

INDUSTRY COMMISSION INQUIRY INTO INTERNATIONAL AIR SERVICES

SUBMISSION by the DEPARTMENT OF FOREIGN AFFAIRS AND TRADE

This submission focuses on arrangements for negotiating entitlements under Air Services Agreements (ASAs) and the process of allocating capacity entitlements to Australian carriers, and related issues.

Issues considered include:

1. the approaching Ministerial-level South Pacific Forum Aviation Policy Meeting;
2. the APEC Transportation Working Group;
3. Air Transport and the General Agreement on Trade in Services;
4. Aviation links with South America; and
5. Air freight services.

1. THE SOUTH PACIFIC FORUM AVIATION POLICY MEETING:

The Ministerial-level South Pacific Forum Aviation Policy Meeting will be held on 4-5 May. Its objectives include:

- developing awareness of future management options for aviation services
- facilitating inter-government decisions on achieving safe and efficient airspace
- introduction of CNS/ATM (Communications, Navigation and Surveillance/Air Traffic Management) in the region
- progress cooperation towards liberalisation of services
- moving towards higher levels of aviation security and harmonisation of air navigation regulations

As a Forum member, Australia will be represented at the meeting by the Parliamentary Secretary to the Minister for Transport and Regional Development, Michael Ronaldson. Australia is also providing funding support.

The Forum's Economic Action Plan aims to develop strategies to enhance regional service delivery. Key issues relevant to the IC's enquiry to be addressed at the meeting include:

- 1) future airspace arrangements in the Pacific
- 2) liberalisation of air service agreements in the Pacific
- 3) regulatory oversight and safety surveillance

- 4) enhanced aviation security in the Pacific
- 5) harmonisation of air navigation regulations
- 6) future aviation consultation arrangements

Forum Leaders have been concerned for some years about the commercial viability of aviation in the Pacific. At the 1994 Forum in Brisbane, in response to concerns about regional airline losses, leaders agreed to examine options for a rationalisation of air services among Forum island countries, perhaps on a sub-regional basis. Leaders agreed that any reform of airline structures should take into account the need to ensure adequate services throughout the region (a formidable constraint given the distances and market sizes involved) and would need to look at factors such as the frequency and cost of operations, fares and safety.

At the following Forum in Madang in 1995, leaders noted the positive developments which had taken place in aviation in the region since the previous Forum, especially steps taken to stem the substantial losses being incurred by some airlines. These included route and fleet rationalisation (to match capacity more closely with demand), restructuring of airlines' management, code-share and joint aircraft leasing arrangements.

The May Ministerial meeting will be the first since 1995. Australia's participation will highlight the importance it attaches to assisting countries in the Pacific to understand and manage the complexities of aviation services, which are crucial in many ways to the development of the region's economic infrastructure.

In this context, an initiative by the Department of Transport and Regional Development to offer to Pacific island countries a proposal which provides their airlines with more flexible access to Australian gateways, and access to the Australian market in code-share with Australian carriers, has been most welcome. The initiative will help island airlines to be commercially viable and to develop their services creatively in ways which can assist the development of their economies. The initiative also demonstrates that Australia is prepared to be flexible in its approach to air services negotiations with Pacific island countries. There remains, however, much work to promote the potential benefits of the proposal to key Pacific island countries.

2. APEC TRANSPORTATION WORKING GROUP:

The Air Services Group (ASG) of the APEC Transportation Working Group in 1995 identified eight options for more competitive air services with fair and equitable opportunity for all member Economies. The eight options are as follows:

1. Air Carrier ownership and control
2. Tariffs
3. Doing Business Matters
4. Air Freight
5. Multiple airline designation
6. Charter Services
7. Airlines' co-operative arrangements
8. Market access

In 1997, APEC Transport Ministers endorsed these eight options and further instructed the TPT-WG to reconvene the ASG "to analyse and prioritise the eight options and prepare, on a consensus basis, a recommendation on the options to be developed and how they should be implemented".

Australia, through the Department of Transport and Regional Development (DOTRD), has been actively involved in the ASG, which met in October 1997 and February 1998 and has successfully completed a Report on Options. One of the recommendations is the progressive removal of restrictions on the operation of freight services, including the separation of freight and passenger capacity in air services agreements. All eight options have been prioritised and recommendations were agreed to on how they might be implemented. At the April 1998 meeting of the TPT-WG, it was agreed that the Report would be submitted to Transport Ministers by the Minister of the Lead Shepherd economy (Indonesia).

