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Developments in the Aviation Industry in Australia and Asia - Implications for Australian Tourism

by

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Abstract:

The Asia-Pacific region is expected to be the main region of growth in airline travel for at least the next two decades. According to the forecasts, China will become one of the largest domestic airline markets in the world alongside Japan, already one of the most significant domestic markets outside the USA.

The inability of government-owned airlines in the region to cope with rapid growth and with the need to upgrade their services in domestic markets has resulted in major changes in policy. As a result, new airlines have been permitted to operate in South Korea, Taiwan, the Philippines, Indonesia, India, Nepal and Pakistan with governments adopting a more liberal attitude towards competition. A common experience has been that the new airlines cannot survive on a domestic base and a number of countries have allowed the new carriers to fly international routes.

These new airlines are more likely to fly between regional centres and so take away some of the pressures on the key hub airports that tend to be congested. Also, they provide direct links to tourist attractions away from the main metropolitan centres in Australia. This paper analyses these trends in aviation in the Asian region and explores their implications for the continuing development of Asian markets by Australian airlines and the tourism sector.

1. Competition in the Airline Industry - Australia and its Neighbours

Australia entered the 1980's with an aviation policy that preserved trunk routes in its domestic market for two airlines competing on a controlled basis and an emphasis on the commercial viability of Qantas as the sole national carrier in international markets. Over the coming decade, there were significant changes in the attitude of successive Federal Governments and changes in policy resulted in a more dynamic industry with much reduced distinctions between domestic and international airline operations, at least as far as Australian carriers are concerned. The pressures that were building up during the 1980's included expectations of gains to Australian consumers in a more competitive airline industry, aggressive competition from carriers in South-East Asia, the USA's insistence on increasing opportunities for its carriers, and recognition of the importance of international tourism to Australia. At the same time, Australia was committed to a path of microeconomic reform. The result is that Australia has a deregulated domestic airline industry, it has established a mechanism to allocate commercial rights to operate on international routes to its own carriers, and its approach to international aviation encourages competition where this is likely to generate benefits to the nation as a whole.

The Australian experience is being mirrored across Asia and there is a common interest in pursuing opportunities for new carriers to gain access to international markets. Moreover, 'multiple designation' is one of the measures being advocated as part of a package of reform that will lead to a more competitive international airline industry. For example, the Transportation Working Group of APEC has tabled a paper on the subject for consideration at the Ministers of Transport in June 1997. The paper points out that the growth in the number of airlines providing services in the region enhances competition and results in greater range of services for consumers. The question is posed whether APEC should endorse the concept of multiple designation, or at least member economies could promote conditions that would allow their APEC partners to designate more than one carrier. The Pacific Economic Cooperation Council (PECC 1995) has promoted similar initiatives.

The continual pressure of competition has been the most potent agent of change in the international regulatory framework. The aggressive approach of newer airlines seeking to cement a position in international markets has made attempts to control the industry more and more difficult to achieve and several nations, notably the USA, have been ardent advocates of a more liberal approach. Many governments have abandoned attempts to regulate fares and there has been a consistent trend towards the active promotion of competition. Under the auspices of the Uruguay Round of GATT (General Agreement on Trade and Tariffs) and ICAO (International Civil Aviation

Organisation), there have been wide-ranging debates about appropriate regulatory structures. Multilateralism, a fundamental principle promoted by the World Trade Organisation (WTO), has been rejected thus far in aviation (Nuutinen 1992, Findlay 1997). Nevertheless, multiple designation and rapid growth in traffic is placing pressure on the bilateral system and there is increasing interest in regional arrangements.

This paper examines the trend towards multiple designation of airlines in Asia where rapid growth of traffic and economic pressures on the airline industry have not provided opportunities for the same type of public debate and gradual process of change that occurred in Australia. However, the well-documented Australian experience provides valuable insights into the factors leading to multiple designation in Asia. The paper examines the Australian experience in some detail and then analyses liberalisation of domestic airline markets in Asia citing the particular cases of South Korea and the Philippines. New entrants tend to emerge because of developments in domestic markets, but once they have made their presence felt, there are irresistible pressures on governments to allow them to operate on international routes.

Often, these new entrants are encouraged to develop new routes, particularly on a regional basis, but the bilateral system of regulation is an inhibiting factor. There is growing interest in forming regional groups, which agree to a more liberal approach to airline operations within the membership, but it is possible these regional blocs could become anti-competitive for outsiders. This could have implications for Australia, especially in the formation of hubs and the roles that might be played by Australian carriers in the increasingly global airline industry.

2. Australia’s Aviation Policy in the 1980’s and 1990’s

2.1 International Aviation

Despite several attempts to organise a multilateral framework for the conduct of commercial aviation services, the system that has evolved is a complex web of more than 3,000 air services agreements on a world-wide basis. Bilateral negotiations establish how airline services between the respective countries will be regulated, usually specifying which airlines are permitted to operate, what capacity they can provide and what routes/airports they are permitted to use, and perhaps what fares can be charged (Bureau of Transport and Communications Economics 1994). Historically, Australia tended to have a restrictive approach to competition in its negotiations. Since most of the travel to and from Australia was undertaken by Australian residents, the right to enter the market was regarded as valuable commercial property that should be exchanged only when there was some reciprocal benefit.

