

WEANING THE INFANT - REGULATORY OPTIONS
FOR AUSTRALIA'S MATURING AIRLINE INDUSTRY

PAUL HOOPER
SENIOR LECTURER
FACULTY OF BUSINESS
ROYAL MELBOURNE INSTITUTE
OF TECHNOLOGY

CHRIS BIGG
EXECUTIVE OFFICER, AVIATION
NORTHERN TERRITORY DEPARTMENT
OF TRANSPORT AND WORKS

ABSTRACT

Australia's 34 year old Two Airline Policy has been the subject of debate for many years. The current Commonwealth Review of Australia's domestic aviation regulation has focussed attention on the economic efficiency and public interest aspects of the Two Airline Policy. This paper discusses the fundamental issues raised by submissions to the Review. In particular the extent to which competition in the industry should be regulated, and the applicability of overseas deregulation and post-deregulation experience to Australia. This paper canvasses options for regulatory reform in Australia and proposes a favoured option.

ACKNOWLEDGEMENT

The authors have drawn upon material used in the preparation of the Northern Territory Submission to the Independent Review of Economic Regulation of Domestic Aviation, and use of this material is gratefully acknowledged. The views expressed in this paper are the responsibility of the authors.

WEANING THE INFANT - REGULATORY OPTIONS
FOR AUSTRALIA'S MATURING AIRLINE INDUSTRY

INTRODUCTION AND BACKGROUND

For the last half century aviation has played an important part in the economic and social life of Australia. As a consequence, government and public interest has often been focussed on the efficiency and well being of Australia's domestic airline industry. Due to the Commonwealth's Independent Review of Economic Regulation of Domestic Aviation, more commonly known as the Two Airline Policy Review, particular attention is currently being paid to the introspective domestic airlines, TAA and Ansett, and their regulatory environment by government, consumer organisations, potential and would be trunk route entrants, tourism interests, employee organisations and academics.

The object of that interest is the legislative regime which regulates Australia's domestic aviation and which we know as the Two Airline Policy. The Two Airline Policy was instituted by the Menzies Government 34 years ago, and it is important to consider it in its historical perspective in order to be able to analyse the arguments being put for and against the current regulation.

Fear of monopoly is often the basis for government intervention in the market place. Australia's government owned domestic airline, TAA, was born in 1946 through fears that an important developing industry would be monopolised by foreign shipping interests. The public interest was to be protected by public ownership. Subsequent developments, though, led the government of the day to favour a policy of limited competition between two major airlines; monopoly, either public or private, was to be avoided at all cost.

However, the first attempt to stabilise the industry failed, due at least in part to competitive pressure. A third operator, Ansett Airways, aggressively competed with TAA and Australian National Airways (ANA) with a no-frills, low fare service. ANA was subsequently taken over by Ansett, which proceeded to also take over the remaining threats to the major airlines. In concert with the Two Airline Policy, the Ansett action meant that entry to the domestic airline industry was closed until further notice.

The current regulation is based on the Airlines Agreement Act 1981, Independent Air Fares Committee Act 1981 and Airlines Equipment Act 1958 as amended. This legislative regime arose out of a 1981 Agreement between TAA, Ansett and the Commonwealth which will run until at least January 1990. In essence, the Agreement acts to preserve the main airline routes for TAA and Ansett.

For its part the Commonwealth agreed not to permit the importation of heavy jet aircraft which would compete with Ansett and TAA, effectively controlling entry to the domestic airline industry. The airlines agreed to compete in a predetermined way and abide by decisions of the Independent Air Fares Committee and Ministerial equipment determinations. The role of Qantas is specified as an international carrier only, and domestic freight and charter operations are not regulated. However, as charter is almost non-existent and freight accounts for around 10% of airline revenue, these two activities are peripheral to scheduled passenger flights. In short, entry to the industry, pricing arrangements and the productive capacity of the industry are all regulated.

When passing the 1981 legislation, the Commonwealth agreed to review the Two Airline Policy prior to 1990. Notwithstanding this, an early commencement of the review, under the Chairmanship of Mr Thomas May, began after East-West Airlines challenged the Constitutional validity of the Independent Air Fares Committee Act in the High Court. East-West subsequently dropped the constitutional challenge, but resumed High Court action in December 1985 upon Commonwealth refusal to allow importation of a fifth F28.

Justification to continue the Two Airline Policy continues to rest upon the argument that a monopoly would emerge. In addition, TAA, Ansett and airline employee organisations have argued that deregulation will lead to wasteful competition, reduction in safety standards and an unprofitable, unstable industry. The current policy is criticised because of the lack of a truly competitive environment, resulting in the travelling public not having access to the fare/service combinations it wants. Lack of competition blunts the stimulus to efficiency, leading to a dead weight loss and higher fares. In summary, there are weighty arguments on both sides for the May Review to consider.

This paper examines the nature of the current air travel market and airline servicing of that market, surveys the major arguments for regulatory reform, discusses some regulatory options, leading to the development of a preferred option suitable to Australia's current circumstances.

THE AUSTRALIAN AIRLINE MARKET

If it can be said that there is a "natural market" for air travel within Australia, it needs to be recognised that this can only be viewed within the perspective of airlines servicing the wider travel market. Airline technology is able to provide safe and comfortable travel over large distances much more quickly than competing surface modes. However, air travel's share of the total non-urban market is small, although its attractiveness improves with journey distance. The decision to travel by air is strongly influenced by the value attached to travel time and the ability to pay. Both are related to purpose of journey.