With regard to monitoring the implementation of the recommendations made by the ASG, economies can provide progress reports to the TPT-WG on a voluntary basis.

The Department of Foreign Affairs and Trade supports the work of the Transport Working Group in developing more competitive air services and believes the eight options endorsed by Ministers provide scope for the progressive liberalisation of civil aviation services within the APEC region. The Department considers that the separation of passenger and freight capacity, a position strongly advocated by DOTRD in the ASG, should result in a better service for Australian exporters and the Department fully endorses this recommendation. The removal of impediments to doing business and the lowering of tariffs, which are directly relevant to APEC's trade liberalisation and facilitation agenda, have also been supported by DOTRD.

The Department of Foreign Affairs and Trade considers that the APEC forum provides an opportunity for a co-operative and constructive approach to liberalisation of aviation services, an approach which distinguishes itself from the adversarial national interest approach usually adopted in bilateral air services negotiations. However, the sensitive nature of this issue and the consensus-based approach to APEC decision-making will continue to dictate the pace and direction of aviation reform in APEC.

3. AIR TRANSPORT SERVICES AND THE GENERAL AGREEMENT ON TRADE IN SERVICES (GATS)¹:

The treatment of air transport services in the GATS is set out in the Annex on Air Transport Services. The Uruguay Round negotiations on air transport services were difficult. They raised a number of problems reflecting the difficulty of reconciling the multilateral MFN-based GATS regime with the existing international air traffic system which, in the main, is based on bilateral reciprocal arrangements. In the end, agreement could not be reached on replacing or supplementing these existing arrangements and, as a result, the Annex confirms that any specific commitment or obligation assumed under the GATS does not reduce or affect a Member's obligations under bilateral or multilateral air services agreements that were in effect on the date of entry into force of the WTO Agreement, that is on 1 January 1995.

¹ Background information on the GATS is provided at [Attachment A](#).

In addition, the Annex makes clear that the provisions of the GATS shall not apply to measures affecting air traffic rights, however granted, or services directly related to the exercise of traffic rights. The only exceptions to this exclusion are for aircraft repair and maintenance services, the selling and marketing of air transport services and computer reservation system (CRS) services². In the case of the last three services categories, the usual GATS principles and rules apply (except for dispute settlement provisions - see below) and negotiations for specific commitments on these services took place in the Uruguay Round. Table 1 provides a summary of the air services in which key GATS Members undertook specific commitments and any listed MFN exemptions³.

The Annex also specifies that the dispute settlement mechanisms included in the GATS do not apply to measures affecting air traffic rights or services related to traffic rights. In fact, the GATS dispute settlement procedures can only be invoked with respect to air services where obligations or specific commitments have been assumed by the concerned Members but only when dispute settlement procedures in bilateral and other multilateral agreements or arrangements have been exhausted.

These arrangements for the coverage of air transport services in the GATS are not immutable. The Annex provides for periodic reviews, at least every five years, of developments in the air transport sector and the operation of the Annex with a view to considering the possible further application of the GATS in this sector. On this basis, the first review of the Annex will take place in the year 2000. At this stage, there have been no discussions by Members of the forthcoming review nor any indication of likely negotiating positions.

Table 1:

Member	Repair and maintenance services	Selling and Marketing services	Computer Reservation System services (CRS)	MFN Exemptions
Australia	Yes	No	Yes	No
Canada	Yes	No	Yes	Yes (Tax)*
European Union (12)	Yes	Yes	Yes	Yes (Sales and Marketing and CRS)
Hong Kong	No	No	No	No
India	No	No	No	No
Indonesia	No	No	No	No
Japan	Yes	Yes	Yes	No
Republic of Korea	No	Yes	Yes	Yes (CRS)
Malaysia	No	No	No	No

² Definitions of these services are given at [Attachment B](#).

³ Note: Table 1 does not attempt to describe the actual level of guaranteed market access and national treatment which a Member has undertaken to provide in the services listed. These will vary from Member to Member and can only be determined through examination of each Member's schedule of specific commitments.