Accordingly, Australia was reluctant to enter into air services agreements with other countries that did not appear to have a significant volume of traffic. As an end-point on the international network, Australia’s interests were seen to be served best by having a strong carrier; foreign carriers provided sufficient competitive pressure and multiple designation on Australia’s part would only weaken its position. The Government’s stated position was that it aimed to have international services provided at fares consistent with the public interest while protecting Qantas and the Australian Government actively sought the advice of Qantas whenever air services agreements were being negotiated.

In the early 1970’s, the commercial environment made it progressively more difficult for governments to control fares as promotional fares proliferate as scheduled airlines learned to cope with floating currency exchange rates and competition from charter airlines (Lyle 1995). Australia, like many other countries, concentrated its attention on controlling entry and on allocating capacity. However, during the 1980’s, there were two major developments that resulted in a change in the Government’s attitude. First, the Government committed itself to a comprehensive programme of microeconomic reform with the transport sector high on the agenda (Hensher 1993). A process of reviewing and reforming government regulation was commenced and closer scrutiny was placed on government business enterprises. The trend was for the Government to withdraw from activities that could be performed more efficiently by the private sector. Nevertheless, aviation is treated as a ‘special sector’ in most economies, especially given the difficulty of taking unilateral action in the international arena. Changes in the Government’s aviation policy occurred only after a considerable amount of investigation and debate.

The second major change was the recognition that tourism had become an important sector of the Australian economy. For the first time, the number of international visitors coming to Australia exceeded the number of Australian residents departing the country (short-term stays). International tourism was going through a boom after a number of factors had combined to create greater awareness of Australia and as a weaker currency made Australia competitive as a tourist destination. At first, the major growth markets included Europe and North America, but growing incomes and changing attitudes to foreign holidays in Asia, coupled with supportive Government policies saw Japan take a lead as a generator of visitors.

The tourism sector was coalescing into a powerful industry group and it was raising aviation policy as a serious constraint (Wheatcroft & Lipman 1989). A consistent theme has been that the international tourism market is intensely competitive and that Australia, as a long-haul destination, tends to be regarded as a costly alternative. The Asia-Pacific region boasts some of the world's most efficient airlines (Findlay 1985, Forsyth 1997) and this makes it imperative for Australia to seek effective arrangements for the provision of its airline services.

Recognising the growing importance of tourism and the need to devise appropriate policies, the Government directed the Industries Assistance Commission (IAC) to conduct an inquiry into the tourism. A vigorous debate ensued about the role and importance of travel costs. The Australian Tourism Industry Association (ATIA) and the Australian Federation of Travel Agents (AFTA) argued to the IAC that high travel costs were deterring development of the market and this view was supported by research reported by the Australian Tourist Commission (IAC 1989, 49). Qantas held an opposing view that Australia ought to focus on 'high-yield' tourists. The IAC considered there was scope to reduce costs and air fares under more competitive conditions and that the economy-wide effects of this would be considerable. It advocated a far-reaching agenda of reform to be implemented in several phases including abandonment of the separation between domestic and international markets for Australian carriers.

The day after the IAC's draft report was released to the public (15 June 1989) the Government announced a major shift in its international aviation policy. The Minister for Transport and Communications indicated it was beneficial for Australia to have a more liberal approach to the negotiation of air services agreements and that, in future, the over-riding objectives would be to maximise the welfare of users and of Australia as a whole. He said 'The Government's (IAC) review was particularly prompted by a surge in inbound tourism last financial year. Because seats were scarce, not everyone who wanted to travel to Australia was able to. The Government was determined to ensure that Australia's approach to negotiating aviation rights was able to meet the growing demand for travel' (Willis 1989). He noted that Australia's airline market had changed; Australia had become a major tourist and business destination and that approaches that had been pursued in the past were no longer relevant. The IAC advocated extension of the Australia-New Zealand Closer Economic Relations Trade Agreement (CER) to include aviation services. The Government acted on this by entering into a joint study with New Zealand to assess the costs and benefits. The study concluded that there were significant welfare gains to be made by creating a single market (BTCE & NZ MoT 1991).

The next major change in policy occurred when the Minister for Transport and Communications announced in February 1992 that reforms would be introduced to promote national interests and to enhance competition by removing barriers between the domestic and international markets. Qantas now was able to sell spare capacity in the domestic market. At the same time, domestic operators would be permitted to fly on international routes. To achieve this, it was necessary to renegotiate air services agreements, but it was necessary to devise a mechanism for allocating commercial rights to any current and future Australian airlines. The International Air Services Commission (IASC) was formed to make decisions about capacity and renewal of allocations, reviewing this decision and providing advice to the Minister on matters related to international operations.