WEANING THE INFANT - REGULATORY OPTIONS
FOR AUSTRALIA'S MATURING AIRLINE INDUSTRY

The National Travel Survey (BTE 1981) provides useful data on non-urban travel. The private car dominated the market for non-urban trips with a share of around 84%. Air travel was next with 6.2%. For journeys in excess of 300 km, air transport carried as many travellers as buses and trains combined. For journeys in excess of 1000km air carried 5.5 times the number of passengers than did bus and train. Air transport only began to compete with the private car for journeys over 1000km, with 35% and 52% market share respectively.

Around 50% of airline travel is for business purposes. Non-business travel is usually divided into holiday, visiting friends and relatives (VFR), and other. These represent national figures of around 20%, 20% and 10% respectively. As early air travel was dominated by the business traveller and the wealthy, it is not surprising that the current market displays these characteristics. Through rising real incomes, more efficient aircraft, increasing convenience, and greater public acceptability of air travel the airlines have been able to make inroads into the total market which travels for non-business purposes. ⁽¹⁾

However, airline travel remains relatively expensive and the holiday travel market is strongly sensitive to price (BTE 1985 p.14). In contrast, there is strong evidence that business travel is more sensitive to service level changes rather than price, particularly in the high density corridors between Melbourne, Sydney and Brisbane. On the longer routes, demand becomes progressively more responsive to price level for all passenger traffic. Since these routes generally have low traffic densities, it is understandable that TAA and Ansett have concentrated their marketing efforts on the domestic routes where the business traveller can be easily targeted.

Around 75% of TAA and Ansett aircraft capacity is devoted to the markets contained in the triangle linking Brisbane, Adelaide and Hobart. Eleven city-pair markets in this area accounted for 64% of total passenger traffic (passenger kilometres) and 75% of network passengers in 1983. The routes between Melbourne, Sydney and Brisbane carried one-third of the total passenger traffic and 44% of network passengers. The dense routes in the south-east corner are mostly less than 1000km, while the longer routes can generally be described as low density. Only the Perth markets (i.e. Melbourne-Perth, Adelaide-Perth and Sydney-Perth) are included in the long-dense category. The structure of Australian routes can be seen in Figure 1 and Table 1.

1. It is also worth noting that the holiday travel market does not recognise the artificial boundaries of domestic and international airline regulation. A holiday abroad can be substituted for a holiday in Australia, and Australia is but one of the many destinations for foreign tourists. Hence, the domestic airlines (and domestic destinations) face strong international competition.

HOOPER/BIGG

TABLE 1

Australian Market Share by Density and Distance - 1983(a)

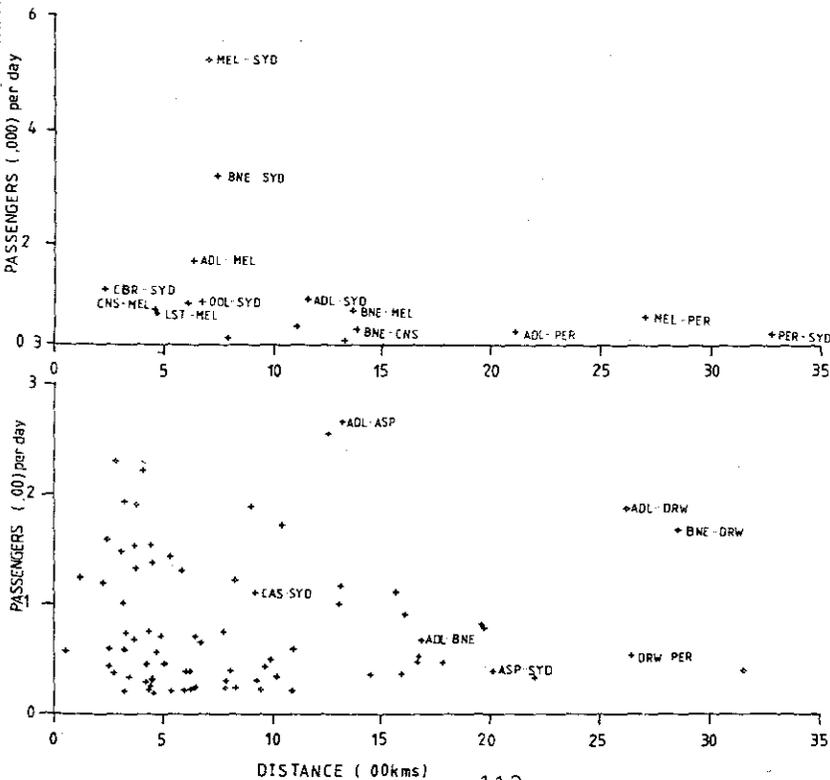
DISTANCE (km)	Less than 300	% PAX PER DAY (b) 300 or more	TOTAL
Less than 1000	18.5 [59.2] (c)	54.7 [8.2]	73.2 [67.4]
1000-2000	11.4 [21.4]	7.1 [2.0]	18.5 [23.4]
2001 +	5.4 [8.2]	2.9 [1.0]	8.3 [9.2]
TOTAL	35.3 [88.8]	64.7 [11.2]	100.0 [100.0]

Notes: (a) Top 98 city-pair markets
 (b) Percentages calculated on passengers "uplifted and discharged within flights"
 (c) Bracketed figures are percentages of city pairs in each segment

