Liberalisation of international passenger airline services

Australia’s international aviation industry is heavily regulated. Whether or to what extent the segment of the industry that provides scheduled passenger airline services should be further liberalised is again being debated, a particular focus being whether more airlines should be allowed to carry passengers between Australia and the United States. This Brief contains background to the debate, and examines some related economic issues.

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Executive summary

The broad thrust of Australia’s international passenger airline services is increased liberalisation where this is possible and in the national interest. Past liberalisation measures have included the provision to foreign international airlines of unrestricted access to all international airports except Sydney, Melbourne, Brisbane and Perth, the removal of all fare regulation, and the easing of restrictions on charter flights.

International passenger airline services are among the most regulated in the world with competition and trade in services curtailed. The main regulatory device is government-to-government bilateral air service agreements (ASAs). They can prevent or restrict the entry into international routes of carriers other than those designated in the agreement, and set out the terms and conditions under which airlines can fly. Australia is a signatory to 57 ASAs.

Ownership requirements that a carrier must be effectively owned and controlled by a country’s nationals for it to be designated an airline of that country are another barrier to competition. Australia has two sets of foreign ownership requirements, one for Qantas and the other for other Australian international airlines.

Slots—the right to schedule an aircraft arrival or departure, on a specified day within a specified time frame—are a device for allocating airport capacity. But the methods used to allocate slots often benefit incumbent airlines over new entrants and limit competition because, generally, access to slots is not contestable.

Some countries have liberalised their arrangements. This liberalisation has taken the form of bilateral and regional ‘open skies’ agreements.

A bilateral open skies agreement permits airlines of the signatory countries to fly via any country to any city in the other country and beyond to any other country, without any restriction on frequency of service or fares. But such agreements fall short of full liberalisation because, for example, they include restrictions such as limiting flights only to nationally-designated carriers, and do not include cabotage rights—the right of an airline of one country to carry domestic traffic between any two points in another country. Regional aviation markets are the aviation equivalents of free-trade areas for goods. An example is the Australia-New Zealand Single Aviation Market. But regional aviation markets—like open skies agreements—are limited to the carriers of the signatory countries.

International experience supports the case for entry liberalisation. In Australia’s case, the Productivity Commission found that liberalisation would benefit consumers in the form of lower fares, stimulate downstream industries such as tourism and other industries, and increase the availability of international air freight capacity in regional areas.

Critics, however, charge that the Government has done little to liberalise bilateral agreements. Critics also claim that the Government has ‘protected’ Qantas including, most recently, by excluding Singapore Airlines (SIA) from the trans-Pacific route for an indefinite
period; critics claim that the lack of competition on the route has resulted in Qantas’s fares being almost 40 per cent higher than on comparable routes where competition is greater, and that the decision will result in Australia forgoing $114 million annually in tourist revenue. For its part, Qantas claims, among other things, that Singapore has little to offer, there is no lack of capacity on the trans-Pacific route, and that other carriers have either abandoned or have chosen not to enter it. The Government has said that the benefits of allowing SIA on the route would be very small, and that Virgin Blue (and possibly Air Canada) will provide competition for Qantas. Some proponents of the status quo argue that it is in Australia’s national interest to protect Qantas from competition from government-owned airlines which, they claim, receive government financial support, giving them a competitive advantage over ‘fully commercial’ airlines such as Qantas.

Introduction

The international airline industry is an important segment of the Australian economy; in 2005, more than 50 airlines operated scheduled passenger and freight services to and from Australia. But in contrast with most sectors of the Australian economy, the segment of the industry which provides scheduled international passenger airline services is heavily regulated. The desirability of liberalisation is again being debated, a particular focus being whether more airlines should be allowed to carry passengers between Australia and the United States. This Brief contains background to the debate, and examines some issues in international passenger airline services policy. In particular, it focuses on the potential benefits for Australian consumers. It does not deal with charter and freight services or with aviation safety.

Forms of regulation

Air service agreements

A fully liberalised international passenger airline system would be one in which routes between, say, countries A and B would be open to carriers from not just A and B but also from other countries, provided the other countries’ carriers meet the safety and other strictly operational requirements of A and B. In contrast, the industry is one of the most regulated in the world, and competition and trade in services are curtailed. Consequently, few long-haul routes are fully open to competition.

