

COMPETITION AND PRICING UNDER THE NEW DOMESTIC
AIRLINE POLICY

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ABSTRACT: *Changes to Airline Regulation in 1981 are assessed. There are two main areas of changes considered; the changes to the competitive environment, and the changes to the methods of regulatory fares. The new policy is not likely to affect the actual degree of competition substantially, though competition in the industry depends on the government's discretion to a degree. New entry is made more difficult, though there is more scope for price competition between the major airlines. Fares are to be regulated by the Independent Air Fares Committee. The problems it is likely to encounter in determining the overall level, route-by-route structure, and discount structure are examined. Lack of information will make detailed regulation by the Committee difficult, and its choice of degree of involvement will be a difficult one.*

INTRODUCTION

In 1981, a new Two Airline Agreement came into force. Its main provisions were similar to those of the previous agreement, but there were some important differences. The ground rules for consultation between the airlines were changed, making jointly agreed actions, especially with respect to fares less likely. The restricted scope for competition between the airlines has been expanded. At the same time, however, the chance of additional competition from other airlines was further reduced. It was not eliminated entirely, however. Fare setting has been changed by the establishment of the Independent Air Fares Committee.

It is pertinent to ask how these changes might affect the operation of the industry. The fact that there is still important scope for government discretion was illustrated by the decision, taken under the terms of the old Agreement, to allow East-West Airlines to operate a "specialised" service between Sydney and Canberra.

In this paper, an assessment is made of the likely effects of the new Two Airlines Policy on the operations of the industry. In section 2, the question of whether additional competition from other airlines, on the main routes, is possible and likely, and of the ways in which the two major airlines can compete against each other, are examined. In section 3, the problems facing the Independent Air Fares Committee in its role as regulation of fares are examined, and some suggestions about the Committee's likely impact are made.

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Competition Under the New Policy

The Framework for Competition

The new Two Airline Agreement was clearly intended to preserve the status quo, notwithstanding many statements about it. In some directions, it seeks to limit competition below the level which might have eventuated under the old Agreements, and in some directions it seeks to expand the scope for some forms of competition.

The position of the two major airlines is confirmed, and defined more tightly. With the intensive definition of trunk routes, and the prohibition of entry of scheduled airlines on to them, the scope for competition from additional airlines, at the core of the route system, or even on its fringes, is substantially restricted. While this competition hardly existed before, the new framework makes it even less likely.

Between the two airlines, there has not been much competition, but the scope for it has been extended. This is mainly true in the pricing area. The airlines will still charge the same core fares, yet can operate different discount structures, or put different emphasis on particular discount fares (and discount fares are going to become an increasingly important part of the whole fare structure). The ending of the Rationalisation Committee will not mean that consultation and agreement between the airlines, with the effect of reducing competition, is abolished, but it will mean that there are different rules of the game. An airline may find it more difficult to hold back when the other seeks to introduce an innovation.

The more important aspect of competition is whether new competitors can enter and compete, rather than what the rules under which a small, defined number of competitors can operate are. On balance, in practice, it is possible that there will be a slight net increase in competition even though the new Agreement is more restrictive, this is because it tightens the restrictions where competition was virtually excluded before anyway. The new Agreement makes it less possible than before for a government which wishes to increase competition to take decisions which have this effect.

There are loopholes, however, and those could be important. Much will depend on the attitude of the government towards potential competition, and the legal interpretation of the legislation. Governments until now have been single-minded about the Two Airline Policy, and have kept very much to the spirit as well as the law. In the past, the courts have done good business in interpreting airline legislation, and the current market structure is partly a result of their attitudes. Given that the government has been consistent in its pursuit of airline policy, the operation of the law has not been challenged as often as it might have. Potential competitors have realised that even if they win on one point,

the government has sufficient discretion to turn this into a pyrrhic victory; there are sufficient points at which it can block entry.

Hence, if the government continues its strong stand against new competition, the main effect of the new legislation is likely to be some greater freedom for the two major airlines. However, there is the possibility that the government might change its attitude towards new competition, and at one extreme, it might decide to positively encourage it, to the extent possible within the new Agreement. The critical question then is one of how much lee-way the government has to allow extra competition.

The most important loophole which the government has is Section 6(1) (d) of the Schedule to the Airlines Agreement Act. This allows other operators to provide "specialised scheduled passenger air services". This clause was not in the original proposals for the new Agreement, and it follows on from a similar clause added in the 1972 amendments to the earlier Two Airline Agreement. It is more restrictive than the earlier clause in that a new operator will be permitted only when the two airlines have been offered the chance of providing the service, and, given time, have not provided it to the satisfaction of the Minister.