Source: Department of Aviation Domestic Air Transport Statistics, Year Ended December 1983

FIGURE 1

Markets by Density and Distance



WEANING THE INFANT - REGULATORY OPTIONS
FOR AUSTRALIA'S MATURING AIRLINE INDUSTRY

Although TAA and Ansett emphasise their role in provision of a national jet network, it can be clearly seen that most of their activity is concentrated in the south-east. This is especially so during peak periods. Equipment availability on the long-thin routes is mainly dictated by the requirements of the dense south-east routes, in accordance with a marketing strategy focussed on the needs of the business traveller. The development of this market has been promoted through attention to personalised reservations and check-in services, high frequency, direct flights, convenient schedules, in-flight service, creation of a business class in aircraft, and frequent flyer clubs to maintain airline loyalty.

This is not to suggest that TAA and Ansett have neglected the needs of non-business travellers and the thin routes. The airlines have sought to promote discretionary travel by offering reduced fares, although it has been claimed that these often resulted more from public pressure than marketing initiatives. Indeed, it is common to refer to the lower fares as concessions rather than a device to develop price sensitive markets. In contrast, East-West Airlines seems to have achieved some success in stimulating demand. They have offered new fare/service combinations which are acceptable to travellers who would otherwise not have travelled by air (see Milloy, Douglas and Sullivan, 1985).

The consequences of this focus on the south-east on the remainder of the network are that frequency remains relatively low, flights arrive and depart at inconvenient times and connections within the network are sometimes limited, load factors are higher, and service levels are periodically reduced through rationalisation practices. Furthermore, parallel scheduling has exacerbated the problem of low frequency and gives rise to severe congestion at the smaller airports. Alice Springs Airport at around midday is a prime example. In summary, service levels on the longer routes have remained low while the range of low fares on offer is limited, reflecting marketing strategies which recognise the captive nature of the traffic on the longer routes.

The nature of that captive market can be seen through load factors on Northern Territory routes and the dependance on air travel by Territorians. On Northern Territory routes average load factors are high (refer Table 2). Most of the major routes have load factors of 75% and upwards, with some as high as 85% and 90%.

TABLE 2

Selected Load Factors

ROUTE	CARRIER	
	TAA	ANSETT
Adelaide-Alice Springs-Darwin	75.0	74.8
Brisbane-Darwin	84.6	78.0
Brisbane-Mt Isa-Darwin	75.6	72.3
Cairns-Gove	90.2	78.7
Sydney-Alice Springs-Darwin	69.6	78.7

Source: Department of Aviation, Air Transport Statistics, Year Ending June 1984

National Travel Survey statistics indicate the extent of Territory dependence on air travel. Although the private car dominates the share of travel to nearly all significant destinations in Australia, over half of the travellers to Darwin arrived by air. Visiting friends and relatives, the most important journey purpose elsewhere, accounted for only 14.5% of total trips to Darwin and 4.5% of trips to Alice Springs, indicating the relative isolation of the Northern Territory. Both the Northern Territory and Western Australia have much lower trip rates per household than the rest of Australia, reinforcing the difficulty and cost of travel. The continued improvement of air transport services is vitally important to residents of northern and western Australia.

Realistically, the basis upon which services can be significantly improved is growth in the non-business market, especially tourism. Some traffic growth can be expected through population increase and rising incomes. However, the key to developing better services for the benefit of all travellers, especially on the long-thin routes, is to stimulate the demand for tourist travel. Internationally recognised tourist attractions abound in the north and west of Australia. What is required to develop these tourist markets is a commitment by the travel industry, tourist operators and the airlines to foster the required growth.

Since 1952, when the Two Airline Policy was introduced, airline traffic has increased by at least six times. The Sydney-Melbourne market is now as big as the total Australian market was then. Growth will no doubt continue on the south-eastern network resulting in further improvements in service levels. However, for there to be significant improvement in the airline servicing of the current long-thin routes, tourism development is the only answer. The existing Two Airline Policy seems to have provided an environment that has little inherent incentive for the airlines to develop tourism markets.

WEANING THE INFANT - REGULATORY OPTIONS
FOR AUSTRALIA'S MATURING AIRLINE INDUSTRY

The supporters of the Two Airline Policy, which include TAA and Ansett, strongly argue that there is little need to change the underlying basis of the existing regulatory framework. It is maintained that the Two Airline Policy has served Australia well through providing an environment for the orderly development of:

- a safe and efficient airline industry;
- a national jet network serviced by modern equipment; and
- competition that is appropriate to Australia's market size.

According to some industry members and employee organisations the removal of the current system could lead to abandonment of some thinner routes, wasteful competition, and possibly the emergence of a monopoly on the entire network. Furthermore, the consequent financial instability could lead to a collapse of airline investment, a lowering of crew training and maintenance standards, with resulting compromise of Australia's excellent aviation safety record.

In spite of these arguments, strong criticism of the Two Airline Policy has persisted, as evidenced by the submissions to the May Review from a wide range of sources, including every State Government and the Commonwealth Treasury. The main criticisms can be summarised as follows:

- industry market performance has been unsatisfactory, as evidenced by the limited range of fare/quality service choices available to consumers;
- the Two Airline Policy does not provide sufficient stimulus to efficiency, leading to lower productivity, high costs and high air fares;
- the regulatory mechanism of itself represents a deadweight loss to the community.

