ECONOMIC DEREGULATION OF AVIATION : THE AUSTRALIAN APPROACH

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ABSTRACT: *On 7 October 1987 the Federal Minister for Transport and Communications, Senator Evans, announced a package of measures setting out future arrangements for the Australian aviation industry. This package included termination of the Airlines Agreement from 31 October 1990, and economic deregulation of interstate aviation*

The paper presents an historical perspective on the decision to deregulate and an account of the industry under regulation.

Experience of deregulation in the United States of America and Canada is drawn upon to illustrate both the potential problems of deregulation the policy is designed to avoid, and the potential benefits expected to result from the decision.

ECONOMIC DEREGULATION OF AVIATION: THE AUSTRALIAN APPROACH

INTRODUCTION

The Australian Government announced in October 1987 that it would deregulate the Australian domestic aviation industry from 1990.

The economic regulatory arrangements by which the Australian Government regulates the domestic aviation industry, collectively known as the two airlines policy, have emerged over a period of some 40 years.

The two airlines policy has been reviewed a number of times. These reviews examined the need for the continuation of the policy against contemporary circumstances, and established the basis on which the economic regulatory arrangements continued in their various forms.

The first part of this paper outlines the development of the domestic aviation industry and the two airlines policy.

The second part addresses the most recent Review of the policy, the May Review, and the regulatory options identified by that Review.

The third part discusses the Australian Government's domestic aviation policy for the 1990's.

AUSTRALIAN DOMESTIC AVIATION: REGULATION AND GROWTH

Australian Constitution

At the outset, it is important to outline the constitutional framework of Australia on which the legislation regulating the airline industry is based. An understanding of the powers available is essential to understand the development of the current regulatory regime and the future policy.

In Australia, the Commonwealth and State Governments may both legislate on a range of matters. The Australian Constitution accords the Commonwealth legislative powers over specific subjects and reserves to the States, broad powers under which they can regulate intrastate activity.

The Constitution does not provide the Commonwealth with specific power over aviation. Nevertheless, the Commonwealth has been able to regulate aviation as a consequence of its power to make laws with respect to other subject matters. In contrast, in accordance with the broad powers reserved to them, the States can exercise direct control over intrastate aviation.

Section 92 of the Constitution has been of particular significance in limiting the Commonwealth's ability to control interstate aviation. It deals with the freedom of persons to engage in 'trade, commerce and intercourse among the States...'.

Within this Constitutional framework Commonwealth control of domestic civil aviation takes two major forms: safety/operational control and economic regulation, in the form of the two airlines policy.

The Commonwealth regulates safety/operational standards for all domestic civil aviation through the Air Navigation Act 1920, the Air Navigation Regulations and the Air Navigation Orders.

Under the two airlines policy in its present form the operation of scheduled passenger air services over trunk routes is generally restricted to Australian Airlines (TAA) and Ansett.

While the Commonwealth licenses domestic air services under the Air Navigation Regulations, in most circumstances it is limited to assessing applications for licences on safety/operational grounds only. Consequently, the Commonwealth has relied primarily on its ability to control the import of aircraft to uphold its obligations under the two airlines policy. That power is exercised through the Customs (Prohibited Imports) Regulations, which state that a permit issued by the Commonwealth is necessary to import an aircraft, airframe or aircraft engine.

The Commonwealth generally restricts the operation of passenger airline operations over trunk routes to Australian Airlines and Ansett by controlling other operators' access to large aircraft.

The Commonwealth's control over the importation of aircraft has also provided the basis for limiting aircraft capacity of the Australian Airlines and Ansett groups each to 50% of the maximum capacity necessary to service their combined estimated traffic over the routes on which they compete.

In contrast to the indirect economic regulatory controls excised by the Commonwealth, the States and the Northern Territory may legislate to license air services within their borders on grounds such as economics and the public interest. Only Victoria and South Australia have chosen not to license intrastate air services.

The Early Years: pre-World War II to 1957

Before World War II, the domestic aviation industry in Australia was characterised by numerous small, private operators providing limited services. These were heavily subsidised by the Commonwealth Government through both mail contracts and direct subsidies in recognition of the importance of aviation in the development of Australia. There were frequent mergers and takeovers in the industry and by 1945, Australian National Airways (ANA), an agglomeration of numerous smaller undertakings emerged as the major operator. Although smaller operators such as Ansett Airways, Butler Air Transport, and

MacRobertson-Miller continued to serve regional networks, ANA was the only operator with a national network. (Independent Review of Economic Regulation of Domestic Aviation, (Thomas E May, Chairman) AGPS Canberra 1986).

The Australian National Airways Commission was established by the Australian National Airlines Act 1945. The Government was concerned at the possibility of a private monopoly being established. It considered a public monopoly over interstate airline services was more appropriate. The legislation was however, challenged in the Courts by ANA and it was found that the Government did not have the power to create a monopoly as it was inconsistent with the freedom of interstate trade and commerce as provided in the Australian Constitution.

In light of these legal restrictions, the Government instituted strong measures to give the Australian National Airlines Commission trading as Trans Australian Airlines (TAA), a most favourable environment in which to operate. These measures included financial assistance, monopoly of Government business and other administrative action which placed private operators at a disadvantage compared with TAA.

However, in 1949 the new Government sought to place TAA on a "true competitive basis with no preferences either in cheap capital or dollar expenditure". (The Prime Minister, Parliamentary Debates, 1951, v. 215, p.2399) This led to the Civil Aviation Agreement Act 1952 which sought to restore the balance between the hitherto privileged TAA and the private airline ANA so that competition could occur and efficient and economical operation of air services within Australia could be maintained.

The 15 year Civil Aviation Agreement Act 1952 between the Commonwealth and ANA, provided that both the major airlines were to have equal access to mail and Government business, and financial assistance by way of loan guarantees was to be afforded the private operator to permit re-equipment with aircraft fully competitive with the pressurised aircraft procurred by TAA. The Agreement also required the airlines to keep under review air routes, timetables, fares, freight rates and other related matters. This "rationalisation" was an adjustment process to avoid overlapping, to give the most effective service, and bring earnings into a proper relation to overall costs. The Australian National Airlines Act 1952, which was also enacted, contained a provision requiring TAA to accept the provisions of the Agreement and also subjecting TAA to income tax.