The Minister also said the Government would pursue the single aviation market with New Zealand and, on 3 June 1992, the two governments had reached an agreement on some of the major changes to Australia-New Zealand aviation. There appears to have been a presumption on the Australian side that a merger of Air New Zealand and Ansett Airlines should proceed, possibly because of the belief such a combination would provide effective competition for Qantas on routes to and from Australia and New Zealand (Findlay 1996). However, late in 1994 the Australian Government decided not to proceed, largely because of concern about an adverse effect on the sale price of Qantas, then in the process of being privatised. Ultimately, the single aviation market has been established, but the impetus for this, and indeed for the changes in policy in 1992, resulted more from the pressures building up in the domestic airline industry in Australia.

2.2 Domestic Policy Responses

The Australian Government introduced economic regulation of the domestic airline industry in the early 1950’s when the first attempts to develop a national network appeared likely to result in a monopoly. The policy that evolved by 1954, and which remained in place for more than three decades, avoided this outcome by fostering limited competition between two airlines. The measures put in place prevented new competitors emerging on the trunk routes, determined what capacity should be provided and allocated this equally to the two airlines, and also decided what fares the airlines could charge (May et al 1986, Bureau of Transport and Communications Economics 1991). The proponents of the policy argued that these arrangements ensured Australia avoided ‘destructive’ or ‘wasteful’ competition among its airlines and allowed for the orderly development of a national network.

When the USA deregulated its domestic airline industry in 1978, and several other countries followed suit, it was perhaps inevitable that Australia would review its situation. New entrants in the USA had slashed fares, especially on longer routes and this raised expectations that similar outcomes could be achieved in Australia. Since 1974 the Federal Government had set fares using a formula approach incorporating a ‘flag-fall’ and a ‘distance’ component. The premise was that there is a fixed cost per passenger involved in making reservations, issuing a ticket, processing at the airport and getting airborne, and there is a cost related to the distance traveled. The formula used a linear relationship and it was recognised there was an element of cross-subsidisation involved. However, during the late 1970’s, pressure built up to reduce air fares on the longer routes which, by then, seemed high compared to fares charged in the United States. When the Government commissioned an inquiry into domestic air fares it found there was a widely-held opinion that air fares in Australia were too high and that the structure was inequitable (Holcroft et al 1981). Although there is evidence that a linear relationship exists between an airline’s direct operating costs and distance, there are theoretical and practical grounds to question the straightforward application of a formula approach (Gannon 1982).

As a result of these pressures, the Government made two important concessions when it came time to renew the Airlines Agreement Act in 1981. It gave an undertaking to assess the advantages and disadvantages of deregulating the domestic airline industry prior to renewing the Airlines Agreement Act, and regional airlines were given some scope to introduce jet aircraft and to expand their services to non-trunk routes. Fares were to be regulated henceforth by the Independent Air Fares Committee (IAFC). After September 1982, the IAFC set fares according a cubic formula that reduced prices on long-haul and on short-haul routes while also introducing greater scope for the airlines to introduce promotional discounts.

The independent East West Airlines (EWA) expanded its operations and ordered jet aircraft. In an aggressive approach that pushed the regulations to the limits, it commenced a de facto Melbourne-Sydney service via Albury in 1983. Using F27 turbo-prop aircraft and a ‘no frills’ approach to service, it initially set its fares at around 50% of the applicable TAA and Ansett fare. The Government then found itself in the position where it was unwilling to approve a large reduction in the price of airline travel. This ‘experiment’ with competition attracted a considerable amount of public attention and heightened interest when it came time in 1985 for the promised review of policy. Known as the ‘May Review’, the inquiry received a large number of submissions, the overwhelming majority arguing that the industry should be deregulated (May et al 1986).

Those in favour of maintaining some form of regulation included the airlines, the unions and the Department of Transport. The travel industry was critical of the airlines for not taking a more active role in promoting tourism and for restricting the options for other groups to introduce a wider and more attractive range of domestic travel packages. Other major opponents of the ‘two airline policy’ were the Federal Government’s Treasury and Finance Departments and the State Governments across the nation. When the inquiry’s report was published (May et al 1986), it agreed with the view that too little effort had been devoted to the non-business market and that the two airlines were too narrowly focused on serving the business travel market.

The ‘May Review’ set out the options for the Government, although it is notable that it had been directed not to consider the privatisation of TAA. In October 1987, the Federal Government, by now strongly committed to the pursuit of microeconomic reform, chose the path of deregulation. The Government was obliged to give the airlines three years notice, but after October 1990 the two established carriers would be free to make independent commercial decisions. The IAFC was disbanded and the Prices Surveillance Authority and the Trade Practices Commission became the relevant regulatory bodies (now combined under the banner of the Australian Competition & Consumer Commission). Also, as of July 1 1988, Qantas was permitted to resume the carriage of passengers of other international airlines on the domestic sectors of its services. The Government rejected the possibility of extending the Closer Economic Relations Agreement with New Zealand to aviation services.