Although the Two Airline Policy has been controversial for two decades, the current Review reflects the mounting criticism which has been given added impetus by relaxation of domestic airline regulation in Canada, United Kingdom and New Zealand, but most notably in the United States. It is hence important to examine this recent overseas experience and to consider its relevance to the Australian industry and market.

United States

In some respects US regulation prior to the Airline Deregulation Act 1978 was similar to Australia's regulatory regime. Controls on entry to the industry and fares existed. Special features were the lack of capacity controls, servicing of small communities and the existence of sizeable semi-competitive intrastate markets in Texas and California.

A visible consequence of the lack of capacity controls, in conjunction with entry and fare regulation, was the concentration of competitive strategies around offering greater frequency. Since the airlines were permitted to maintain profitability through airfare increases, additional market share could be won by increasing capacity. A feature of the airline industry was the capacity 'wars' of the late 1960's and early to mid 1970's.

One of the important aspects of the US industry was the liberal Government attitudes to regulation of intrastate services in California and Texas. In California, Pacific Southwest Airlines and Air California emerged as efficient and competitive operators in the 1960's; similarly with Southwest Airlines in Texas. They were low cost operators of jet aircraft and competed successfully with the trunk carriers on the basis of substantially lower fares. Their success strongly influenced the deregulation debate and suggested that lower fares would result from an abandonment of economic regulation.

Following the formal commencement of deregulation in 1978, the airline industry was subject to several external factors which increased its costs, reduced demand and restricted operations. However, sufficient time has now elapsed to draw some valuable lessons from the US experience. The significant aspects of the deregulation era to examine are entry to the industry, new entrant marketing strategies, counter strategies by the established carriers, and effects on services to small communities.

New entrants have included the previous intrastate carriers, former commuter operators and several completely new airlines. In addition, many of the 'local service' operators expanded their existing interstate networks. Former charter airlines such as World Airways began scheduled services. Hence there was a ready pool of potential entrants and this has led to a significant change in the dynamics of competition. In the first 3 years after deregulation at least one additional carrier had entered 122 of the 200 most heavily travelled markets, although only 24% of the smaller markets had experience entry. Hence barriers to entry did not appear great.

Cost advantages were the main characteristic of the new entrant carriers. These existed because of low labour costs through higher productivity and comparatively lower salaries, lack of airline infrastructure and basic passenger service, purchase or lease of used jet equipment, identification of the optimum aircraft capacity (less than 130 seats) and initial fleet size. An aggressive and entrepreneurial management complemented the inherent cost advantages and allowed the new entrants to offer low fares. Most entrants have concentrated on short to medium-haul high density routes. Few are servicing routes in excess of 1200km.

WEANING THE INFANT - REGULATORY OPTIONS
FOR AUSTRALIA'S MATURING AIRLINE INDUSTRY

New entrant carriers were not interested in the dense long-haul routes because of the excess capacity possessed by the major trunk airlines. Another important element was the successful model of the pre-deregulation intrastate carriers. The new entrants often utilised secondary airports and initiated operations with a single route shuttle service type operation. Later they developed more complex route structures, often employing hub-and-spoke principles. The overall impression was one of aggressive and low cost operators, making in-roads into the total market by concentrating on price-sensitive passengers who are willing to accept a lower level of service. The regional airline statistics in Table 3 are an indication of their growth.

TABLE 3

Growth of Regional Traffic Following Deregulation in USA

	1978	1979	1980	1981	1982	Percentage Change 1978-82
Carriers operating	252	258	237	277	245	-3%
Passengers emplaned (in millions)	11.3	14.0	14.8	15.4	18.6	+54%
Revenue passenger km (in billions)	2.20	2.77	3.09	3.36	4.20	+92%
Average trip length (km)	195	198	208	219	227	+17%

Source: U.S. Regional Airline Association, 1982 Annual Report

In defence of their markets, the trunk carriers tended to match the low fares of the new entrants, but later imposed capacity restrictions. They stressed their superior levels of service and concentrated on the dense long-haul routes. However, they were all forced to drastically reduce costs by cutting unprofitable services, making more efficient use of capacity through hubbing and negotiating lower labour costs. Two major carriers, Braniff and Continental, filed for bankruptcy.

Many smaller communities had been receiving direct services from the major carriers. In their route rationalisation most major carriers withdrew from these communities. The larger jets were replaced with smaller aircraft operating to a major regional centre where connections were made on the larger carriers. The Essential Air Service scheme under the Airline Deregulation Act guaranteed an air service till at least 1988 through a subsidy mechanism. In 1984 this scheme cost US\$50 million.

On assessment, the US experience supports the view that airline markets' entry and exit barriers are not great, and economies of scale are not significant. One outstanding feature of the deregulated US market has been the effect of the new entrants. They have captured only a very small percentage of the market, but their influence in transforming the industry's marketing attitude and revolutionising productivity practices extends to all airline companies.

Deregulation did not guarantee that competition would increase in all markets; and it did not have to. A more efficient industry has emerged with better seat capacity management, profitable route structures, lower fares in many instances, and a greater range of price/quality choice in most markets. The US industry has acknowledged the benefits of deregulation, as leaner and more efficient carriers now have the flexibility to exploit market opportunities. Although the number of competitors in each market has remained small, the threat of competition has had a salutary effect.