However, despite these Government actions, ANA's financial position declined. The reasons put forward included, TAA's established and strong position, poor equipment choices by ANA and competition by Ansett Airways and Butler Air Transport Ltd. The later point is

important to note because the 1952 policy did not explicitly exclude smaller operators from obtaining aircraft and competing against the big two. This factor was subsequently addressed in reviews of the policy.

In June 1957, ANA advised that it could not meet its Government loan repayments. Ansett Airways which had progressively taken over a number of intrastate airlines, was the only suitable buyer. Ansett agreed to take over ANA in 1957, provided the two airlines agreement continued with some strengthening.

Ansett subsequently obtained control of Butler Air Transport Ltd and its subsidiary Queensland Airlines Pty Ltd and restricted these operations to routes that did not compete with Ansett services, thus ensuring that the new airline would not be jeopardised by other existing airlines operating competitive interstate services.

Graph 1 shows the growth of the industry from 1946 to 1957. Over this period the industry recorded an increase in revenue passenger kilometres (RPK's) of 338%. TAA's growth was strong and by 1956 it had captured 42% of the market. ANA basically maintained its level of RPKs but its market share fell from 78% in 1946 to 31% in 1956. Ansett recorded very strong growth over the period and by 1956 it had nearly 10% of the market. In 1957 Ansett acquired ANA and by October 1957 both airlines' services had been fully integrated. In 1957 Ansett/ANA services in total captured about 41% of the market, whilst TAA's was 42%.

Attachment 1 shows revenue passenger kilometres for Australian domestic scheduled airline services from 1946 to 1957.

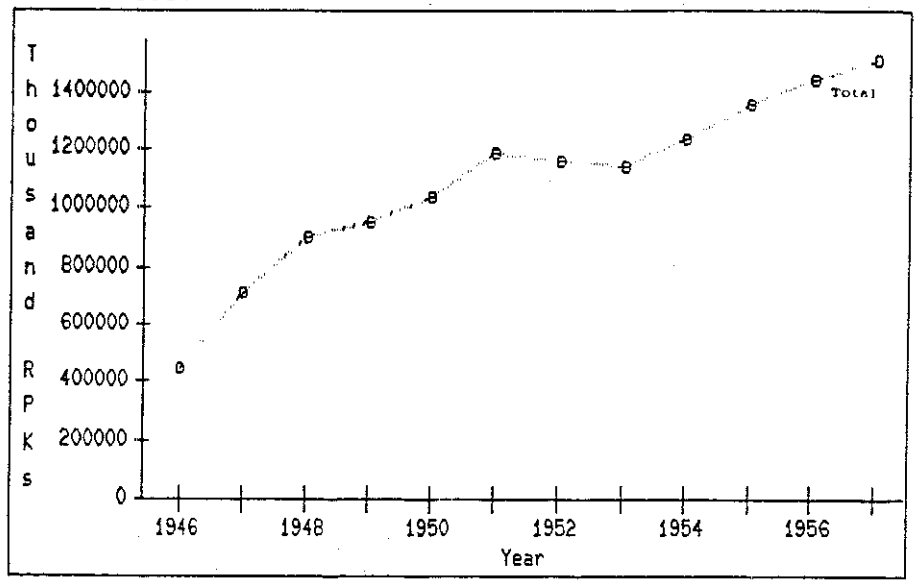
The 1957 Review and Introduction of Capacity Controls

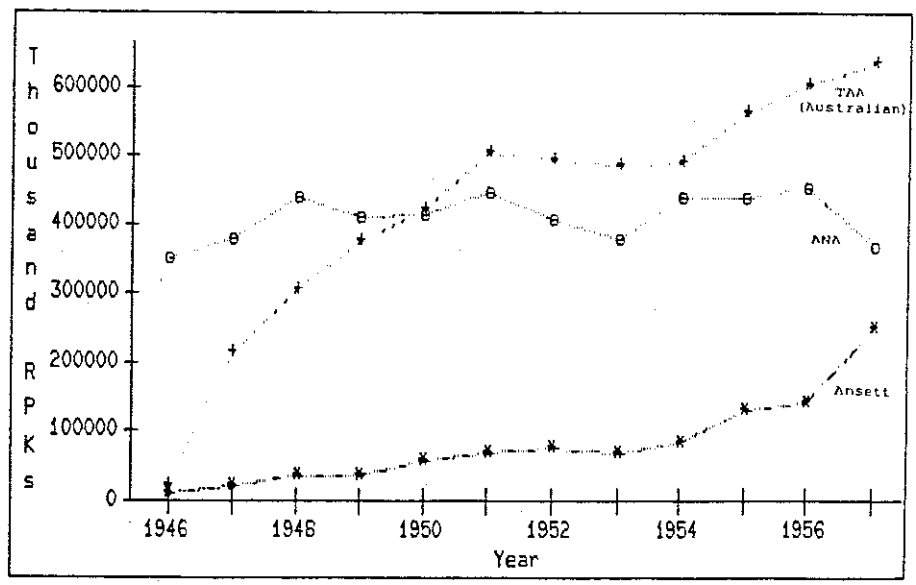
In 1957 the first major review of the two airlines policy was undertaken. The review noted that the "laissez faire" competitive system on the interstate routes may well have caused the airline industry to contract by forcing some operators out of business. The existence of the government owned TAA complicated matters as this may, in the future, cause all private operators to fail in the market. The Review also noted the uneconomic services operated by DC3 aircraft which comprised in numbers, the main element of the Australian aircraft fleet. Heavier, more economical aircraft could have been acquired, but this would have required the provision of costly airport infrastructure.

Following the 1957 Review, the Government announced it would provide subsidy assistance to operators of essential air services and to aid selected operators in obtaining DC3 replacement aircraft. Operators who accepted financial assistance were required to provide services at approved frequencies and to set approved fares and freight rates. In regard to trunk route operations it introduced the 1957 Civil Aviation Agreement which was aimed at eliminating the wasteful effects of uneconomic competition on trunk routes.

AUSTRALIAN DOMESTIC AVIATION INDUSTRY
DOMESTIC SCHEDULED AIRLINE SERVICES
1946 - 1957

GRAPH 1





The Civil Aviation Agreement Act 1957 primarily transferred the rights of ANA under the earlier 1952 Agreement to Ansett; but, the opportunity was taken to extend and improve the rationalization provision of the earlier Act by making provisions for a three person Rationalization Committee. The new Act also succinctly stated the Government's view, that one of the objects of the parties to this agreement, is to secure and maintain a position in which there are two, and not more than two, operators of trunk route airline services, one being the Commission, each capable of effective competition with the other.