The main regulatory device is government-to-government bilateral air service agreements (ASAs). They can prevent the entry into international routes of carriers other than those designated in the agreement and:

… set out the terms and conditions under which airlines can fly. Typically they specify capacity, frequency, routes, cities, ownership provisions, safety certification, price approval processes and many other details.
Most ASAs, however, do allow some access to ‘bilateral’ routes by third country airlines. For example, Qantas is permitted to fly between Singapore and the UK under Australia’s ASAs with Singapore and the UK.

The policy framework within which countries negotiate capacity rights and other matters contained in ASAs are known as ‘freedoms of the air’. They are shown in Table 1.

**Table 1: Freedoms of the air**

<table>
<thead>
<tr>
<th>Freedom Type</th>
<th>Description</th>
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<tbody>
<tr>
<td>First</td>
<td>The right of an airline of one country to fly over the territory of another country without landing</td>
</tr>
<tr>
<td>Second</td>
<td>The right of an airline of one country to land in another country for non-traffic purposes such as refuelling or maintenance, while en route to another country</td>
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<tr>
<td>Third (to)</td>
<td>The right of an airline of one country to carry traffic (passengers, cargo or mail) from its country to another country</td>
</tr>
<tr>
<td>Fourth (from)</td>
<td>The right of an airline of one country to carry traffic from another country to its own country</td>
</tr>
<tr>
<td>Fifth (intermediate and beyond)</td>
<td>The right of an airline of one country to carry traffic between two other countries providing the flight originates or terminates it its own country</td>
</tr>
<tr>
<td>Sixth</td>
<td>The right of an airline of one country to carry traffic between two other countries via its own country. A sixth freedom is effectively a combination of two sets of third and fourth freedoms</td>
</tr>
<tr>
<td>Seventh</td>
<td>The right of an airline of one country to operate flights between two other countries without the flight originating or terminating in its own country</td>
</tr>
<tr>
<td>Cabotage</td>
<td>The right of an airline of one country to carry traffic between two points within the territory of another country</td>
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Note: cabotage generally applies only to scheduled services and not to, say, charter flights.

Australia is a signatory to 57 ASAs. An example of a restrictive ASA is that with the United States. It is quite open in terms of access for Australian and United States airlines but, apart from New Zealand, no major third country has airline rights to fly the Australia-United States route.
Ownership restrictions

Requirements that an international carrier must be substantially owned and effectively controlled by nationals of the designating country are a barrier to competition. The Productivity Commission report on international air services noted:

Of all of the bilateral system’s constraints on efficiency and competition, probably the most fundamental is the requirement that national flag carriers be locally owned and controlled.\(^8\)

Most countries—including the United States, Canada, Japan, China, New Zealand, European countries and Australia—restrict foreign (in the case of the EU, non-European) shareholdings in national airlines.

Australia has two sets of foreign ownership requirements, one for Qantas and the other for other Australian international airlines.\(^9\) Foreign ownership for both is limited to 49 per cent. In addition, ownership of Qantas by foreign airlines is limited to a total of 35 per cent in aggregate, while a single foreign airline cannot hold more than 25 per cent. Other airlines must demonstrate that Australian nationals have substantial effective control.

Airport access and slots

Adequate access to airport infrastructure is essential for safe and efficient services. Slots—the right to schedule an aircraft arrival or departure, on a specified day within a specified time frame—are a device for allocating capacity. But the methods used to allocate slots often benefit incumbent airlines over new entrants and limit competition because, generally, access to slots is not contestable.

Sydney is the only Australian international airport that has a slot management scheme. The scheme was introduced in 1998 to facilitate the cap on movements authorised under the *Sydney Airport Demand Management Act 1997*\(^10\).