Both of the incumbents began to prepare for deregulation, including a change of name for TAA to Australian Airlines. Both carriers increased their marketing activities and ordered new aircraft as they enjoyed a surge in the travel market during the Bicentennial and World Expo in Brisbane. When their pilots initiated industrial action in support of a wage claim the airlines, with the backing of the Federal Government, took an uncompromising stance and signaled a tougher approach to the control of costs and the pursuit of productivity improvements. During the dispute, several business groups were advancing their plans to start new airlines and Compass Airlines, the eventual winner of this ‘contest’, found it was relatively easy to attract qualified employees and to gather the support of the travel industry. Traffic levels had begun to recover after the cessation of the pilots’ dispute, but real growth in the market had begun to fall away just before the dispute had commenced. When it started its first services in December 1990, Compass set its peak fares 20% and its off-peak fares 50% below the level of its rivals. This was matched immediately and Australian and Ansett introduced frequent flyer plans. Compass reduced its prices even more in May of 1991 and a full-scale price war erupted. Traffic levels boomed, especially on the longer routes and on those serving tourist destinations.

The subsequent failure of Compass was, in part, attributed to the inadequacy of infrastructure at Australian airports to cater for new airlines. Although much of the cause of Compass’ financial problems can be sheeted home to its business strategy and lack of capital (Nyathi et al 1993), there have been concerns that the Australian market will not sustain more than two major airlines. Spurred on by the tourism sector and its commitment to microeconomic reform the Federal Government has been prepared to extend the reform agenda and to seek ways to increase competition.

The IAC's inquiry into tourism was completed just prior to deregulation and its package of recommended reforms applied as much to domestic aviation as it did to the international airline sector. The IAC suggested the distinction between domestic and international markets be reduced for Australian carriers and that a single aviation market ought to exist for Australia and New Zealand. Both Qantas and Australian Airlines had submitted that Government ownership impeded their ability to compete, but the IAC placed primary importance on the creation of a competitive environment. Nevertheless, the issue of privatisation of the Government's two airlines had been placed on the agenda.

2.3 Privatisation and the Formation of a Single Market with New Zealand

In November 1996, the Australian and New Zealand Governments finally signed an agreement allowing designated carriers to fly within and between the two countries provided they are at least 50% owned and controlled by nationals of either country. However, this occurred only after other events had overtaken the policy making process.

Despite having excluded privatisation as an option in 1985 for the May Review, by 1991 the Government had accepted the desirability of privatising Qantas and Australian. Options considered along the way included partial privatisation of each airline as separate entities, but the Government decided in the end that both its airlines should be merged first and then sold as a unified business. Announcing this in 1991, the Government indicated it would broaden the scope for other Australian airlines to operate international services. In September 1992, Qantas acquired Australian Airlines saying that it planned to create 'a seamless domestic and international airline service' and, by October of 1993, Australian was no longer being promoted as a separate entity. Also, the Government had given its permission for Qantas to begin selling its spare capacity on the domestic sectors of its international flights, a step taken by the carrier in November of 1993. British Airways was permitted to purchase 25% of Qantas in March 1993 and by November of 1995, the privatisation process was completed.

Australian Airlines had expanded its fleet in 1990 and Qantas continued to increase its capacity, allowing it to add routes, particularly within Western Australia

(Australian Airlink). By July 1995, it was able to offer half hour headways on its dense east coast markets in peak periods. Ansett Airlines' ability to respond to the competition was limited, partly because it was having difficulty controlling costs with its fleet configuration. Both of Ansett's owners, TNT and News Corporation, had signaled their interest in selling their equity stake, with TNT unable because of its financial problems to provide the capital required for expansion into international markets. Lacking international experience, the attraction of Air New Zealand becoming an owner was attractive.

However, the market was running ahead of policy. The Australian Government had vetoed plans to proceed with a single aviation market late in 1994, but throughout 1995 negotiations proceeded for the sale of the News Corporation share of Ansett to Air New Zealand. There were additional complicating factors. One was that Ansett Airlines provided the only domestic competition to Air New Zealand and the Commerce Commission of New Zealand was opposed to the sale. The eventual outcome was a commitment by News Corporation to Ansett Australia with an injection of capital and the sale of TNT's half share to Air New Zealand. News Corporation purchased Air New Zealand and operates it as a separate entity.

Another complicating factor was the rules on foreign ownership. Australia had set the limits of foreign ownership at 49% in the sale of Qantas, with a foreign-owned airline limited to 25%. Ansett Airlines International had been awarded routes by the Government that now could be in breach of the air services agreements under which they were awarded, specifically those with Japan, Hong Kong, Indonesia, Malaysia, Singapore, Taiwan and South Korea. The solution was to pass control of Ansett Airlines International to Australian investors (AMP and County Natwest Australia), and the New Zealand Commerce Commission and the Australian Foreign Investment Review Board approved the sale.

In agreeing to the formation of a single aviation market between Australia and New Zealand, it can be argued the Australian Government was giving recognition to an arrangement that had come into being by virtue of the cross-ownership arrangements. Within a decade, Government policy had turned completely on its head. The domestic industry was deregulated, the airlines were privatised, foreign ownership restrictions were eased, the Australian and New Zealand aviation markets were unified, and multiple designation was accepted. Moreover, the Government became an open advocate of competition in international markets.