In 1958 the Government saw the need to introduce the Airlines Equipment Act 1958 because of the re-equipment requirements of both TAA and Ansett. Particularly of Ansett which urgently needed to re-equip with the latest turbo prop aircraft if it was to carry on the Government's intention that it should offer effective competition with TAA. The legislation conferred on the Minister for Civil Aviation, power to determine the number and types of aircraft used by the airlines and the capacity that should be provided by each airline.

The twin aim of the Airlines Equipment Act was to limit the importation of new aircraft to the real needs of the industry and to increase airline profitability by limiting capacity, each operator being permitted to provide only 50 per cent of the total capacity to be scheduled on competitive routes.

In debate in the Senate, as the Airlines Equipment Act 1958 was being introduced, the Government inferred that it would use the Customs Prohibited (Imports) Regulations to prevent a competitor acquiring aircraft and emerging in the way that Butler and Ansett had done. This import power was challenged in the High Court by IPEC in 1965 and held not to be unconstitutional.

In the early 1960's Ansett entered into a Cross Charter Agreement with the Government which required the cross charter of two DC6B aircraft from Ansett for three of TAA's Viscount 700 aircraft. This Agreement was made to halt a threatened re-equipment race for Lockheed 188 Electras prior to the introduction of jet aircraft and served to provide equipment parity between the two operators. This event set the precedent that both Ansett and TAA should have the same aircraft types in their fleets. This practice continued for the next 20 years.

By 1960 the basic thrust of the two airlines policy had been established. The policy had the following objectives

to foster the development and growth of the "infant" aviation industry in an orderly manner;

- to ensure financial stability within the industry and to ensure the long term solvency of the major domestic airline operators, including assistance to operators on unprofitable routes in rural areas to ensure air services for country people;

- to enable airline capacity to be closely matched with market demands, thus avoiding the provision of excessive capacity and resultant higher costs which could ultimately be borne by the whole community;

- to promote a climate of fair and workable competition between the domestic trunk route operators and to discourage monopolisation or uncompetitive practices within the industry.

The 1960's: 1961 Review and Strong Growth

In 1961 Ansett, concerned about its profitability and its perceived disadvantages in relation to TAA, requested the Government to extend the provisions of the 1952 and 1957 Civil Aviation Agreements for a further 15 years and to incorporate several amendments.

The Government after reviewing the industry, introduced the Airlines Agreements Act 1961 and the Australian National Airlines Act 1961. In essence, the Airlines Agreements Act 1961 consolidated the arrangements and principles developed in the 1950's and facilitated the introduction of jet aircraft.

It was recognised that the Government's two airlines policy required, first of all, a situation in which the airlines operated fleets comparable in quality and capacity. Secondly the fleets were to be operated under regulated competition with due regard to the interests of the public and a proper relation between earnings and costs. Third, since the two airlines were selling the same commodity under competitive conditions, it was decided that they were, as far as practicable, to enjoy comparable cost structures.

The Agreement authorised the Treasurer to provide additional loan guarantees for the acquisition of jets as the loan guarantees under the 1952 Agreement expired in March 1962. It also set the timing for introduction of jet aircraft to avoid an equipment race which would have constituted a most damaging form of wasteful competition.

The Airlines Agreement also extended the rationalisation machinery until 1977 and set out with greater precision, the matters TAA and Ansett agreed to keep under review.

The Australian National Airlines Act 1961 was intended to make TAA a more commercial operation, by requiring it to present estimates and meet a dividend target set by the Minister and by altering its insurance arrangements.

By 1962/63 both major airlines declared significant improvements in profit, which not only reflected the state of the Australian economy but a clear indication of the success of the Government's two airlines policy.

The 1960's apart from 1961 when there was a recession, recorded strong, steady traffic growth of about 9% per year.

The success of the Airlines Equipment Act at sharing equally traffic between Ansett and TAA is clearly shown in Graph 2. Graph 2 shows traffic carried by both airlines between 1958 and 1985.

1972 - 1976

In April 1972 the Senate referred Thomas Nationwide Transport Ltd (TNT) proposed takeover of Ansett to a Senate Standing Committee on Industry and Trade for consideration and report. However, TNT announced on 27 April that it would not proceed with the takeover.

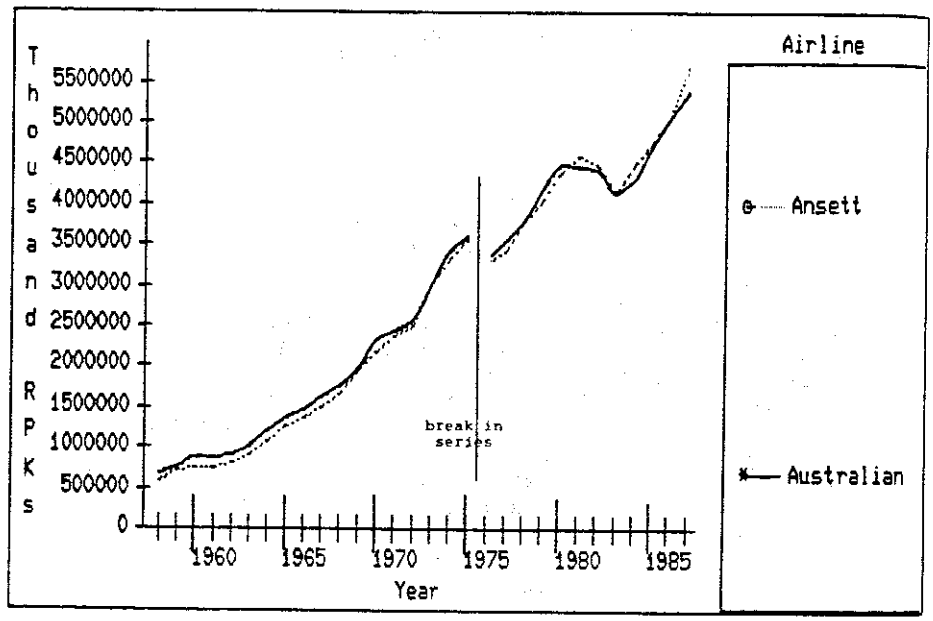
The Senate Standing Committee tabled its report on 11 May 1972 which discussed the effectiveness of the two airlines policy. The Committee reported that the general consensus of opinion as expressed to the Committee is that despite some shortcomings in certain matters of its detailed operation, the two airlines policy had resulted in the development of a stable, economically viable airline industry which is providing an efficient network of air services with modern equipment and with an excellent safety record. It was also advised that the Government's reliance on controlled competition had been largely instrumental in ensuring proper growth in the airline industry without the financial crisis experienced in prior years in Australia and from time to time overseas.