New Zealand	No	Yes	Yes	No
Philippines	Yes	Yes (General sales and cargo sales agency)	No	No
Singapore	No	No	No	Yes (CRS)
Switzerland	Yes	No	No	Yes (Selling and Marketing and CRS)
Thailand	Yes	Yes (Includes CRS)	No	Yes (Selling and Marketing and CRS)
United States	Yes	No	No	Yes (Selling and Marketing and CRS)

*The Canadian MFN exemption on Tax: Exemption from taxes on income and capital of a nonresident person earned in Canada from the operation of aircraft in international traffic on the basis of reciprocity with the country in which the person resides.

4. AVIATION LINKS WITH SOUTH AMERICA

Poor aviation links have been repeatedly identified as an impediment to the development of Australia-South America trade and investment relations. Criticisms of air services to South America have centred on three factors: the low frequency of services, the limited choice of destination and route and high ticket costs (relative to other journeys of similar length). Those criticisms might be linked to other concerns as well: visa issue; distance; language problems; ignorance of the market. However, the March 1998 air services negotiations with Argentina, which resulted in an agreement permit greater competition on the Australia-Argentina route, signalled a change in approach.

At present, it is possible to fly from Australia to Argentina on Aerolineas Argentinas (AR) via New Zealand or to Chile on Qantas/Lan Chile via New Zealand, Tahiti and Easter Island. Until November 1997, both routes were twice weekly in both directions, with extra flights in peak periods. Since November 1997 AR has been operating three services per week on a full-year basis. The alternative to these services is to fly to South America via the United States, a significantly longer journey.

The report of the Senate Standing Committee on Foreign Affairs, Defence and Trade into Australia-Latin America relations (published in June 1992) devoted a chapter to the issue of transport links. The report concluded that inadequate air links between Australia and Latin America were a significant impediment to trade and investment flows between the two regions.

In July 1996, the Senate Foreign Affairs, Defence and Trade References Committee conducted an inquiry into Australia-Latin America air links and issued a report entitled The Development of Australia's Air Links with Latin America. This report concluded that

inadequate air links were a "major impediment" to growth in commercial relations with Latin America.

A 1997 DFAT/Austrade study also pointed to the paucity of air transport links with the region. In a survey of Australian businesses conducted for the study, air transport was the most frequently-cited impediment to doing business in South America, with 69% of respondents nominating poor air links as a problem. By contrast, only 33% of respondents complained of difficulties with sea transport to the region.

The problem affects both freight and passenger traffic. Globally, most air freight is carried in the holds of passenger aircraft, and the scarcity of passenger flights from Australia to South America is an impediment to the development of trade in high-value, time-critical goods and manufactures. In its submissions to the 1996 Senate inquiry, Aerolineas Argentinas claimed that its existing freight capacity on the Australia-Argentina route was almost fully utilised following rapid growth in demand in the early 1990s. Qantas argued that indirect services to Latin America through the US supplemented this capacity.

Australian trade data show that, in recent years, around 40% of total Australian non-metal manufactures exports were carried by air, but the corresponding figure for exports to Latin America was just 30%. The significantly lower proportion of Australian non-metal manufactures exports carried by air to Latin American markets seems consistent with the view that present air links are inadequate. Given the growing importance of air freight in manufactures trade, the weakness of air links between Australia and Latin America suggest that many exporters (and importers) of time-critical products are unable to exploit market opportunities fully.

Inadequate air links are probably holding back trade and investment relationships more generally.

- . Poor air services have a direct impact on the tourist trade.
- . Personal contacts in most areas of services trade and for managing investment relationships depend heavily on adequate transport links.
- Australian direct investment in South America may well be inhibited by the scarcity of direct air links, as frequent travel between the Australian headquarters and the South American subsidiary is often necessary.
- . There are also indirect effects on trade in bulk commodities which typically travel by sea flowing from the difficulties faced by business travellers to South America.

Qantas has argued previously that there is insufficient demand to warrant an expansion of capacity under the ASAs with Argentina and Chile. However, data on short term passenger movements suggest that increased services may attract more passengers. As the following table shows, large increases in inward and outward passenger movements occurred following increases in capacity between Australia and Latin America. The capacity increases occurred in March 1994 (when AR was allowed to introduce an extra flight, and April 1996 when the Qantas/Lan Chile connection to Chile gained an extra weekly flight). From November 1997, AR extended a third weekly flight to year-round operation, but the impact of this is not yet captured by the available data. While growth in short term passenger movements was

relatively slow in periods when capacity was fixed, in the year following increases in capacity rapid expansion in demand occurred. It is possible that current levels are close to a natural limit to traffic, but there is no way to test that hypothesis. Flights are generally not full.