Liberalisation

Bilateral open skies

Some countries have liberalised their arrangements. Liberalisation has taken the form of ‘open skies’ agreements between pairs of countries and within regional groupings. Open skies:

\[ \text{… imply no limits on the number of airlines that may be designated by either country; ii) unrestricted capacity and frequencies on all routes; iii) full fifth-freedom and sixth-freedom rights and unlimited change of aircraft type on all routes; and iv) full pricing freedom unless fares are contested simultaneously by both governments …}^{11} \]
An example of a bilateral arrangement is the (yet to be ratified) agreement between the United States and the European Union (EU). This will replace the bilateral agreements between the United States and individual EU countries. The agreement will allow, among other things, every EU and United States carrier to fly between every city in the EU and every city in the United States. The agreement also allows United States and EU carriers to determine matters such as the number of flights, routes and fares according to market demand.

Open skies agreements fall short of full liberalisation. For example, they include restrictions such as limiting flights only to nationally-designated carriers, do not include cabotage rights—the right of an airline of one country to carry domestic traffic between any two points in another country—and discriminate against third parties if open skies agreements are not in place with those parties.

**Regional markets**

Regional markets are the aviation equivalents of free-trade areas for goods. Examples are the EU single aviation market, the Australia-New Zealand Single Aviation Market (SAM), and the Multilateral Agreement on the Liberalisation of International Air Transport (MAlgorithm of which Brunei, Chile, New Zealand, Singapore and the United States are members. The SAM allows, among other things, airlines from both countries to fly unrestricted within each other’s territory, and across the Tasman and then on to third countries without restriction, subject to safety and operational regulatory requirements being met. It goes further than other open skies agreements in allowing cabotage and cross-border ownership of domestic airlines. Regional aviation open skies markets—like bilateral open skies agreements—are usually limited to the carriers of the signatory countries, although MALIAT is open to any country or economy to join.

**The case for liberalisation**

International experience supports the case for entry and pricing liberalisation. A survey of experience in OECD countries found:

> On the whole, these results confirm that air transport reforms aimed at liberalising entry (e.g. by eliminating bilateral designation rules or extending charter flights) and prices involve significant benefits for all categories of travellers.

In Australia’s case, the Productivity Commission found that liberalisation would benefit consumers in the form of lower fares, stimulate downstream industries such as tourism and other industries, and increase the availability of international air freight capacity in regional areas.
Liberalisation and Australian Government policy

Australia’s international passenger airline policy is set out in the document titled *International Air Services* issued in June 2000. The broad thrust of the policy is greater liberalisation where this is possible and in the national interest. Liberalisation measures include the removal of all fare regulation, and liberalisation of the charter market. (The Government has also implemented open access for dedicated freight services).

The Government announced the policy in 2000 in response to recommendations in a Productivity Commission report. The Commission’s findings had five main elements:

- national designation requirements should be less restrictive
- Australia should pursue reciprocal open skies agreements based on removing restrictions on capacity, routes (including points of access) and other matters
- Australia should pursue, internationally, measures to deregulate the industry
- Australia should unilaterally remove restrictions on foreign airlines’ access to international airports other than Sydney, Melbourne, Brisbane, and Perth; and
- more efficient use of capacity-constrained airports. The Commission also recommended that the Government commission an inquiry into airport capacity.


With respect to national designation, the Commission noted that designation does not require national ownership and argued that:

> Designation should be based on a less restrictive test that does not require ownership by nationals.

The Government decided to retain the ownership requirements on Qantas but changed the requirements on other airlines to those described above.

The Government accepted the Commission’s recommendations to pursue open skies agreements on both bilateral and multilateral bases. The former is in keeping with international experience:

> The predominant regulatory response to this pressure [on bilateral agreements] has been to maintain the bilateral system, but to relax many of the provisions in these agreements.

Critics, however, argue that the Government has done little to liberalise bilateral agreements. For example:
The best indicator of how serious the Government is about open skies is its record. It is
dismal. In six years, it has signed only one full open-skies agreement (with New Zealand)
and only one cargo-only open-skies agreement (with the US). In contrast, the US has signed
40 in the past six years … A possible government defence is that the US, with its huge
bargaining power, can more easily strike these agreements. But even NZ has 11 open-skies
agreements in place. And NZ, Singapore and the US signed the first multilateral open-skies
agreement in 2001.22

The Government partly eased access to airports to provide unrestricted access for foreign
international airlines to all international airports except Sydney, Melbourne, Brisbane and
Perth.23 This has, for example, allowed Singapore Airlines (SIA) to offer additional flights to
and from Adelaide.