The Committee also highlighted some areas of criticism. These included, parallel scheduling, withdrawal from rural air services, freight services given a low priority, limited range of concessional airfares, curfew infringements, low cost recovery, pressures created by the two major airlines against expansion by small operators, and the lack of adequate published financial data for proper comparison of the two airlines.

The Airlines Agreements Act 1972 recognised these criticisms and sought to provide a certain standard of service across the national network in recognition of the public interest obligations which the two airlines undertook to abide by in return for the retention of the two airlines policy. The Agreement sought to overcome the criticisms highlighted by the Senate Standing Committee.

AUSTRALIAN DOMESTIC AVIATION INDUSTRY
DOMESTIC SCHEDULED AIRLINE SERVICES
1958 - 1987

GRAPH 2



It is interesting to note that TAA in its submission to the Senate Committee on the proposed takeover of Ansett by TNT, stated that it believed the competitive balance had swung too far in Ansett's favour and that a number of moves should be made to allow TAA greater competitive freedom within the two airlines policy. This reflects a full turn around from the 1950's where the policy was designed to protect Ansett from the Government owned TAA.

The new Government elected in December 1972 stated that it was in complete agreement with sentiments of the previous Government regarding changes to TAA and believed changes were necessary to give it additional powers so as to place it on a more fair and equitable position in relation to Ansett. The Australian National Airlines Act 1973 was passed, widening TAA's operations considerably.

The Airlines Agreements Act 1973 addressed the issue of cost recovery. The Government's view was that the airlines had reached a stage where they could shoulder greater responsibility and the Agreement provided for Air Navigation Charges to be increased by a maximum of 15% per year until 1978 when it would revert back to 10%. This was in recognition of the Government's objective to move towards greater recovery of costs of providing aviation facilities.

Reviews 1977 - 1981

In 1977 the Minister for Transport announced The Domestic Air Transport Policy Review (DATPR) of the two airlines policy.

DATPR, which reported in 1978, examined in detail the role of the economic regulatory framework governing aviation in Australia. The Report noted the benefits of the two airlines policy as the development of a financially stable industry operating modern technology equipment, with regular scheduled services over a widespread national network and an outstanding safety record. However, the DATPR was of the view that the airlines could withstand greater competition from other operators on parts of their operations and recommended the continuation of the two airlines policy with controls over fares, capacity and entry to remain, but with substantial changes to allow the opportunity for greater competition and innovation.

The changes recommended included; regional operators be permitted to compete over some sections of the network, Government maintain controls over import of aircraft, rationalisation provisions be repealed, the airfare formula be revised, wider range of fare types be explored, more flexible cost recovery, proposals to overcome parallel scheduling and air freight to be excluded from the terms of the two airlines policy.

One particular recommendation of DATPR - that relating to restructuring of the air fare formula to reduce cross-subsidisation of short distance fares by long distance travellers - gained considerable attention. As a consequence an Independent Public Inquiry into Domestic Air Fares chaired by Mr W J Holcroft was set up in 1980.

The Holcroft Report was released in February 1981 and its recommendations included the adoption of a cost based pricing formula; pricing on a nationally consistent basis; the adoption of a revised formula comprising a flagfall and single distance rate for the national jet network; and the availability of as wide a range of discount fares as possible.

When announcing the Government's response to the Holcroft Report the then Minister foreshadowed the establishment of an independent tribunal to hear and make decisions upon proposals for changes to air fares; which led to the establishment of the Independent Air Fares Committee (IAFC).

Concurrent with the conduct of the Holcroft inquiry, negotiations between the parties to the Airlines Agreement concerning the implementation of the DATPR recommendations occurred, including the formulation of a new Agreement which was signed in 1980 but not ratified by Parliament.

During the negotiations for the 1980 Agreement it became evident that further changes to the Australian National Airlines Act were required to place TAA on a more commercial footing. The then Government's policy was to establish TAA as a public company ensuring that the airline operated in a competitive and commercially oriented manner but was anxious to ensure that as a Statutory Authority it was not advantaged over its competitors. The legislation covering this matter however was not proclaimed.

Consequent upon the decision to establish the IAFC and in response to criticism of the termination provisions of the proposed 1980 Agreement, it became necessary to re-negotiate the Agreement to reflect these changes.

In summary, the major reviews conducted between 1977 and 1981 questioned the extent of the role of the economic regulatory framework which had developed for competitive airline services over the trunk route system. The 1981 legislative package was an attempt to increase competition into the system.

1981 Legislative Package

This package of legislation was necessary to give effect to the renegotiated Airlines Agreement and to establish the IAFC. The package included the Airlines Agreement Act 1981, the Airlines Equipment Amendment Act 1981 and the Independent Air Fares Committee Act 1981.

AUSTRALIAN DEPARTMENT OF TRANSPORT AND COMMUNICATIONS

The Airlines Agreement Act 1981 made the following major changes

- removal of air freight from the ambit of the two airlines policy
- provision of limited access to trunk route operations by regional operators
- access, in particular circumstances, to jet aircraft for regional operators
- confinement of consultation between TAA and Ansett to specific matters such as capacity and aircraft utilisation/load factors
- fare consultations to be limited to core fares in the presence of an IAFC member or delegate. Consultation on discount fares can only take place at the discretion of the IAFC.

The Airlines Equipment Amendment Act 1981 provided for the exclusion of air freight from the capacity determination process, and that operators, other than TAA, Ansett and Qantas, who acquired jet aircraft would be subject to the provision of undertakings on the use and disposal of those aircraft.

Developments since 1981

The domestic airline industry has changed significantly since the 1981 legislative package was introduced.

The major developments in the industry can be categorised into two broad groups: competition between Ansett and TAA and competition from the regional airline East-West.

Both Ansett and TAA had planned major aircraft re-equipment programs for the early 1980's. They had for the first time in over twenty years planned to purchase different aircraft: TAA A300s, Ansett B767s and B737s.