Short Term Passenger Movements: Australia-Latin America (a)

Year ended June	Arrivals	change on previous year	Departures	change on previous year
1990	11,200		15,300	
1991	11,400	1.8%	15,700	2.6%
1992	11,600	1.8%	16,300	3.8%
1993	12,900	11.2%	16,200	-0.6%
1994	14,600	13.2%	17,700	9.3%
1995	18,500	26.7%	21,000	18.6%
1996	20,600	11.4%	22,800	8.6%
1997	25,800	25.2%	25,300	11.0%

(a) Defined as the Americas, less Canada and the US.

Source: Australian Bureau of Statistics

The recent Australia-Argentina agreement enables airlines of both countries to increase the frequency of services to 2000 seats per week (roughly equivalent to five 747 services per week), with provision to increase the frequency to 2,800 seats per week (equivalent to seven 747 flights per week) as of March 1999. A major concession on Australia's part to Argentina was to allow fifth freedom rights to Aerolineas Argentinas on the trans-Tasman route. AR had previously complained in a submission to the 1996 Senate inquiry that it was the only carrier operating the Tasman which did not have fifth freedom rights, and that restrictions on fifth freedom and beyond rights had been impediments to more efficient air services. In evidence to the Senate inquiry, AR claimed that if it were allowed to carry passengers on the Australia-New Zealand leg of its route, it could reduce seat prices by some 11.5% (page 30). Lower prices should attract more tourist traffic and help create the conditions for greater frequency of services (the prime requirement for business travellers). AR also argued that beyond rights from Australia to Asia (which it would have to operate on a code-share basis due to fleet constraints) would increase the marketability of the Australia-Argentina service: transitting through Australia is a more direct route from South America to Asia than transitting through the US. By comparison, Qantas was entitled under the existing ASA to beyond rights to South America (two points) and Europe (one point) on the Australia-Argentina route. The revised ASA now allows AR beyond rights to one point in Asia on a code-share basis, for a similar concession (beyond rights from Buenos Aires to a fourth point) granted to Australia. The revised ASA also increased the number of entry points into each country, and improved the ability of airlines to code-share on domestic services in the other country.

Under the Chile-Australia ASA, both carriers having access, albeit limited, to fifth freedom in the case of code-shared services. By comparison, New Zealand has quite liberal ASAs with both Argentina and Chile, based on the principle of competitive neutrality and incorporating extensive traffic rights.

It remains to be seen to what extent Australian and Argentine carriers will take up the new air services provisions.

5. AIR FREIGHT:

DFAT notes that air freight for Australian exporters, especially those exporting time-critical products, is likely to be increasingly important to our competitiveness. Economic research has consistently shown that social welfare is maximised when minimal artificial regulations are placed on markets. Australia's economic well-being depends on domestic and international factors, especially the competitiveness and flexibility of the Australian economy, and the strength of international markets and their openness to our exports and investment. As Australia becomes more integrated into the world economy, trade and investment will contribute more to Australia's overall economic well-being. The Government has committed itself to creating a more productive economy, in part, through cutting the regulatory burden faced by business and lifting the efficiency of infrastructure, including in transport services.

In principle, regulation is employed where markets fail. When the scale of an industry exceeds the scale of demand for its product, a natural monopoly will form. In such scenarios the successful company would maximise its profits by holding back production and charging a higher monopoly price. Such a situation is a classic example of market inefficiency. When government regulates such industries, it forces the firm to charge a price which covers its costs and a fair amount of accounting profits. The regulated price would be lower than the monopoly price, although not as low as the competitive price.

Government regulation policies are intended to protect national interests and for many years Qantas was Australia's sole international carrier and wholly owned by the Government. In this case, motivation for protectionist regulation is clear. However, in recent years, moves towards deregulation have seen the partial privatisation of Qantas, and the entry of Ansett into the international market as Australia's second international carrier. Accompanying these changes, there has been significant foreign investment in both companies. Under these circumstances, the benefits of continued regulation of access to the Australian air services market on the protection of Australian national interests are somewhat diminished. Qantas and Ansett are now "Australian flagged", internationally owned airlines, rather than Australian owned airlines. Australia's national interests are advanced through increased competition, which would result in greater market efficiency and thus lower costs to Australian businesses and consumers.