2.4 Multiple Designation and Advocacy of Competition

With hindsight, it is interesting to reflect on public statements made by the various interest groups to the IAC in 1989. Qantas argued it was 'the only airline in the world without any domestic network to feed its overseas flights and to link its incoming traffic to a wide network with low add on fares'. Having said that, it quickly dismissed any interpretation that it wished to compete on a wider basis in the domestic market. Australian Airlines, stating its desire to operate regional international services, said '... domestic operations by Qantas are an appendage to its main business, a business that is protected because it is the sole designated carrier'. Ansett Airlines submitted it would be at a disadvantage were Qantas to be given access to its markets without reciprocal rights for Ansett to compete on Qantas' international routes. Indeed, the Australian Government expressed the view that 'to allow Qantas to perform such a role (carrying domestic passengers) Ö would undoubtedly lead to pressure for other domestic operators to be allowed to operate as designated international Australian carriers, which pressure would be difficult for the Government, on grounds of fair and equitable commercial opportunity, to resist' (IAC 1989, 77-79).

Given these arguments, it was impossible for the Government to merge its two airlines and allow them to integrate their domestic and international operations and then to privatise this entity while continuing to deny Ansett Airlines, or any other new entrants, the right to fly internationally. In February of 1992, the Government took the logical step of approving multiple designation. To implement the change in policy, though, it was necessary first to renegotiate air services agreements and set up an independent process to allocate operating rights.

The IASC has been given several directives. One is to promote greater economic efficiency in the airline industry and competition among Australian carriers. Added to this, its determinations should result in airlines responding to the needs of consumers while supporting Australian tourism and trade. In permitting a new entrant into a market, the IASC has to assess whether the level of capacity allocated is consistent with the development of commercially sustainable operations by the entrant and the incumbent Australian carrier when they operate efficiently. 'Commercial sustainability' is defined for this purpose as the minimum capacity necessary to allow a level of scheduled international passenger services consistent with an efficient, commercially sustainable operation. The problematic issue here is on the definition of the market.

The IASC has interpreted the relevant market as the traffic between the two countries. Findlay and Round (1994) argue that airlines tend to approach their marketing plans by looking at groups of countries. Currently, regulators in the USA, the UK and the European Commission have a major disagreement over just such an issue (Anon. 1996). The proposed alliance between American Airlines and British Airways, according to the proponents, has a minor share of the market between North America and Europe. At issue is whether the proposed alliance's domination of traffic flowing through Heathrow Airport is a serious threat to competition (Odell 1997, Alamdari & Morrell 1997). The bilateral approach to negotiation of air services agreements constrains the way regulators and airlines consider markets, but the trend towards globalisation of airline services will pose increasingly difficult issues for regulatory bodies such as the IASC.

A related issue is how the IASC determines what is commercially sustainable. Its approach has been to take account of the importance of network characteristics and of the potential for economies of scope. Also, it has considered the size of the network of the applicant, the size of the network of the incumbents, the degree of competition on the route, the nature of the traffic, the ability to match aircraft type with demand characteristics, and revenue and cost characteristics of the route. As a result, the IASC is confronted with a difficult task that is growing in complexity and it lacks wider powers necessary to promote competition (Findlay and Round 1994).

The Australian experience over the past decade illustrates the power of market forces as an agent of change it shows that interventionist regulations will continue to be under pressure. It is unlikely these competitive forces will abate as new airlines vie for a share of the market and as the world's major airlines seek global network coverage of through their alliances and equity investments. Only the USA has a consistent policy on the formation of these 'mega' alliances. Alliances are acceptable provided they operate under an 'open skies' regime and if dominant positions on less competitive routes are weakened. The formation of alliances between carriers on either side of the Atlantic has given the USA the lever with which to negotiate very liberal air services agreements with ten European nations (Odell 1997). The USA is driving home the advantage and it is pursuing a similar approach in Asia (Ballantyne 1997, Jennings 1996).

According to one line of argument, the major airlines will determine the location of key hub airports and the lesser airlines will be relegated to feeder roles (Shenton 1996). From Australia's point of view, the emerging alliance between American Airlines and British Airways ensures Qantas is part of a powerful bloc. However, if this comes at the price of Qantas being relegated over time to being a feeder airline there are important implications for Australia (Bureau of Transport Economics and

Policy 1994). Before considering that possibility, an overview of the policy and competitive environment in Asia will demonstrate there are countervailing forces.

3. The Coming Era of the Asia-Pacific Airline Industry

3.1 The Pragmatic Asian Approach

It is difficult to find situations anywhere in the world where governments promoted open competition in their domestic airline markets prior to the late 1970's. In part, the reason for this has been the fear of control over the industry by monopolies or of persistent financial crises resulting from 'destructive' competition. Asian nations have shared these concerns, but in addition they still rely upon their domestic airlines to compensate for a sub-standard or congested surface transport system, to overcome the barriers of mountains or water.

Another common factor is that the economic boom in Asia and the growth in international tourism are generating rapid and sustained increases in airline traffic. It has been predicted that Asian carriers, not including Japan's, will account for one in eight revenue passenger kilometres (RPK's) performed by the world's domestic carriers in 2014 (McDonnell-Douglas 1995). China's market is expected to grow at an average annual rate of more than 11% for several decades with the result that its carriers will perform more than 100,000 million RPK's in 2014 (Boeing 1995). Carriers from Japan and China will have substantial domestic markets exceeded only in the USA.