However, at the time of acquiring these aircraft the domestic air travel market experienced a major decline, some 0.3 and 5.8 percentage points in 1982 and 1983 respectively.

The next phase saw competition based on frequency. Ansett had an advantage over TAA as it did not take delivery of its B767s until after TAA took delivery of its A300s. It therefore had smaller aircraft which it could operate more frequently.

As the airlines each sought to capture a larger share of the on-demand business travel, their marketing strategies extended beyond frequency to associated airline services, both on the ground and in the air including, first class terminal services and the introduction by TAA of business class travel.

The air fare legislation provided little incentive for one airline to offer fares significantly different from the other. In particular economy fares on trunk routes for Ansett and TAA cannot be different.

Less than 45% of Australian trunk route passengers utilise discount fares. However, the number of discount air fares has increased since the 1981 Airlines Agreement. The IAFC approved 181 discount air fares in 1986/87.

In May 1983 the Government provided TAA with a capital injection of $115 million (including $25 million which had been allocated by the previous Government) to revitalise the airline and place it on a more commercial footing.

The Australian National Airlines Amendment Act 1984 was passed in June 1984. Its main objective was to give TAA greater flexibility of management and greater responsibility in its commercial airline operations.

In 1986, TAA, as a part of a program aimed at transforming itself into a more aggressive and competitive force changed its trading name to Australian Airlines.

Competition from East-West has, however, clearly been the major change in the industry since 1981.

Since 1981 East-West's general marketing strategy has been aimed at the leisure market. It has offered a wide range of discount air fares and developed new services to major tourist destinations throughout Australia. It has also operated services which link trunk route centres via intermediate, non-trunk centres. The operation of such services is consistent with the 1981 Airlines Agreement unless it is considered that the services are primarily aimed at the trunk route market.

From 1981 to 1987 East-West has recorded an average annual increase of about 22% in revenue passenger kilometres performed, due mainly to the introduction of F28 aircraft into its fleet.

Competition from East-West has seen an unprecedented use of the Courts by the industry to resolve differences on administrative decisions made under the two airlines legislation. These matters covered decisions of the Minister and the Secretary relating to capacity determinations, aircraft acquisitions, import certificates and route operation provisions of the Airlines Agreement.

Also, during this period East-West launched two High Court challenges against the two airlines policy. However, both challenges were discontinued by the airline. The 1983 legal challenge was discontinued following the takeover by Skywest in December 1983. The new management announced that it was ending the legal proceedings following the Government's announcement that it would conduct a review of the two airlines policy. The second challenge in 1985 was discontinued when East-West was acquired by TNT/News Ltd.

East-West has been owned by five different organisations since 1981. The last change of ownership was in 1987 which saw TNT/News Ltd acquire the airline. The Trade Practices Commission concluded that the acquisition of East-West resulted in TNT/News Ltd being in a position to dominate the market in New South Wales and Western Australia, and accordingly directed that some of their aviation interests be divested.

The non-airline sector of the industry has also experienced significant changes since 1981. Operators have acquired modern turbo-prop aircraft and, in general, have aligned themselves with either Ansett or Australian for on-carriage, baggage handling and reservation arrangements.

In 1985, there were about 40 commuter operators which carried approximately one million passengers. The 6 regional airlines, consisting of the four operating divisions of Ansett plus East-West and Air Queensland, carried just over two million passengers. One regional airline, Airlines of South Australia has ceased to exist since that time and another Air Queensland is to cease shortly. Commuter operators have taken over most of these services.

ECONOMIC DEREGULATION OF AVIATION:
THE AUSTRALIAN APPROACH

INDEPENDENT REVIEW OF ECONOMIC DEREGULATION OF DOMESTIC AVIATION

On 7 March 1985, the establishment of the Independent Review of Economic Regulation of Domestic Aviation (May Review) was announced. This review was foreshadowed by the former Government when the 1981 legislation was being introduced into Parliament and again by the current Government in 1984 when it indicated the review would not simply provide an assessment of deregulation, but that it would need to consider the total framework of economic regulation best suited to Australia's unique national requirements. This would provide the Government with sufficient information to determine the nature of arrangements to apply in the 1990's.

Mr Thomas E May was appointed Chairman of the Review and in October 1985, two committee members were appointed to assist the Chairman, Mr E W A Butcher, and Professor Mills. The terms of reference for the Review are at Attachment 2.

May Review Options

The May Review presented its Report to the Government in December 1986. The Review proposed five options for the future economic regulation of domestic aviation in Australia, namely retention of the 'status quo', 'revised' regulation, 'modified' regulation, 'partial' regulation and 'deregulation'.

In assessing each of these options the Government was faced with a number of important questions that went to the assumptions made by the May Review, but not explicitly considered by the Report.

The first of these questions was, could the aviation industry be differentiated from other industries that were not subject to industry specific controls.

Competition policy for industry generally is embodied in the Trade Practices Act, and one must find some specific features of an industry if it is to be exempted from generally applicable competition policy.

A second question was, does it matter who the regulator is? The May Report criticised a number of aspects of the administration of the two airlines policy and proposed the setting up of an independent aviation-specific regulatory body to administer whatever option was adopted.

There was no evidence to suggest that an 'independent' regulator would be able to administer the policy better than the current arrangements and may if anything be more constrained by its own enabling legislation than a Department of State. The IAFC for example has been constrained by its legislation in its pursuit of consumer orientated objectives.

The third, and perhaps the most important question was what regulation is actually constitutionally possible in Australia if we move away from a contractual agreement system as put forward by the Review?

The Status Quo

The May Review's status quo option, which included the retention of the current system of regulation, based on import controls, capacity determinations for operators of large jet aircraft, controls on route entry and price setting, was never considered to be a serious possibility. The two airlines policy had very little public support and the administration of the policy was under severe attack in the courts.

'Revised' Regulation

This option essentially involved the retention of the current system (though with some minor modifications), but with all the controls being administered by an aviation-specific independent economic regulatory body. The main change proposed under this system was a shift in emphasis from capacity controls to controls on route entry.

The May Report proposed that under this option most trunk routes would continue to be reserved for Ansett and Australian, however a third operator could be allowed to operate specialised services on some 'dense' routes. On some low density routes the regulator could decide to allow only one operator to offer services.