Canada

May 1984 saw the Canadian Government announce the first phase of a long term plan to liberalise the economic regulation of domestic aviation. Canada is often considered as an economic laboratory for a range of primary and tertiary Australian industries because of its concentration of population in the southern border areas, large distances and relatively comparable economic profile. As such, any Canadian experience in airline deregulation should be examined in detail, although it is obviously too early to draw firm conclusions about its success.

Until 1979 very little competition was permitted. The Canadian Government regulated intra as well as inter-provincial air services and controlled entry and capacity on individual routes. Price control was exercised. Initially the Dominion Government carrier, Air Canada, was given a monopoly on transcontinental routes. During the 1960's and 1970's the regional carriers - Pacific Western Airlines, Eastern Provincial, Quebecair, Nordair and Air Ontario - began to emerge. Canadian Pacific was also expanding and by 1979 was competing equally with Air Canada on the transcontinental routes. In 1977 the Air Canada Act was amended to place the carrier under the same regulatory control as other carriers. The new Act also instructed Air Canada to be market-oriented and profit seeking.

Only Canadian Pacific, Eastern Provincial and Wardair (charter operator) are wholly private enterprise carriers. Air Canada's traffic task is around twice that of its nearest rival, Canadian Pacific, which in turn has around 6 times the traffic task of the third largest carrier, Pacific Western. Air Canada is around 5 times the size of TAA or Ansett (excluding subsidiaries), and Canadian Pacific is over twice their size. Effectively, Canadian competition has been between a large government airline and a somewhat smaller privately owned airline. A feature of the Canadian market during US deregulation was the diversion of Canadian traffic to US airlines after the introduction of low fares on American carriers.

WEANING THE INFANT - REGULATORY OPTIONS
FOR AUSTRALIA'S MATURING AIRLINE INDUSTRY

Existence of low fares across the border and the ambition of Canadian Pacific and Wardair gave rise to added pressure for regulatory reform in the early 1980's. Elements of the new Canadian Air Transport Policy which are relevant to this Review are detailed below.

Pricing - price increases to be limited to the rise in the industry input index (excluding labour), no 'mandatory' booking and travel restrictions on discount airfares, no controls on offering discount and premium airfares.

Entry/Exit - any new or existing carrier can apply to enter any market; incumbent carriers cannot exit a market unless a replacement carrier is willing to enter.

Capacity/Equipment - no controls on any carrier.

Regulation Zones - northern Canada has not been subject to regulatory reform.

There are several aspects of Canadian regulation that are unique to Canada and will no doubt be closely examined by their Standing Committee on Transport, which has continuing responsibility for reviewing the regulatory arrangements. Exit conditions, services to northern communities, probable cross-subsidisation of routes, and government policies on Air Canada will all have to be addressed in the future.

United Kingdom

The United Kingdom Civil Aviation Authority (CAA) issued a report on airline competition policy in 1984. This report set out new CAA policies on domestic and international airline competition. The principal issue was the dominance of the publicly owned British Airways and possible privatisation.

The early UK airline industry was under a government monopoly until the 1950's when independent airlines were allowed to expand. The domestic market is dominated by traffic between London and Glasgow, Edinburgh, Belfast and Manchester. These routes carry 60% of all domestic passengers. British Airways has 50% of the domestic market, British Midland 16%, British Caledonian 9%, air UK 7%, Dan-Air 6% and 16 other airlines 12%.

In framing its new domestic aviation regulatory arrangements, the CAA emphasised that it was not interested in competition for competition's sake. Rather, it judged that increased competition would serve the public interest and promote industry efficiently. The CAA was also concerned about the market power of British Airways and its ability to engage in unfair competitive practices.

Entry controls to routes were abolished. All carriers can now operate between any two points in the UK, Channel Islands and the Isle of Man, with the exclusion of Heathrow and Gatwick Airports. The new entry conditions are to be reviewed this year. Market forces determine fare levels but the CAA still requires the filing of fares. The filing of fares with the CAA allows it to intervene to prevent predatory or monopoly pricing.

New Zealand

New Zealand domestic airline services have been dominated by a government carrier since the National Airways Corporation (NAC) was formed in 1945. By 1948 it enjoyed a monopoly of domestic services. The pressure for feeder services to complement NAC routes resulted in the appearance of several private enterprise companies, many of which went out of business or were absorbed by other operators. By the 1970's the only other carrier with a national operation was Mount Cook Airlines. In 1978 Air New Zealand and NAC were amalgamated.

Economic regulation of domestic aviation is entirely at the discretion of an independent licensing authority. There is inbuilt flexibility enabling the licensing authority to regulate or deregulate air services as it thinks fit. Until the 1983 Report on Domestic Air Services Policy, Government policy objectives related only to the state owned carrier.

Recent amendments to air transport licensing legislation removed any inherent constraints on competition. There is now no economic regulation controlling entry to the industry, entry or exit on routes, schedules or pricing. Air New Zealand has been directed to assist other carriers with reservations, ticketing, ground handling etc at normal commercial terms. The new Air Transport Licensing Policy states 'Privately owned operators should have the same opportunity as Air New Zealand to provide appropriate services to the public'. Mount Cook Airlines and the new entrant, Newman Air, are aiming to become the alternative trunk route airlines.

Application to Australia

Until recent times the domestic airline industries in western countries have been characterised by two dominating features - high industry concentration and comprehensive economic regulation. Governments have been persuaded to relax those controls and permit greater competition. The United States has abolished many controls, and even dispensed with its main regulatory authority. It is held up as the working model for competitive airline markets. However, a close examination of several other countries reveals that substantial regulatory reforms have not been confined to the US.