The Government rejected the recommendation that it commission an inquiry into airport
capacity on the grounds that a review could generate uncertainty amongst bidders for the
purchase of Sydney Airport. This argument is obviously no longer valid now that Sydney
Airport has been sold.

With respect to airport efficiency, the Commission found that:

… there is still significant scope to increase efficiency through greater use of market
mechanisms.24

These mechanisms include peak-load pricing, and markets for landing and take-off slots and
terminal facilities. Peak-load pricing is a means of rationing demand whereby airport charges
are higher at peak than off-peak periods. For example, in the United Kingdom, BAA levies
different landing charges in peak, shoulder and off-peak times at Heathrow and Gatwick
airports in the United Kingdom.25 No Australian international airport now applies peak-load
pricing, which is a common in public transport and the electricity industry.

With respect to slots, it has been argued that:

Economic efficiency … requires slots to be allocated among carriers in such a way that they
serve those passengers or shippers of freight who value them most highly.26

Sydney Airport fails this criterion. The Commission found that the system of slot
allocation—slots were initially allocated to airlines on the basis of the services that they
operated in 1997—entrenches incumbent airlines, and that peak-period slots that incumbents
hold are generally not available to new entrants27 (slot constraints apply mainly at peak
times).28 It seems unlikely that the Government will change the slot system greatly if at all.

Qantas: a protected species?

Qantas is the dominant Australian-designated international passenger carrier. This seems
likely to remain the case for some time.29 While Pacific Blue—Virgin Blue’s international
airline—is also a designated carrier, its services are, for the moment, limited to the South
Pacific. Qantas, however, competes with other airlines on most of the routes it services. The level of competition differs among routes. For example, price competition on the Australia-UK route is strong where ‘hub’ (sixth freedom) airlines located along the route like SIA, Malaysian, Cathay Pacific and Emirates provide significant competition.

**Trans-Pacific route**

A policy issue is whether SIA—and possibly other airlines—should be allowed to fly the trans-Pacific route. This route is reportedly Qantas’s most lucrative. Only Qantas and United Airlines provide direct flights on this route since Air NZ withdrew from direct flights in 2003. However, on 25 January 2006, Air Canada announced that it would apply to Canadian and Australian authorities to start a daily Toronto-Los Angeles-Sydney flight beginning in the first half of 2007. Under the Australia-Canada ASA, Canadian airlines can fly via San Francisco to Australia, but not via Los Angeles.

**Qantas’s and other airlines’ positions**

Qantas opposes SIA’s entry to the trans-Pacific route. Qantas claims that Singapore has little to offer: Qantas already has unlimited access to Singapore, and SIA has little to offer by way of ‘effective reciprocity’ which would allow Qantas to provide ‘beyond services’ to third countries from Singapore, for example, to Europe where Qantas does not have the same access to slots as its competitors. Qantas also claims that there is no lack of capacity on the route, that other carriers have either abandoned or have chosen not to enter it, and that competition on the route is considerable. More generally, Qantas claims that it does not face a level playing field with subsidised and government–owned airlines benefiting from unfair advantages. Finally, Qantas argues that its foreign investment requirements increase its cost of capital by inhibiting access to international capital markets.

Virgin Blue has joined with Qantas in arguing against allowing SIA’s entry to the cross-Pacific route. Virgin Blue argues that it, as an Australian-designated carrier, should be granted preferred access over SIA.

It seems that United Airlines and the US Government do not have a specific view on the existing Australian-imposed regulatory constraints on competition on Australia-US direct services. However, it seems likely that the financially-troubled United Airlines would be a net beneficiary from Australia’s protective stance.