Governments have recognised their unreliable and under-resourced airline systems inhibit the development of their tourism sectors, now one of the most promising sectors of their economies. The initial step away from the strictly regulated approach has been to permit the entry of private sector airlines and there has been no shortage of business interests prepared to take up the challenge (Bailey 1993). However, the economic realities of the airline industry progressively make it more and more difficult to sustain controls over entry, capacity and fares (Hooper et. al. 1996). One of the most problematic aspects of liberalisation is how to ensure unprofitable but necessary community services are sustained. Many of the governments in Asia have shown a greater willingness to allow their new private sector airlines to operate on international routes rather than dismantle controls over domestic fares and over the enforced continuation of 'necessary' services (Hooper 1997).

This gradualist approach to liberalisation has been labelled as 'pragmatic' with the airlines regarded as instruments of national development; the airline sector continues to be regarded as something special (Bowen & Leinbach 1995). This approach means that there are differences in the way the liberalisation is occurring from nation to nation, but at the same time there are strong similarities in terms of the agents of change, the process of reform and the outcomes. The process of reform opens the door for new airlines, but no matter how much regulators might try to control competition, there is an inevitable struggle for market share. Pressure builds up for further changes and it is recognised that competition must be permitted more or less on the basis of equal opportunity. Privatisation and multiple designation become inevitable under the weight of market pressures.

The Australian case illustrates this and what tends to be different in Asia is that the pace of change, once commenced, is more rapid and occurs without the opportunity for detailed prior analysis. South Korea has adopted a form of limited competition in which it allowed the new carrier to operate international services because it could not compete purely on its domestic base. The Philippines exemplifies a country concerned about the performance of its national carrier and its subsequent attempts to privatise while fostering a liberal aviation policy. Hooper (1997) has identified a general movement to liberalise domestic competition leading to multiple designation in international airline markets, but South Korea and the Philippines will be examined here to shed insights into this trend.

3.2 South Korea

Korean Air Lines commenced in 1948 and, though it was privatised as early as 1969, it enjoyed a monopoly in the domestic market until 1988. In response to criticisms of the services provided by Korean, the Government approved the commencement of a second domestic carrier, Asiana Airlines. Owned by the Kumho Corporation, a large Korean enterprise with diversified interests, Asiana commenced services in December 1988 on six routes using leased Boeing 737-400 aircraft. However, it placed orders for B767-300 and B747-400 aircraft early in 1989 as part of a stated plan to operate regional and long-distance international services in 1990. Asiana complained that it could not compete unless granted access to international routes. The Government had continued to control airline fares and, together with the competition from a dominant Korean Air, there was a danger that the new pro-competition policy would founder.

In 1989, the Government lifted restrictions on travel abroad by its citizens and the resulting boom in traffic provided an opportunity for Asiana to be granted international rights. In October of 1990, the Minister of Transportation announced a new policy according to which Korean Air would fly all domestic routes and any international routes within the limits of air services agreements negotiated by the Korean Government. Asiana's rights to compete on domestic routes was reaffirmed and it was permitted to fly to the United States, Japan, South East Asia and South West Asia. Special consideration was to be given should Asiana wish to fly to China, Vietnam, the Soviet Union, Laos and Cambodia.

Double tracking was to be permitted on routes where the traffic level reached 200,000 passengers a year. Asiana was to be granted capacity rights in the ratio of 2:1 on new routes to Japan, South East Asia and South West Asia, but Korean Air would be given a 2:1 capacity differential on routes to the USA. However, neither airline was satisfied with the new policy and the Government was immediately placed under pressure to review its position (Hong 1992). The ratio of traffic on new routes to the USA and Southwest Asia subsequently was changed to 1:1. Also, Asiana was given a priority allocation of three flights per week on the Korean Air routes which satisfy the double tracking rule which was reduced to 150,000 passengers each year (Oum & Taylor 1995).

In effect, the Government attempted to cross-subsidise the domestic operations with its international policy. However, Asiana had to enter some highly competitive routes without having a clear strategic advantage. Its lack of a significant profile as an international airline placed it at a disadvantage in the market and there was no evidence that it could produce with lower costs than its rivals. In its first five years, Asiana lost US$292 million and only turned in its first profit in 1994 with a surplus of US$37 million. The airline's cause was not helped when one of the B737-400 aircraft crashed in 1993.

The domestic market had grown to 21 million passengers in 1995 and was maintaining an annual growth rate in excess of 14% due to increasing affluence, low air fares, and congested roads. The Government relaxed its regulation of domestic fares, requiring only that the airlines notify it of changes. However, the airlines consider they are obliged to operate unprofitable services and Korean voluntarily reduced its already low fares by 5% across-the-board in 1995, explaining the decision as 'duty' (Mackey 1996).

