Deregulating air services to improve competition

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CAPABLE, INNOVATIVE, RIGOROUS

I. Introduction

Australia currently bans foreign aviation carriers from transporting domestic passengers or cargo, known as aviation 'cabotage'. Banning cabotage therefore reduces competition. Domestic carriers are able to charge higher prices on domestic routes they fly, while foreign carriers are not allowed to provide services even on routes domestic carriers don't.

II. How much do the regulatory bans on aviation cabotage cost?

Regulatory bans on aviation cabotage are a particularly bad form of protection since we don't really know the size of the net costs to the economy. With a tariff, economists can see how many imports are coming in at a certain rate and make assumptions about what might happen if the rate was raised or lowered. But a ban on cabotage is effectively setting an 'infinite tariff' wall which is difficult to see beyond.

Banning foreign airlines from domestic routes doesn't cost the economy much if they would make no difference to prices or service routes. But then again, it costs a lot if the ban suppresses lots of services or raises prices significantly. We just don't know.

III. But there are some reasons to think that the costs could be large…

In aviation (like any industry with large fixed costs) any empty seat or space in the cargo hold is ‘costly’. Getting the ‘load factor’ up (the percentage of seats filled with paying passengers) is important for profitability (and efficiency). That is why seats in competitive airline markets are often sold for different prices reflecting the demand of individual passengers. For similar reasons, back-haul rates are often much lower than directions with high demand for cargo.

If they were allowed, foreign airlines are therefore likely to sell those final seats and cargo spaces on planes cheaply (if demand was low), since the last few passengers and pieces of cargo just need to cover variable costs (such as fuel and labour). In Australia, this would mean foreign airlines potentially offering low cost flights on routes they were flying anyway – such as Perth to Christmas Island on their way to Singapore.

This would most likely benefit price conscious consumers able to bear uncertain availability, such as many leisure travellers.

Access to such domestic revenue should also open up or sustain stopovers that foreign airlines would otherwise fly over, since most of the fixed costs would be borne by travellers on the international leg. For example, struggling Asian airlines stopping over at Darwin would be able to increase their load capacity on their onward trips south – which is presumably one reason the Northern Territory Government supports aviation cabotage (Propelling the Territory forward as Australia's northern gateway, p15).

There are other reasons why cabotage should increase competition. Airline services are notoriously difficult for new entrants because of substantial fixed costs (such as ticketing facilities, marketing, landing slots and infrastructure). But foreign airlines have already borne such costs – indeed, their links into international networks could even be an advantage (particularly with the burgeoning Chinese market). Greater liberality of cabotage therefore intensifies the implicit threat of entry which would help discipline existing providers with the threat of entry.

Domestic carriers also have less incentive to 'segment the market' to keep ticket prices higher in case it undercuts their ability to sell higher priced tickets. In particular, some domestic carriers don't offer low cost carrier fares or services for fear of reducing revenue from business class passengers who may take up the cheaper flights. Again, foreign airlines would not be as concerned about cannibalising higher paying customers since many do not currently operate domestic services through subsidiaries. Foreign airlines are more likely to offer seats reflecting marginal cost, irrespective of the impact on prices on other flights.

IV. ...particularly for some industries and regions

The costs of banning cabotage may be worse for Australia than for other countries given our relatively large distances and remote communities close to potential low cost foreign providers from the Asia Pacific (such as SilkAir). Airlines are more likely to have monopolies over regional routes – particularly in cases where other forms of transportation do not exist or are inconvenient (such as poor road networks).

Further, air transport services are often used by businesses, so banning cabotage acts like a tax on business inputs, distorting production. Some businesses are likely to be hit harder than others. Unlike sea cabotage which helps traditional industries relying on slow transportation of bulk commodities, air cargo services the newer industries that tend to add higher value to weight needing faster transport, such as high end agricultural products (fresh seafood from Darwin to Sydney) and tourism (Chinese tourists wanting a stopover in Cairns). The vast bulk of Australian air cargo trade travels in the belly of passenger planes – and not much has changed since the Australian Chamber of Commerce and Industry called for 'decisive' air liberalisation last century (ACCI submission to Industry Commission).

Even though cabotage restrictions are applied uniformly, they are likely to have more significant impacts on remote or regional areas. While it may not be profitable for Australian carriers to fly certain routes, low cost foreign carriers may be able to provide some capacity. A recent parliamentary committee recommended removing cabotage restrictions for the Indian Ocean Territories to allow flights to go from Perth to the Cocos Islands or Christmas Island and onto Singapore of Kuala Lumpur (Joint Standing Committee on External Territories report, 26 March 2010). Banning foreign carriers everywhere is a blunt instrument for assisting domestic operators who care mainly about protecting their east coast custom.

V. What evidence is there?

Previous international experience with airline deregulation has seen significant reductions in cost to travellers and cargo transport, as well as increased innovation. Modelling in a 2008 WTO paper found restrictions on cabotage to be one of the key regulatory barriers inhibiting international passenger services.[1] Reduced restrictions on aviation cabotage between New Zealand and Australia has improved prices and services on that route (Productivity Commission, Strengthening Trans-Tasman economic relations). More significantly, the complete removal of restrictions amongst European Union members led to price falls of 30 per cent in discount fares in the 10 years to 2002 (p12, PC,).

[1] There aren't any reliable estimates. Obviously the impact is likely to be different for Australia; particularly if we lifted the ban unilaterally.

VI. Let competition regulate cabotage

There may be some reasons to regulate cabotage specifically, such as safety and security (Secretary of the Department of Infrastructure, letter 22 November 2009). However, restrictions on competition need to show that the social benefits are worth the costs and that the regulation is the least cost means of achieving the objective. The onus should also be on those wishing to prove the anti-competitive regulation is needed (Harper draft report, p33). Without such a process, we cannot be sure that the simple ban tis the most cost effective means of dealing with such concerns.

Deregulating aviation cabotage may even be easier than for coastal shipping. While no supranational body exists for ocean travel, safety, security, environmental standards for air travel are already set by the International Civil Aviation Organisation. Expectations and legal frameworks around labour conditions for foreign workers servicing short stay planes are also less contentious than for longer stay coastal ships.

Cabotage is just like any other imported good or service. If foreign products are cheaper or otherwise better, we are better off as a nation buying them. That foreign carriers may access cheaper labour and taxes can be a good thing for Australia if it means they will haul routes Australian carriers wont at competitive prices. Nearly every imported good or service comes from countries with different labour and tax laws. Even if foreign governments subsidies their airlines to haul Australian passengers or cargo, this makes Australian businesses and consumers better off.

VII. Reform options

Cabotage is one of the few services Australians are not allowed to access simply because it is provided by a foreigner. But removing it may overnight could be disruptive and is almost certainly not politically feasible. Instead, governments could consider reforms that remove much of the costs of current restrictions, including allowing cabotage –

- for all cargo; and/or
- for specific geographic areas (such as island territories or regional airports); and/or
- all airports not sufficiently serviced by domestic carriers.

Finally, there would be a significant community benefit from requiring a statement outlining the objectives of cabotage restrictions, the impact of such restrictions and why alternative policy responses are not as effective as a blanket restriction on foreign competion.