Regulatory reform in other countries gathered momentum after observing the US experience. Hence there has been insufficient time to assess any effects of these changes. The main features of US liberalisation are detailed below:

WEANING THE INFANT - REGULATORY OPTIONS
FOR AUSTRALIA'S MATURING AIRLINE INDUSTRY

- industry entry and exit have occurred;
- often the new entrants possessed cost advantages and competed on the basis of lower airfares;
- a typical entry strategy was expansion into a short-haul market with the offering of lower fares generating extensive media coverage;
- existing airlines became more innovative, reduced costs and lowered fares;
- evidence suggests that carriers with hub and spoke systems are inherently more flexible and more likely to survive;
- small carriers with lower capacity aircraft have effectively competed with larger carriers;
- competition on the long-haul dense routes is mainly between the pre-existing major airlines which possessed excess capacity.

Although entry has not occurred in all markets, the usual number of competitors in the more dense markets is less than 4, and for the majority of markets only 1 or 2 airlines operate (refer to Table 4). Hence the stimulus of competition has gone further than its local impact - the threat of entry, and existence of low cost and efficient operators can have far reaching effects even though they only physically operate at the margin of the total market.

TABLE 4

Airline Competition in the USA : 1980

Distance (km)	Number of Monopoly Markets	Number of Competitive Markets
0-320	425	111
321-645	294	106
646-970	140	78
971 Plus	302	230

Source: Bailey and Panzar (1981)

Other countries have started from different positions with respect to the size and structure of airline industries and type of economic regulation (refer Appendix 1). One of the outstanding features of pre-deregulation was frequency competition, with resulting low load factors.

After deregulation US carriers had to cope with excess capacity of which they had little opportunity to divest themselves. Concerns in other countries have largely centred on:

- how to deal with dominant publicly owned airlines;
- aviation infrastructure constraints;
- how to maintain viable services to small communities.

In Canada, UK and New Zealand the dominant airline is publicly owned. In unleashing these airlines each country employed different policy and regulatory mechanisms to ensure that the public enterprise airlines did not compete unfairly. Canada has permitted Air Canada to compete with services and fares, but only in response to initiatives by other airlines. Entry was made easier but fare increases are controlled. British Airways dominates the UK domestic market. Entry to domestic routes has been freed up but the CAA retains powers to take action against predatory or monopoly pricing.

When applying overseas experience to Australia it is important to note that the Australian industry is much smaller than in the US. Even there it is uncommon to find a significant number of direct competitors. Hence it is extremely unlikely that Australia will experience many new entrants in a deregulated industry. The more successful US airlines concentrate on hubbing, whereas there is little potential for this in Australia. Unlike the US, long-thin routes are an important feature of the Australian market.

However, increased competition has promoted lower fares and increased airline efficiency. Even the mere threat of entry can have far reaching effects. The concerns about effective competition in countries with smaller industries than the US suggests the need to provide some constraining mechanism to prevent predatory pricing and the abuse of market power.

Conclusion

Under the Two Airline Policy competition has been constrained to ensure that both TAA and Ansett survive. Neither the potential benefits of competition or monopoly have been realised. The industry has matured but its environment has not.

The emergence of East-West as a significant market force suggests that the Australian regulatory regime is subject to the same pressures as previously existed prior to relaxation of economic controls elsewhere. There is also some doubt as to the Constitutional validity of the current legislation.

Overseas experience indicates that airline markets are contestable. Also that competition benefits the community through lower fares and more efficient airlines. Current events suggest that market forces and the questionable Constitutional validity on the legislation will place strain on the existing economic regulation. It is time to change the regulatory environment and institute arrangements which can serve the public interest and promote economic efficiency.

WEANING THE INFANT - REGULATORY OPTIONS
FOR AUSTRALIA'S MATURING AIRLINE INDUSTRY

OPTIONS FOR REGULATORY REFORM

Any future regulatory regime must recognise that the industry and market are relatively mature and that more competition needs to be promoted. The inherent problems are to facilitate a credible threat of competition given the size of the market and the intra-state regulation of aviation that exists in Australia. These two factors work against wholesale deregulation, and it is anticipated that this will not be considered a practical option by the May Review or Commonwealth Government. Hence, attention must focus on regulatory reform.

It has often been suggested that the Australian domestic market has expanded to the stage where a third operator could be supported. The rapid expansion of East-West has placed it in the position of being the third national airline. East-West themselves have stated that their plans are very much in the nature of Australia's third airline. Obviously one of the options is to admit East-West to the trunk routes and insert "and East-West Airlines" into an Airlines Agreement. Another option would be to allow Qantas, an airline already established in Australia, access to domestic routes. Either of these options would undoubtedly inject more competition in the short term.

Current cost advantages enjoyed by East-West will certainly be reduced over time. Even the new entrants in the US have faced rising cost structures with consequent effect on their competitive advantage. It is important to remember that the new entrants enjoyed lower costs largely through lower staff remuneration levels, higher staff productivity and the use of secondary airports. Because of institutional constraints in Australian labour markets and the lack of secondary jet airports, there is little scope for that here.

A restrictive airline policy with one or more emerging domestic airlines and two established airlines would be a regulator's nightmare. In addition, none of the basic weaknesses of the present arrangements would be rectified.