The adoption of this option would have actually increased the amount of regulation over the domestic aviation industry, notwithstanding that it would be administered by an 'independent' authority. Moreover, there is some doubt as to whether the Commonwealth actually has the power to directly control route entry because of s.92 of the Constitution's provisions relating to the freedom of interstate trade. In view of this, it was considered that the adoption of this scheme would in all probability lead to further legal challenges to the policy.

'Modified' Regulation

The 'modified' regulation option also proposed the retention of much of the current system, but with some liberalisation: the number of routes subject to controls applicable to trunk routes would be reduced and new entrants allowed to operate on trunk routes provided they could demonstrate the merit of their proposal; once again the system would be administered by an independent authority.

'Partial' Deregulation

This option took a much more liberalised approach, retaining controls over capacity and import only. There would be no controls over route entry or prices. Again, it was proposed that an independent regulatory body be set up to administer the system.

Deregulation

Under this option there would be no controls over import and pricing. Only State Government licensing and Commonwealth operational and safety requirements would effect capacity. There would be no controls over route entry, with the exception that Qantas and foreign airlines would be excluded from domestic passenger carriage.

There was substantial and broadly based support for this option.

AUSTRALIAN DEPARTMENT OF TRANSPORT AND COMMUNICATIONS

DOMESTIC AVIATION POLICY FOR THE 1990's

On 7 October 1987 the Australian Government announced that it would adopt the broad thrust of the deregulation option and serve notice to terminate the Airlines Agreement.

The Minister for Transport and Communications said in his policy statement of 7 October 1987, that to maintain the current arrangements would not promote, and may prevent, economic efficiency and the other options would involve a considerable amount of regulation, but would still fail to resolve the problems identified in the current arrangements.

The Government considered that the benefits that may reasonably be expected to flow from economic deregulation are:

- greater incentives for existing and new participants in the industry to become more efficient and responsive to consumer needs;
- a wider range of air fares, in particular an increased availability of discount fares;
- growth, particularly in the price sensitive travel market;
- a greater variety in the types, standards and frequency of services provided, and use of more appropriate aircraft on some routes.

(Senator Gareth Evans QC, Policy Statement, 7 October 1987)

The Government's policy to deregulate is part of a comprehensive package of initiatives including new approaches to the provision of infrastructure and services, safety regulation and the role of Government aviation business undertakings.

Overseas Experience

The more recent experiences of deregulation in the USA were examined and the Government's policy was designed to avoid the undesirable effects of the kind of economic deregulation that occurred in that country.

The USA experience does not directly translate to Australia, due to respective constitutional frameworks, size and distribution of markets, political ethos and industrial relations structures, but nevertheless, the major issues that had accompanied deregulation in that country were closely examined.

Also the benefit of the Canadian experience was drawn upon where the industrial relations framework and market size and characteristics are closer to Australia's.

The major concerns that have been raised in relation to overseas deregulation include:

- increased safety risk;
- reduced levels and quality of service;
- concentration of aviation markets.

Safety

Safety will continue to be of paramount importance after the Airlines Agreement terminates. The Government has announced a series of initiatives that will significantly further strengthen Australia's already outstanding aviation safety record.

It is acknowledged that there has been significant concern expressed at the effect of deregulation in the USA on passenger safety. However, there is little evidence of a direct impact. While there were four fatal airline accidents in the USA last year compared to 1986 when there were none, 1987 is rated as the seventh safest since regulation began 61 years ago.

The USA Air Transport Association said that the fatal accident rate per 100,000 departures has "dropped significantly" in the nine years since deregulation to an average of 0.048, or one for every two million flights, versus 0.090, or one fatal accident for every one million flights in the nine years prior to deregulation (Aviation Daily, 1988, Vol 291, No 8 Washington).

The safety concerns expressed in the USA however cannot solely be levelled at deregulation. In 1981, the air traffic controllers' dispute had a significant impact on the industry. Also, the USA Federal Aviation Administration had to meet the challenge of coping with deregulation with reduced resources. It has now been given increased staff and greater power to deal with breaches of regulations.

Canada, unlike the USA, recruited additional people in line with requirements flowing from deregulation and has stepped up its program of surveillance, visits and inspections etc. The Canadian Department of Transport believes that its safety program has developed to complement the economic deregulation program.

These developments have been noted and adequate resources will be provided to ensure the functions of standard setting, operational controls and safety investigation are carried out efficiently in Australia.

Both safety standard setting and the day to day regulatory control will be the responsibility of the proposed new Civil Aviation Authority. This Authority is expected to be formally established on 1 July 1988. The Authority will be required to give priority to safety considerations over commercial areas and the legislation will make provision for the Minister to give broad directions in relation to safety regulation to ensure that this occurs.

The Australian Bureau of Air Safety Investigation, which investigates all aircraft accidents and incidents involving civil aircraft operating in Australia, will be directly responsible to the Minister.

Also, a review of the legislative framework for safety regulations is being undertaken which will ensure that effective compliance tools are in place before 1990.

Airport Facilities

Control of Australia's major civil airports was transferred on 1 January 1988 to the Federal Airports Corporation, a statutory authority designed to manage airports on a proper commercial basis.

Prior to vesting of the airports in the Corporation, long term leases of the domestic terminals were granted to Ansett and Australian Airlines - the major domestic carriers. The leases provide for the airlines to control and manage existing facilities, and construct future facilities.

The airlines are also required to make provision for access for future carriers after deregulation in 1990, if the Corporation cannot make alternative facilities available.

The domestic terminal leases form a keystone in the move to a deregulated environment as they give the existing carriers security of tenure without limiting the opportunity for new entrants to the industry.

The congestion that resulted from deregulation in the USA is mainly due to the development of hub and spoke networks ("hubbing"). There are not, however, expected to be major changes to the structure of the route network in Australia following deregulation.

Competition and Consumer Protection

Air fares

Following the abolition of the IAFC in 1990, interstate air fares will be made subject to surveillance by the Prices Surveillance Authority (PSA). Increased competition following deregulation should ensure that the PSA influence will, in practice, be limited to isolated cases involving abuse of market power.

The overseas experience in deregulation has lead to a greater variety of price options and lower average fares. The major impact has been the availability of a wide range of discount air fares. In 1986 more than 90% of USA passengers used some form of discount fare as compared with 48% before deregulation, and the average level of discount had by 1986 become around 60% compared to just 25% before deregulation.