Air Service Agreements (ASAs) are, with the exception of arrangements with New Zealand and possibly Thailand, negotiated on the principle of bilateral reciprocity (i.e., country A receives an equal share in the market of country B as B receives from the market of A). These agreements do not encourage improved services through greater competition in a global market. Rather, they regulate and restrict the performance of participants in a fragmentary collection of bilateral markets. It has been argued that such arrangements provide a reciprocity in outcome, not opportunity, frustrate gains from comparative advantage and are costly to administer. This suggests it would be better for a country to be signatory to one or a few comprehensive multilateral agreements, than to negotiate/regulate separate treaties with all potential trading partners.

The ASAs with Chile and Argentina, as mentioned above, are a good example of how such arrangements can be restrictive for Australian exporters. Air freight is largely dependent upon the passenger market (90% travels in the belly-holds of passenger aircraft), and the

scarcity of passenger flights from Australia to South America is a clear impediment to the development of trade in high-value, time-critical manufactures. In particular, the significantly lower proportion of Australian non-metal manufactures exports carried by air to Latin American markets supports the view that present air links are inadequate.

GENERAL AGREEMENT ON TRADE IN SERVICES (GATS) - BACKGROUND

The General Agreement on Trade in Services (GATS) was an important outcome of the Uruguay Round of multilateral trade negotiations. The GATS, along with a series of other agreements such as the General Agreement of Tariffs and Trade (GATT), is an integral part of the World Trade Organization (WTO). The GATS entered into force on 1 January 1995 and provides, for the first time, a multilateral framework of rules for trade in services and a timetable for the progressive liberalisation of international trade in services. Australia is a Member of the GATS.

The GATS consists of three main components:

- i. the overall framework agreement of 29 Articles which sets out principles and rules
- ii. a schedule for each Member listing its "specific commitments" and any exemptions to the principle of most-favoured-nation treatment
- iii. special rules for some sectors which are contained in eight annexes.

The GATS covers all traded services sectors and applies to all measures affecting trade in services taken by all levels of government or non-governmental bodies exercising powers delegated to them by government. It applies to services supplied across the border, through the establishment of a commercial presence and through movement by individual consumers and suppliers across borders.

The GATS principles and rules comprise general obligations which apply, with limited exceptions, to all services in all sectors, and specific obligations which apply only to those services where a Member has made a specific commitment in its schedule. One of the most important general obligations is the requirement for most-favoured-nation (MFN) treatment. This requires a Member to give to services and service suppliers from any other Member treatment no less favourable than it gives to like services and suppliers from any other country. Other important general obligations include transparency of laws and regulations; provision of procedures accessible to foreign service suppliers for review of administrative decisions affecting trade in services, and non-discriminatory application of criteria for recognising foreign standards and qualifications.

Additional rules apply only to sectors in which a Member has made a binding commitment in its national schedule, that is a specific commitment. The schedules of commitments are a key component of the GATS and are used to indicate the extent to which Members have guaranteed access to a services market and the extent to which foreign services and suppliers are guaranteed equal treatment with domestic services and providers (that is, national treatment) in that market. Examples of rules which apply only where a specific commitment has been made include those relating to payments and transfers and requirements to ensure that all measures of general application (that is, domestic regulation) are administered in a reasonable, objective and impartial manner.

GATS - ANNEX ON AIR TRANSPORT SERVICES - DEFINITIONS

The following definitions apply to the Annex on Air Transport Services in the GATS:

(a) *Aircraft repair and maintenance services* mean such activities when undertaken on an aircraft or a part thereof while it is withdrawn from service and do not include so-called line maintenance.

(b) *Selling and marketing of air transport services* mean opportunities for the air carrier concerned to sell and market freely its air transport services including all aspects of marketing such as market research, advertising and distribution. These activities do not include the pricing of air transport services nor the applicable conditions.

(c) *Computer reservation system (CRS) services* mean services provided by computerised systems that contain information about air carriers' schedules, availability, fares and fare rules, through which reservations can be made or tickets may be issued.

(d) *Traffic rights* mean the right for scheduled and non-scheduled services to operate and/or carry passengers, cargo and mail for remuneration or hire from, to, within, or over the territory of a Member, including points to be served, routes to be operated, types of traffic to be carried, capacity to be provided, tariffs to be charged and their conditions, and criteria for designation of airlines, including such criteria as number, ownership and control.