It is suggested that the broad direction of future regulation should be to:

- facilitate an increase in the number of viable competitors;
- facilitate industry and market entry, expansion and contraction;
- encourage the free operation of market forces.

Airlines should be permitted to compete freely with respect to fares and services, provided a mechanism exists to prevent anti-competitive behaviour, and monopoly and predatory pricing.

If much of the current regulatory apparatus is dropped, organisations such as the Trade Practices Commission and Prices Surveillance Authority can be relied upon to a certain extent to monitor pricing and competitive practices. However, a mechanism is required which will facilitate the move from a highly protected and regulated industry to a normal business environment, bearing in mind that the industry will still probably be confronted with varying intra-state regulation.

Preferred Option

There are several ways of constructing a regulatory environment that would encompass the above features. The scenario outlined below is developed against the background of the current airline industry and the industry as it is envisaged it will be in 1990.

This regulatory regime would consist of an Air Services Commission Act (or similar name) with a 7 year sunset clause in order to allow a policy review. The Air Services Commission Act would establish the Air Services Commission which would report to the Minister for Aviation.

Commission functions would be to monitor industry pricing and competitive practices, identify any anti-competitive action and act accordingly. The Commission would report to the Minister on industry competition and practices on an annual basis. It is also envisaged the Commission would become the information resource base for the airline industry.

In addition to the Department of Aviation airline licence, a new entrant would require a certificate from the Commission before commencing scheduled services. The certificate would be issued when the Commission was satisfied as to matters such as capitalisation and financial resources, fitness to operate etc. The specific criteria would be left to the Commission. It may be desirable to allow for appeal to the Minister for Aviation by an unsuccessful applicant.

All fares would be notified to the Commission a specified period prior to publicising or introduction. If the Commission wished to investigate any fare it would notify the operator within a certain period, and direct the airline not to publicise or sell the fare prior to completion of the Commission's investigation. The investigation and determination process would involve obtaining pertinent industry information and determination if the proposed fare is monopoly pricing, predatory pricing or acceptable. If monopoly or predatory pricing were identified the Commission would issue a direction to the offending airline not to introduce the proposed airfare.

Monopoly pricing is defined as a fare exceeding the cost of providing a dedicated service in that market. Predatory pricing is defined as a fare being less than the direct operating costs of the airline offering the fare.

WEANING THE INFANT - REGULATORY OPTIONS
FOR AUSTRALIA'S MATURING AIRLINE INDUSTRY

Anti-competitive practices would be monitored by the Commission. There would be two mechanisms for determining anti-competitive action by airlines. The Commission could independently identify an uncompetitive practice, or could find in favour of an allegation from an industry member. On determining that uncompetitive action is being taken, the Commission will direct that the offending operator desist forthwith.

If an airline ignored a direction of the Commission it would inform the Minister for Aviation. The Minister in turn would inform Parliament and request the Attorney-General to instruct the Trade Practices Commission to take action (refer Appendix 2 for a schematic representation).

Operators which would come within the purview of the Commission would be all holders of an Australian airline licence, and any holder of a supplementary airline licence the Commission deemed to have the potential to significantly affect airline markets.

This option serves the public interest through increasing consumer choice and promoting economic efficiency through competition. The Air Services Commission mechanism:

- facilitates competition under any foreseeable industry size and structure;
- affords appropriate roles for existing carriers;
- provides for new entrants and expansion of existing industry members;
- allows market forces to determine airfares and pertaining conditions, removing barriers to cost efficiency;
- provides checks on predatory pricing, monopoly pricing and anti-competitive behaviour.

It is a significant feature of the proposed regulatory framework that the Air Services Commission is placed in a strong position to influence the airline's competitive behaviour. This will be important in moving the airline industry from a highly regulated environment to one that is only subject to those controls which apply elsewhere (e.g. prices surveillance and trade practices). In the transition, the Air Services Commission would be able to draw upon specialist knowledge and would be in a position to work closely with the airlines. It would possess sufficient powers of persuasion, and would have access to legal processes which could be used to give effect to policies to promote competition.

The Commonwealth should seek early amendment to the Airlines Agreement in order to allow a staged implementation of the new regulatory regime by 1990.

SUMMARY

The Two Airline Policy came into effect over 34 years ago to foster limited competition in an important infant industry. The defenders of the policy proudly proclaim the record of a six-fold growth in the size of the market and an industry offering a national jet network with safe, modern aircraft. Despite these claims, the criticisms which have been levelled against the policy from its outset have endured, and there are signs of their being argued with increasing vigour. The May Review is timely; the Commonwealth Government is faced with the prospect of making substantial changes to a long-standing policy.

This paper has presented some pertinent facts about the domestic airline market and about the way the industry goes about serving the needs of the travelling public. In brief, the economics of the industry within its current regulatory environment leads naturally to a focus on the south-east of the network, with importance attached to frequent flights between the larger capitals. The consequences of this on the remainder of the network, where flights are longer and markets are thinner, tend to be seen in low frequency, inconvenient departure times and connections, and high load factors. Given the dependence of travellers on these longer routes on airline travel, improvement of service levels is a priority.

Realistically, though, such improvements are likely to be contingent upon strong market growth. Very likely this will come through increased exploitation of the excellent tourist attractions in the north and west of the continent. To the extent that the airlines are responsive to the needs of holiday travellers through offering a range of fare/quality service options, the industry will promote better services for all travellers.