However, this degree of discounting in the USA is not uniform over all routes, fares on some less competitive routes have actually increased since deregulation.

The proportion of discount travel in Canada is not as great as in the USA. However, it has increased substantially from 25% some 10 years ago to 60-65% of travel in 1986. The level of discount is around 47% of the standard fare.

In Australia, there has by comparison been limited use of discount air fares. Discount air fares have increased in number significantly since 1981, but such fares are used by less than 45% of all passengers. It is thought the increased competition under deregulation will lead to greater availability and use of discount fares.

Service Effects

In the USA there have been some service effects that have not been beneficial to passengers. These include crowding at airports, longer flying time on some services, less non-stop services, delays and cancellations of flights and lost or damaged baggage.

The USA has recently introduced a consumer rule requiring some carriers to submit "on time" data regarding instances of delayed or cancelled services and lost or damaged baggage. These data are publicly released and it is hoped that this will lead to a greater consumer awareness of actual flight time and the probability of arriving at their destinations on time with subsequent airline responses aimed at benefitting the consumer.

These problems have not been as evident in Canada, especially those that relate to hubbing, as hubbing is not a major feature in Canada.

It is also expected that these service effects will not be a major problem in Australia, as most of the structural changes have already occurred prior to deregulation, including a reduction of airports served by Ansett and Australian from more than 150 ports in 1968 to about 50 now. Most of these services have been taken over by East-West or by commuter operators and the communities have often benefited from the use of more appropriate equipment resulting in a higher frequency of service.

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Airline Concentration

In light of the airline concentration in the USA and given the two airlines policy was put in place to prevent either a private or public monopoly in Australia, consideration was given to the need for special aviation competition controls.

It was determined that the aviation industry did not warrant special consideration in a deregulated environment as it was not considered to have special features which distinguish it from other industries.

The aviation industry will be exposed to the Trade Practices Act. Section 50 of the Act, which covers market dominance will be used to prevent monopolies on interstate services.

It was recognised that, after 1990 there would need to be effective competition across the trunk route network. An essential element of this competition would be a strong, viable and efficient Australian Airlines.

The Government decided to incorporate the Airline leading to the removal of day to day controls. Consideration is also being given to the removal of more broad ranging controls. An advisory group is to report back on any further measures that should be adopted to enable Australian Airlines to compete with maximum flexibility and efficiency in a deregulated environment.

ECONOMIC DEREGULATION OF AVIATION:
THE AUSTRALIAN APPROACH

CONCLUSION

After 35 years of detailed economic regulation of interstate aviation, the present Government has decided to bring the two airlines policy to an end.

The aviation industry has reached a stage where detailed economic regulation can no longer help and, in fact, may be hindering the achievement of the broader economic and social objectives which have previously underlined the two airlines policy.

The new policy is a comprehensive package of new initiatives which seeks to encourage the growth of the market and thus make air travel more accessible to a wider range of people, while at the same time providing adequate safeguards for consumers and the maintenance of Australia's high standards of safety.

The Australian Government has been conscious of the difficulties that have occurred in the USA following deregulation there in 1978, and its policy is designed to avoid the undesirable effects of the kind of economic deregulation that occurred in that country.

Canada has benefited from the USA experiences and has been able to overcome many of the problems that occurred there.

The expected benefits and the Government's policy after the Airlines Agreement terminates includes the following

. Safety

- Adequate resources will be provided to ensure that safety regulations and surveillance are maintained.

- The Civil Aviation Authority will be established and will be required to give priority to safety considerations over commercial areas.

. Consumer Protection

- Trade Practices Act will be applied to prevent the emergence of a monopoly on the network of interstate routes and to prevent the abuse of market power.

- Interstate airfares will be made subject to surveillance by the Prices Surveillance Authority.

- Long term leases of the domestic terminals, entered into by the major domestic airlines, require the airlines to make provision for access for new entrants, if the Federal Airports Corporation cannot make alternative facilities available.

- Competition will be enhanced through the presence of a strong Australian Airlines.

. New Entrants

- New operators will be able to enter the market and compete on interstate trunk routes presently served by Ansett and Australian.

- There will be scope for new operators to provide different services using more appropriate aircraft.

. Efficiency

- The increased competition should ensure operators are more efficient and the resultant cost savings should be passed on to the consumer.

. Airfares

- Based on overseas experience, there is expected to be a greater range of discount airfares.

. Growth

- There is expected to be growth in the market, particularly in the price sensitive leisure market.

. Variety of Service Standards

- There should be greater variety in the types, standards and frequency of services available to serve all segments of the market.

AUSTRALIAN DOMESTIC AVIATION INDUSTRY
DOMESTIC SCHEDULED AIRLINE SERVICES, 1946 - 1987
REVENUE PASSENGER KILOMETRES, (000's)