In 1995, Asiana had a fleet of 39 aircraft and it served 42 destinations with a traffic base that placed it as one of the 50 largest airlines in the world. Nevertheless, Korean Air Lines regards its main competition to be the large international carriers from other countries as Asiana is too small to have a major impact. Asiana claims that the loss on domestic services in 1995 was US$20 million (Whitaker 1996), and both Korean and Asiana continue to cross-subsidise domestic services. Korean Air Lines is predicting this will become more difficult as a result of the over-capacity that has resulted from the Government's liberal approach to international aviation and the increased activity by large, foreign carriers. Price discounting appears to be inevitable and this is likely to occur at a time when the national economy enters an uncertain period (Mackey 1996). In this environment, government policy is likely to be under further pressure.

3.3 The Philippines

Philippine Airlines (PAL) started as a domestic carrier in 1941 and built up its international services throughout the 1950 by cross-subsidising the expansion from profits from its lucrative domestic market (Brimson 1985). Operating under private control until 1977, the Government of the Philippines took a 99.7% share. The airline re-equipped just as traffic was about to fall with the second oil price shock and suffered continuing setbacks in its operating environment. By the 1990's, the airline had accumulated losses of US$300 million and there was mounting criticism of the airline's international and domestic operations.

As an archipelago consisting of more than 7,000 islands, the Philippines is an ideal market for an airline and in 1994 PAL carried in excess of 4 million passengers a year with load factors of 80 percent or greater. Between 1985 and 1994, the market had grown at the average annual rate of 4.1 percent, but the forecast was that traffic would grow by 12 percent per annum to 2000 provided sufficient capacity were provided. The Government accepted there was a need for change and scope for competition. The first step was the privatisation of PAL in 1992, followed by deregulation of entry to the domestic market and adoption of a liberal approach to international aviation in 1994. However, the Civil Aeronautics Board retains control over domestic fares and requests for fare increases have to be approved by the Philippine Congress (Hewitt 1996).

Star Asia Airways was the first new entrant into the domestic market, but its strategy has been to operate to secondary airports and to grow at a modest rate. Other airlines to commence shortly afterwards were Grand International Airways, Cebu Pacific, Air Philippines and Silangan Airways, and two others, Asian Spirit and Corporate Air were about to enter in 1996. Grand Air was flying to Hong Kong and Seoul by mid-1996 and it has plans to fly to Taipei, Tokyo, Beijing, Vietnam, Brunei, Jakarta, Singapore, Kuala Lumpur, and Bangkok. Cebu and Air Philippines also have announced their international ambitions.

Wealthy entrepreneurs have financed the new carriers, but they have recruited former PAL executives and they have plans for strong growth backed by an aggressive approach to competition. Grand Air is particularly strong and has captured a significant share of some important domestic markets (Ballantyne 1996a). One reason for this is the airline is setting a high standard for domestic service with superior check-in facilities and hot meals in-flight. Air Philippines claims that it has load factors of 76 percent and that it has exceeded its growth projections in 1996 and it expects to have 16 aircraft by 1997, including three leased B737s, serving at least 12 domestic ports and regional international flights.

PAL's privatisation has not proceeded smoothly. The airline continued to incur losses after privatisation, particularly when faced with additional competition under the Government's new policies. Management inherited a large debt and an ageing fleet with high maintenance costs which, in part, arose because of a lack of uniformity in aircraft and engine choices. The Government had sold 67% of the stock in the airline to PR Holdings, Inc., a consortium that later came under the control of Lucio Tan in 1994. Reputed to be the wealthiest person in the Philippines, Tan has set about restructuring the ailing carrier. He brought in a team of financial advisers from his own business empire and sought advice from academics and international airlines including SAS, Thai International and British Airways. The airline is attempting to lift its on-time performance while reviewing its fleet and network. At the same time, the accounting and computing systems are being overhauled. Tan committed a substantial amount of his own capital but is seeking additional finance to overhaul the fleet.

In serving 38 cities and towns with a fleet of 22 aircraft, PAL dominates the domestic market, but the Government's competition policy has resulted in greater capacity, productivity and performance improvements by the incumbent, and expansion in the market. PAL's major complaint now is that it must fly unprofitable routes 'in the public interest'. When it deregulated entry in 1995, the Government specified that the new carriers should operate some of the less profitable routes with thin traffic densities, but the Civil Aeronautics Board has not policed this requirement. PAL complains that it is at a disadvantage because of this and has asked that it be given the freedom to withdraw from routes.

PAL has invested in night lighting facilities at some airports in an attempt to gain better utilisation of its fleet and the Government has permitted some increases in fares while allowing PAL to import fuel for its domestic operations, a saving estimated at US$20 million per annum (Ballantyne 1996a). The Government of the Philippines had opposed Tan's control of the former state carrier, but the matter seems to have been resolved in mid-1996 and the new competitive regime is about to enter a new phase.

4. Implications for Australia

The developments in Asia have several implications for Australia. First, the growth in traffic means there are opportunities for Australian airlines on routes to and from Australia, but also on routes within and beyond Asia. However, it is not clear on what terms access to these markets would be granted. During 1996, for example, Qantas's carriage of passengers originating in Hong Kong to Bangkok and Singapore became the subject of a bitter dispute. A second matter to consider is that Asian airline markets have attracted major North American and European carriers. Airlines from the USA have enjoyed a considerable degree of freedom to carry passengers from Japan to other parts of Asia, but generally the Asian nations have pursued a protectionist attitude. British Airways has negotiated an air services agreement with Singapore that allows it broad scope to form a regional hub. Hub-and-spoke airline systems have been one of the notable outcomes of competition. A problem for Australia is that it is an end-point and while the Australian traffic might have some role in determining where in Asia hubs might develop the outcome might be that services to and from Australia are relegated to a feeder role.

