lead to a reduction in price competition as the operating carrier knows the price that it sells seats to the non-operating carrier. This places the operating carrier in a privileged competitive position and may enable it to establish air fares at a level higher than in a competitive market. Similarly, the non-operating carrier has a disincentive to compete too vigorously as it may run the risk of having the code share operation terminated.

In the case of a seat swap, such arrangements mean that one carrier may gain an advantage at the expense of the other given that the two carriers will have different operating costs and market reputations. Obviously the carriers make a commercial decision that such an arrangement is in their interest. However, the effects on competition and consumers, particularly pricing practices, need to be assessed.

There are other types of joint services, including revenue sharing, resource sharing, blocked space arrangements and joint sales and marketing efforts. The Commission considers that all joint service proposals need to be considered on a case by case basis. While many joint services have minimal competition effects others may have significant effects and may need authorisation under the Trade Practices Act (e.g. Qantas/British Airways Joint Service Agreement and the Ansett/Singapore Airlines/Air New Zealand Alliance Agreement).

2.2. The ACCC's preferred policy option

The Issues Paper prepared by the Industry Commission raised several policy options. The ACCC does not intend to comment on each of those options.

The ACCC believes that the greatest competition and consumer benefits would arise under an open skies environment. Such an arrangement would generate benefits to the public through greater competition, lower fares and increased choice. While it would be desirable that all countries participating in an open skies arrangement had adequate competition laws to cope with any possible anti-competitive behaviour, the lack of such laws in foreign countries should not be used as an excuse for not pursuing an open skies policy.

While an open skies environment is most unlikely to be achieved on a universal basis, its implementation could be pursued within the bilateral framework. The ACCC notes that, to some extent, this is already happening with the increasingly liberal bilateral air services arrangements. These liberal arrangements could act as a stepping stone to open skies. In the case of New Zealand, an open skies style arrangement exists for operations between the two countries although not for operations beyond the two countries.

3. Consumer issues

The ACCC has previously expressed concern over the potential for consumers to be misinformed about code share operations. It notes that some air services arrangements include a clause requiring airlines to inform passengers about code share operations while others do not. it also notes that Qantas, Ansett and AFTA are signatories to an industry code of conduct on the disclosure of information about code share flights to passengers. However, the effectiveness of the measures put in place needs further study (for example, IATA surveys in other parts of the world indicate that a significant percentage of travellers on code share flights were not informed of the code share operation and almost half of those passengers considered the experience adversely).

A major issue for consumers is prices. As discussed above, the current regulatory environment has the potential to lead to prices higher than would be experienced in a more liberal environment.

4. ACCC/IASC relationship

The Issues Paper raised the question of the role of the International Air Services Commission (IASC) and its relationship with the ACCC, particularly the possibility for overlap between the two organisations on competition matters. In considering this issue it is useful to recognise that there are fundamental differences between the roles of the IASC and the ACCC in assessinq competition issues.

The IASC must be proactive in its consideration of competition issues whereas the ACCC may be reactive in its role. Furthermore, competition is only one of the matters which the IASC must consider in assessing the benefit to the public of an air service proposal. The other matters include consumer, tourism and trade benefits; the development of Australian carriers; the ability of Australian carriers to compete effectively with foreign carriers; and the effect on the structure of the Australian international airline industry (including employment).

An Australian airline requires an allocation from the IASC before it can commence operations. In obtaining an allocation, the airline must submit its business proposal and have it assessed by the IASC. If the proposal contains competition issues (eg code sharing) then it needs to be cleared by the IASC before being implemented because without an appropriate determination from the IASC the airline will not get operational approval from the Department of Transport and Regional Development.

This is contrasted with the ACCC, where an airline can implement its business proposal without prior approval from the ACCC. Of course, the airline runs the risk of action subsequently being taken by the ACCC if there are competition concerns. Thus the ACCC is reactive. Should the airline apply for authorisation under the Trade Practices Act then the ACCC is proactive in considering the proposal prior to its implementation. However, the option remains for airlines to bypass the ACCC whereas they cannot bypass the IASC.

The Commission’s experience to date suggests that airlines are well aware of their obligations under the Act and normally seek authorisation for possible anti-competitive behaviour before implementing it (eg Qantas/British Airways Joint Service Agreement).

Airlines have expressed concern at the possible overlap between the IASC and ACCC on competition matters because an approval from one organisation does not guarantee approval from the other. In cases where an authorisation is sought from the ACCC and it is granted, the proposal still requires IASC approval. For example, Ansett currently has an application for authorisation of an agreement with Singapore Airlines and Air New Zealand before the ACCC. Should that agreement receive authorisation by the ACCC, it will still be necessary for Ansett to obtain IASC approval before implementing it on international routes.

It has also been argued that since the ACCC is the body with prime responsibility for enforcing competition policy the IASC should not be involved in competition matters. If a proposal submitted to the IASC is anti-competitive then the matter is best judged by the ACCC, not the IASC. This would treat the aviation industry the same as other industries. If an airline implements a proposal which is anti-competitive it runs the same risk as any other company. Furthermore, it would permit the airlines to respond more quickly to market developments. At the moment, if a foreign competitor changes its operations in the market (eg engages in fifth freedom code sharing) an Australian carrier cannot respond immediately - it must first get IASC approval. Airlines argue that if they were subject only to the Trade Practices Act they could judge for themselves the competition consequences, the potential for ACCC action and weigh that against the need to respond to market developments quickly.

There would appear to be minimal cause for concern on the behalf of airlines as the two organisations have not disagreed on any competition matter to date and the IASC has yet to refuse an application for code sharing or reject an application on competition grounds.

Furthermore, it has been argued in cases where there is sufficient capacity available the IASC need not consider competition criteria. Even when submissions are received opposing an allocation, the IASC has the discretion not to apply the criteria in paragraph 5 of the Policy Statement if there is sufficient capacity available. Thus the IASC could, if it so desired, leave consideration of competition issues the ACCC.

It is only those cases where there are competing applications and insufficient capacity available that the IASC must consider competition issues. And in such cases an airline is not disadvantaged by the possible overlap between the two organisations because it must first convince the IASC that it has a better proposal than the other applicant before any capacity is allocated and operations could commence.

To minimise overlap the ACCC and IASC have entered into a memorandum of understanding (MOU), a copy of which has been provided to the Industry Commission already. The ACCC will endeavour to work with the IASC to further refine the MOU with a view to making the existing arrangements function more efficiently.

The ACCC does not intend to comment on possible alternative policy arrangements relating to the respective roles of the IASC and ACCC. However, there are two principles which the ACCC would like to bring to the attention of the Industry Commission when it considers such alternatives. First, the ACCC would not support any arrangement which envisaged the expansion of the IASC's role by transferring competition matters relating to international aviation from the ACCC to the IASC. Second, the ACCC does not consider any arrangement which envisaged the transfer of all the IASC's functions to the ACCC as appropriate. The Act confers regulatory powers upon the ACCC in respect of competition matters and transferring the non-competition regulatory functions currently performed by the IASC to the ACCC

would not be consistent with the role envisaged for the ACCC by the Government and the Act.

5. Conclusion

The ACCC's objectives are to improve competition and efficiency in markets, foster adherence to fair trading practices in well informed markets, promote competitive pricing wherever possible and restrain price rises in markets where competition is less than effective.

The ACCC believes that these objectives can best be achieved, in the short term, by continuing to liberalise the regulatory framework for international aviation on a bilateral basis such that airlines of both countries are offered equal competitive opportunities. Where possible, open skies style bilateral agreements should be pursued.