Year (a)	ANA	Ansett (b)	Australian (TAA)	Other	Industry Total	Growth ANA	Ansett (b)	Australian (TAA)	Other	Industry Total
1946	348,052.1	10,013.6	22,955.4	64,188.9	445,209.9	n.a.	n.a.	n.a.	n.a.	n.a.
1947	378,894.7	22,180.8	213,271.2	100,060.5	714,407.2	8.9%	121.5%	829.1%	55.9%	60.5%
1948	438,489.9	36,122.0	302,984.5	120,308.9	897,905.2	15.7%	62.9%	42.1%	20.2%	25.7%
1949	412,837.8	34,543.0	373,397.3	127,312.2	948,090.5	-5.8%	-4.4%	23.2%	5.8%	5.6%
1950	416,321.2	57,340.6	423,911.0	141,029.1	1,036,601.9	0.8%	66.0%	13.0%	10.8%	9.3%
1951	445,910.4	69,915.1	503,405.1	167,505.5	1,186,736.2	7.1%	21.9%	19.3%	18.8%	14.5%
1952	406,969.7	76,190.2	494,475.0	182,639.5	1,160,274.4	-8.7%	9.0%	-1.8%	9.0%	-2.2%
1953	380,094.1	69,148.5	488,038.5	202,785.0	1,140,066.1	-6.6%	-9.2%	-1.3%	11.0%	-1.7%
1954	439,857.6	83,396.9	490,677.4	223,871.3	1,237,803.3	15.7%	20.6%	0.5%	10.4%	8.6%
1955	441,808.3	128,482.7	564,427.8	223,360.3	1,358,079.1	0.4%	54.1%	15.0%	-0.2%	9.7%
1956	453,629.1	139,825.8	601,580.0	244,163.3	1,439,198.2	2.7%	8.8%	6.6%	9.3%	6.0%
1957 (c)	367,323.1	246,993.2	633,619.8	258,915.9	1,506,871.9	-19.0%	76.6%	5.3%	6.0%	4.7%
1958		577,308.5	668,518.0	260,564.3	1,506,390.9		133.7%	5.5%	0.6%	0.0%
1959		699,553.2	760,961.5	295,640.0	1,756,154.7		21.2%	13.8%	13.5%	16.6%
1960		735,131.5	869,358.3	290,465.7	1,894,955.5		5.1%	14.2%	-1.8%	7.9%
1961		748,461.8	865,012.8	266,440.2	1,879,914.7		1.8%	-0.5%	-8.3%	-0.8%
1962		799,860.2	893,911.3	266,972.5	1,960,744.0		6.9%	3.3%	0.2%	4.3%
1963		895,009.6	1,011,105.8	293,950.7	2,200,066.1		11.9%	13.1%	10.1%	12.2%
1964		1,066,849.8	1,184,932.8	338,039.6	2,589,822.2		19.2%	17.2%	15.0%	17.7%
1965		1,262,926.5	1,363,239.6	370,862.7	2,997,028.7		18.4%	15.0%	9.7%	15.7%
1966		1,347,036.5	1,466,016.9	395,869.9	3,208,923.0		6.7%	7.5%	6.7%	7.1%
1967		1,461,401.1	1,623,295.5	397,507.7	3,502,204.3		8.5%	10.7%	0.4%	9.1%
1968		1,663,050.8	1,753,624.1	425,472.3	3,842,147.1		13.8%	8.0%	7.0%	9.7%
1969		1,952,258.5	1,959,466.9	478,313.6	4,390,039.0		17.4%	11.7%	12.4%	14.3%
1970		2,187,717.4	2,322,090.3	569,346.4	5,079,154.1		12.1%	18.5%	19.0%	15.7%
1971		2,368,678.4	2,444,573.6	642,084.6	5,455,336.6		8.3%	5.3%	12.8%	7.4%
1972		2,487,811.0	2,581,464.0	635,535.6	5,704,810.6		5.0%	5.6%	-1.0%	4.6%
1973		3,033,095.3	3,028,951.8	714,433.4	6,776,480.5		21.9%	17.3%	12.4%	18.8%
1974		3,325,975.3	3,419,219.3	800,184.1	7,545,378.7		9.7%	12.9%	12.0%	11.3%
1975		3,561,554.8	3,619,030.7	831,892.4	8,012,477.9		7.1%	5.8%	4.0%	6.2%
1976 (d)		3,267,716.8	3,297,056.7	754,926.1	7,319,699.6		-8.3%	-8.9%	-9.3%	-8.6%
1977		3,414,993.8	3,525,734.0	770,329.9	7,711,057.7		4.5%	6.9%	2.0%	5.3%
1978		3,773,652.6	3,756,937.0	846,504.7	8,377,094.3		10.5%	6.6%	9.9%	8.6%
1979		4,037,593.8	4,156,303.2	870,969.2	9,064,866.2		7.0%	10.6%	2.9%	8.2%
1980		4,393,491.8	4,477,022.0	904,808.0	9,775,321.8		8.8%	7.7%	3.9%	7.8%
1981		4,580,234.3	4,436,498.6	896,700.5	9,913,433.4		4.3%	-0.9%	-0.9%	1.4%
1982		4,495,133.1	4,420,058.0	969,903.3	9,885,094.4		-1.9%	-0.4%	8.2%	-0.3%
1983		4,128,380.2	4,126,579.9	1,059,108.4	9,314,068.5		-8.2%	-6.6%	9.2%	-5.8%
1984		4,473,064.2	4,290,080.7	1,192,195.8	9,955,340.7		8.3%	4.0%	12.6%	6.9%
1985		4,732,760.0	4,700,107.0	1,465,450.0	10,898,317.0		5.8%	9.6%	22.9%	9.5%
1986		5,072,376.0	5,051,911.0	1,517,267.0	11,641,554.0		7.2%	7.5%	3.5%	6.8%
1987 (e)		5,707,165.0	5,429,104.0	1,596,368.0	12,732,637.0		12.5%	7.5%	5.2%	9.4%

NOTES : (a) Years ending December 31
(b) Excludes Ansett's regional airlines.
(c) Ansett acquired ANA in 1957. ANA and Ansett services were fully integrated in October 1957. ANA statistics for 1957 are up to Oct 21, whereas Ansett statistics include ANA operations from that date.
(d) Since 1976 "great circle distances" have been used in the calculation of RPK's. This change had the effect of reducing RPK's by about 3% in 1976. Also, in 1976 traffic between Australia and Papua New Guinea was excluded from the statistics. The actual traffic growth rate in 1976 was in the order of about -4%.
(e) Provisional data.

AUSTRALIAN DEPARTMENT OF TRANSPORT AND COMMUNICATIONS

ATTACHMENT 2

REVIEW OF ECONOMIC REGULATION OF DOMESTIC AVIATION

THE TERMS OF REFERENCE

Recognising the Government's policy to retain TAA as a wholly Commonwealth owned enterprise to:

(a) Review existing arrangements for economic regulation of domestic aviation in Australia and report to the Government on possible options for the future;

(b) Have regard to, and report upon the impact of, the following matters insofar as they relate to domestic aviation:

i) the public interest;
ii) the role of East-West Airlines;
iii) the role of other regional airlines and commuter (Supplementary Airline Licence) operators insofar as they impinge on the major trunk and regional routes;
iv) import of aircraft;
v) capacity control;
vi) pricing control, including public interest considerations of passing on costs;
vii) access by Qantas to carriage of domestic passengers;
viii) the role of large aircraft charters;
ix) Commonwealth/State powers in respect of economic regulation;
x) implications for the air freight sector;
xi) economic regulatory arrangements for domestic aviation in overseas countries, and any conclusions which may be of relevance to Australia;
xii) Commonwealth/State/Territories tourism policies;
xiii) the Government's proposed general review of business regulation

(c) Also have regard to maintaining the safety of air service operations, but shall not make recommendations on operational/safety matters.

(d) Undertake such other related tasks as are referred by the Minister for Aviation.

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