Overseas experience, most notably in the United States, has demonstrated the benefits of allowing greater freedom to compete in mature airline industries. Fares have often been reduced, and airlines now aggressively compete to serve the needs of all travellers. Certainly, some of the key arguments which have supported the retention of the Two Airline Policy have been destroyed. In particular, economies of scale and barriers to entry have been shown not to be significant, and competition has not been wasteful or destructive. The effect of competition has been to expose inefficient and unproductive practices within the regulated environment.

In the light of this experience, and the demonstrated ability of East-West Airlines to expand markets on thinner routes, expectations have been raised about the ability to improve industry performance through relaxation or abandonment of the existing policy. This paper has examined the main options, recognising some of the more important characteristics of the Australian market.

WEANING THE INFANT - REGULATORY OPTIONS
FOR AUSTRALIA'S MATURING AIRLINE INDUSTRY

It is concluded that the industry has matured to the stage where it no longer requires protection as an infant, and that it is time to effect major changes. The aim should be to eventually place the airline industry on the same terms as any other industry subject to trade practices controls and price surveillance legislation. However, as a transitional stage it is recommended that an Air Services Commission monitor industry practices and pricing, and act where appropriate. In essence, the strength of this body would largely reside in its capacity to persuade industry to act in the public interest where the industry is not doing so, with powers to coerce lying elsewhere.

In conclusion, it is pertinent to note that, although the May Review will undoubtedly give consideration to options such as the one outlined above, it is possible that other events might well overtake the Review's deliberations. High Court actions have been commenced which question the Constitutional validity of the legislation enshrining the Two Airline Policy. Whether these succeed or not, the topic to which this paper has been devoted is likely to remain a matter for spirited debate.

APPENDIX 1

Size Comparisons : Selected Carriers - USA, Canada, Australia - 1982

RANK	CARRIER	REVENUE (BILLIONS \$USA)	PASSENGERS (MILLIONS)	REVENUE TONNE KILOMETRES (BILLION)
1	United	4.6	33.2	6.2
2	American	4.0	27.8	5.0
3	Eastern	3.8	35.6	3.9
8	Air Canada	1.8	11.8	2.3
14	CP Air	0.7	3.7	1.1
15	Frontier	0.5	6.0	0.5
16,17	(Ansett	0.5 (a)	4.8	0.5
	(TAA	0.5	4.8	0.5
20	Pacific Southwest	0.4	7.1	0.4
22	Southwest	0.3	9.1	0.4
23	Air Florida	0.3	2.8	0.4
30	People Express	0.1	2.7	0.2
<hr/>				
TOTALS	USA	35.7	293.2	45.8
	Canada	3.1	22.5	4.5
	Australia	1.1 (b)	11.4	1.0

Notes (a) Published data not available. Ansett airline revenue assumed equal to TAA
 (b) Estimate based on combined TAA/Ansett revenue, increased by ratio of revenue tonne kilometres (Ansett + TAA)/Industry Total

Sources: Oum and Tretheway (1984)
 Department of Aviation, Air Transport Statistics

References:

Bailey, E.E. (1985). "Airline Deregulation in the United States: the benefits provided and the lessons learned", International Journal of Transport Economics, Vol. 12(2), pp. 119-144.

Bailey, E.E., and Panzar, J.C. (1981). "The contestability of airline markets during the transition to deregulation", Law and Contemporary Problems, Vol. 44(1), pp. 125-145.

Bureau of Transport Economics (1985). Competition and Regulation in Domestic Aviation - Submission to Independent Review, Occasional Paper 72, (AGPS, Canberra).

Bureau of Transport Economics (1981). National Travel Survey 1977-78: General Overview and Assessment, Report 48, (AGPS, Canberra).

Canadian Transport Commission (1985). Final Report of The Air Transport Committee of the Canadian Transport Commission on the Adequacy of Air Services in Northern and Remote Areas, Ottawa, Canada.

Centre For Independent Studies (1984). Changes in Air? Issues in Domestic Aviation, CIS Policy Forums 3.

Civil Aeronautics Board (1984). Implementation of The Airline Deregulation Act of 1978, Report to Congress, January 1984, Washington.

Civil Aviation Authority (1984). Deregulation of Air Transport. A Perspective on the Experience in the United States, Economic Regulation Group, Airline Economics Branch, CAA Paper 84009, London, May 1984.

Department of Aviation. Air Transport Statistics, Canberra.

Graham, D.R., and Kaplan, D.P. (1982). Competition and the Airlines: An Evaluation of Deregulation, Staff Report of the Office of Economic Analysis, Civil Aeronautics Board, Washington.

Graham, D.R., Kaplan, D.P. and Sibley, D.S. (1983). "Efficiency and competition in the airline industry", Bell Journal of Economics, Vol. 14, pp. 118-138.

Meyer, J.R. and Oster, C.V. (1984). Deregulation and The New Airline Entrepreneurs, (MIT Press).

Milloy, H.B., Douglas, L. and Sullivan, S.M. (1985). "Market response to discount air fares on selected domestic trunk routes", Tenth Australian Transport Research Forum, Melbourne.

Northern Territory Government. (1985). Northern Territory Submission to the Independent Review of Economic Regulation of Domestic Aviation, Government Printer, Darwin.

Pascoe, F. (1983). "Domestic Aviation 1981-86", Eighth Australian Transport Research Forum, Canberra, pp. 1-10.

Ward, J.F. (1984). "Tourism and transport must get their act together", Australian Transport, July 1984, pp. 5-7.