**Government's policy**

The Government initially delayed deciding on SIA’s application to enter the trans-Pacific route citing instability in the international aviation market. On 16 June 2005, the Government stated that it could not grant SIA access at that time, advising Singapore that any decision on its request would be part of a major internal review of aviation policy being undertaken by the Department of Transport and Regional Services.
On 21 February 2006, the Government announced that it had denied SIA’s request:

… on the issue of access to the Australia-USA ‘Pacific route’, the Australian Government may in the future negotiate access to the route on a case-by-case basis where it is in the national interest and where we can gain benefits to Australia. In terms of Singapore Airlines request for access to the Pacific route, the Government has decided not to grant access at the present time. If access is negotiated in the future, it will be limited and phased. We would not envisage Singapore Airlines operating on the route for some years … this timeframe would allow Virgin the opportunity to develop its stated plans for the route. There is already plenty of scope for competition on the route, with any US or New Zealand airline, along with those of a number of countries, able to commence at any time.\(^\text{40}\)

The Government has also said that modelling suggested that the benefits to the economy would be ‘very small’; according to a media report, the Bureau of Transport and Regional Economics found best-case scenario benefits of about $45 million a year and possibly as little as $10 million a year.\(^\text{41}\)

Critics’ positions

Critics charge that the Government is protecting Qantas, and claim that allowing SIA on the trans-Pacific route would benefit travellers and the tourism industry. For example, the Australian Financial Review, writing before the Government’s decision of 21 February 2006, stated:

Until now the federal government has supported Qantas’s bid for protection on the trans-Pacific route … [Further] Qantas’s case against open skies—that Singapore and Emirates benefit from government subsidy and access to European ports—is misconceived. The government shouldn’t deny us choice and convenience on the [Los Angeles] route because of European protectionism, regrettable though it is.\(^\text{42}\)

Critics also claim that the competition on the trans-Pacific route is limited and that this has resulted in Qantas’s fares being almost 40 per cent higher (on a kilometre basis) than on comparable routes where competition is greater, and that the decision will result in Australia forgoing $114 million annually in tourist revenue.\(^\text{43}\)

Conclusions

The restrictions on trade in international airline passenger services contrast with the liberalisation of most sectors of the economy. The arguments and experience—international and for Australia—are persuasive that further liberalisation would benefit travellers and the tourism and air freight industries. However, these potential benefits are only some of the considerations the Australian Government took into account when considering whether further liberalisation is in the national interest. The Government’s decision to give Virgin time to develop its plans for trans-Pacific flights suggests that one such consideration is to allow an Australian airline to develop before allowing foreign airlines on the trans-Pacific route.
It is unclear whether the Government intends to release the findings of the internal review of international aviation policy that the Department of Transport and Regional Services undertook. The *Australian Financial Review* in an editorial called on the Government to release the report to support its claim that the benefit to the economy would be small from allowing SIA access to the trans-Pacific route.⁴⁴

**Endnotes**

2. Australia’s aviation safety regulation is based on the international standards, recommended practices and procedures laid down by the International Civil Aviation Safety Organization.
4. In this respect, the industry is comparable with the sea cargo shipping industry.
7. ibid., p. xxi.
8. ibid. p. xxx.
9. The foreign investment requirements for Qantas are in the *Qantas Sale Act 1992*. The ownership requirements of other Australian international airlines are in section 11A of the *Air Navigation Act 1920*.
10. The Act enshrines a cap of 80 hourly movements partly as a means of limiting aircraft noise.
12. The EU transport Council of Ministers has to approve the agreement.
13. Previously, capacity and destinations of such ‘beyond services’ were restricted. See Productivity Commission, op. cit., p. xxiii.
15. In 2003, the number of inbound visitors from the United States coming for holidays was 247 200 while the number of Australians travelling to the United States for holidays was 166 600. Source: Australian Bureau of Statistics, *Year Book Australia 2005*.
17. ibid.
23. The Government also allowed foreign international airlines operating to regional Australia unlimited capacity, codeshare and own stopover rights. See Hon. John Anderson (Minister for Transport and Regional Services) and Hon. Peter Costello (Treasurer), op. cit.
29. The proposal to allow Qantas’s subsidiary, Jetstar, to fly international routes will probably fall under the Qantas umbrella given that Jetstar is a wholly-owned subsidiary of Qantas.
32. Beyond rights are the right of a carrier from one country to fly to another country, and then beyond to a third country.
36. ibid.