The attempts of these larger airlines to develop global networks through their alliances with other 'mega' airlines adds to the concern about what part they will play in Asia, principally because the smaller carriers, including Australian airlines, could be relegated to being minor players (Bureau of Transport and Communications Economics 1994). The protectionist approach taken by some of the key nations in Asia has discouraged alliances with their own carriers, but even Japan was unable to sustain its opposition under the pressures of competition from the European and North American airlines.

The USA has been using these alliances as a negotiating lever to forge 'open skies' agreements with other nations (Jennings 1996). Singapore and Taiwan have entered into such arrangements and Malaysia has signalled an interest in following suit. The choices open to any particular country might not be whether they will agree to alliances, but whether they can promote competition between major alliance groups. One strategy for smaller nations is to promote a single strong airline that maximises influence within the alliance they join (Oum & Taylor 1995), but this is at variance with all of the other pressures leading to multiple designation. The dynamism of the airline market in the Asia-Pacific region is placing pressure on the bilateral system from within as more and more new airlines seek a role in international markets. It is not so much a question of whether a more liberal regime will emerge in Asia as it is a question of timing and form, whether liberalism will appear within regional blocs or whether it will be a relatively open arrangement.

In April of 1997, a single aviation market will be created in the European Union and airlines from member economies will be able to operate anywhere within the bloc. Argentina, Bolivia, Brazil, Chile and Paraguay recently signed a regional agreement (Mercosur bloc) and this has been mooted as a step towards a pan-American 'civil aviation network governed by a single multilateral regional air transport agreement' (Pereira 1996). The single aviation market for Australia and New Zealand is another example of a regional bloc, and ICAO has identified 50 different groupings of states that are, or could become, involved in the regulation of aviation. Clearly the potential exists to form a similar arrangement in Asia particularly to cater for the new airlines.

In 1994, Indonesia, Malaysia and Thailand signed a joint Memorandum of Understanding under which regional flights would be encouraged within the 'Northern Growth Triangle'. Each of the signatories was free to designate two airlines that would be permitted to operate whatever capacity they wish between secondary airports on a scheduled or charter basis, carrying passengers and/or cargo. In situations where this arrangement was at variance with air services agreements, the latter were to take precedence. Since then, the Philippines and Brunei have joined and the bloc is known as BIMP-EAGA (Brunei, Indonesia, Malaysia, Philippines - East Asia Growth Area) and it covers a market with a potential of 250 million air travellers (Ballantyne 1996b). Discussions between Thailand, Myanmar, Vietnam, Cambodia, Laos and Yunnan Province of China have mooted another aviation bloc. Although Japan has a more protectionist approach to aviation policy, it attempted in 1995 to create an Asian aviation forum to achieve regional cooperation on aviation policies (Ballantyne 1995).

When the Mercosur bloc was formed, there was immediate interest in the development of new north-south routes. Within the group of member countries, a liberal approach appeared conducive to the establishment of new services, but an added attraction is that these would operate free of direct competition from the powerful carriers from the USA. There is a distinct possibility that the formation of blocs could result in greater competition within, but the barriers could rise for airlines from outside the region (Ballantyne 1996b). ICAO has addressed this matter, but there is insufficient experience with blocs to make any firm predictions. Protectionist blocs with large internal markets could use their power to the disadvantage of smaller parties. Spurred on by competition from within the bloc, efficient airlines drawing upon a large market could become dominant carriers on inter-bloc routes (Nuutinen 1992). Indeed, the Director General of the International Air Transport Association was reported to have urged African nations to pursue a strategy of liberalising competition within a bloc to promote efficiency and development, but to use the bloc as a countervailing force to deal with powerful external interests (Vandyk 1995). However, if blocs were to adopt an open approach to membership at the same time as promoting liberal competition within the group, they could become the driving force of multilateralism.

5. Concluding Comments

The lessons learned in Australia over the past decade have been that traffic growth, competition and the growing influence of the tourism sector have been powerful forces working against the status quo of regulation. However, once scope for competition is introduced it becomes a wedge for additional pressures to adopt a more liberal approach. Along the way, domestic deregulation, multiple designation in international markets, privatisation and code-share agreements as part of broader airline alliances become irresistible. Australia is not alone and it could be cast among the ‘pragmatic’ Asian countries, albeit having started the process of liberalisation earlier than most and having advanced further along the path. Seen in this light, the Australian experience offers some insights into the process of change occurring in Asia. Yet Asia holds a key to the future health of an Australian airline industry and to the continued competitiveness of the Australian tourism industry. For this reason, it is imperative that opportunities in forums such as APEC to ensure access to Asian markets on favourable terms. That Australia has been supporting moves in APEC to support a more liberal approach, subject to fair and equal opportunity is significant.

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