The ironic aspect of this is that the 1972 clause was used after the new Agreement had been passed, and it was used in a manner which has ceased to be possible since the new Agreement has come into force. It seems odd to change policy and use an old provision after having committed oneself to altering that provision. As yet, the operator permitted to introduce the service East-West, has not done so, because both the major airlines replied with new services or fares of their own. This is of itself, not so important, as it is the possibility of new entry which is important, and a principle was established. Whether this clause provides wide scope for additional competition or not will be examined later within the confines of the current Two Airline Policy, and its interpretation by the courts, there is scope for some discretion by the government as to how much competition it allows.

Government Policy Towards Competition

If the government decides to oppose new competition, no new policy initiatives are required. If it chooses to encourage competition, it will need to do more than state that new competition will be permitted, within the rules of the Agreement. Much will depend upon how the government defines the conditions under which new operators may be permitted to offer services. At present, there would be considerable uncertainty as to what would happen if the government were to announce that new competition would be allowed, as there are many entry barriers and this uncertainty makes competition less likely. It would be necessary for the government to define a policy in a number of areas, and

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set out clear procedures which it was going to follow.

For example, the questions of import permits for aircraft would need to be resolved. The government would need to guarantee that any potential operator could import aircraft of its choice, subject to the provisions that it is used in conformity with the Agreement. Potential competitors who do not know whether they will have any equipment, or equipment of the appropriate type, are not very effective.

Equally important is the matter of deciding criteria for entry. The major airlines must be offered a chance to operate each "specialised" service, but to what extent does this hold up entry? There would be a need to set a time limit for their decision, and minimum period for operating the service, to determine it was satisfactory in the opinion of the Minister. Clearly the situation of the airlines precluding entry by promising services, but not delivering them would not achieve the desired results. As far as results are concerned, it does not matter if the major airlines or new entrants operate the "specialised" services as long as potential entrants have some chance, and are able to develop a credible threat.

The terms under which a new entrant would have access to a market also need to be defined. If given the option of offering a specialised service, they might or might not be given sole rights to it for a period. While creating such monopolies would be undesirable in a freely competitive environment in a restricted situation such as is likely to obtain, there may be a case for it. This case would rest on (a) the possibility of predatory competition by the major airlines to force the entrant out and (b) given the already substantial barriers to new entrants which cannot be removed, such a condition may redress the balance somewhat. There is also the matter of whether the new entrant would be required to supply the service for a prescribed period.

The definition of "specialised scheduled passenger air services" is quite critical. The term would appear to include charter services, which are non-scheduled services. The Canberra decision indicates that "specialised" can be interpreted quite broadly, it appears that a low price "no frills" service fits the category, even though the difference from a normal service may be quite small. Presumably, holiday flights linked to inclusive tours would fit into this category. As these are the types of services which are least catered for, and are likely to have the greatest competitive impact, the scope for appropriate entrants appears quite broad.

The position of charter operations is not specifically referred to in the Agreement. There are regulations governing them within the Air Navigation Regulations. Charter operations are a traditional method of circumventing regulations which restrict entry into scheduled services. Charter airlines are much the same as scheduled airlines in terms of their

cost structures, except they tend to offer lower service standards and operate at higher load factors (with less booking convenience). As was effectively pointed out during the ICAP Review, a scheduled airline can offer charter type service standards at similar prices. The only distinct advantage a charter operator has over a scheduled operator is some greater flexibility in offering services. In the Australian context, this would be small, as the major airlines operate with flexible scheduling, and add or cancel flights as demand varies. Operators of "specialised" services should have the flexibility they need, if they are permitted the same latitude as the major airlines. Charter operators are not important, per se, but they may be a device for permitting extra competition; experience has shown that they are quite effective in affecting the competitive position on a route (Cooper and Maynard, 1972). For this reason, a government which is interested in increasing the competition in the airline system needs a charter policy.

Any potential entrant, intending to provide specialised or charter services, is at a considerable disadvantage as compared to the major airlines. Even if the government were to adopt a pro competitive policy, and set forth clearly the conditions under which new entry would be permitted, there would be the possibility that the entry could be forestalled by a costly legal battle. It is unlikely that the law as it stands, and any further regulations introduced, would be subject to a simple interpretation. One major airline fought hard through the courts to stop entry of a freight carrier, and the potential entrant, though winning the legal battle, was the loser in the long run.

It is difficult to escape the conclusion that whatever the legal framework, the competitive environment is heavily influenced by the government's attitude, and the way it chooses to interpret and enforce its Policy. Had it chosen, over the past twenty years, the government could have interpreted the Policy more liberally. While the resulting competition may have been, in a sense, at the fringe, it could have influenced the conditions under which all services were provided. The two airlines might have found themselves with a monopoly of a relatively unimportant proportion of traffic. (An international airline flying to Australia with a monopoly of non-discount traffic would possess a weak monopoly indeed). The scope for additional competition has been reduced under the new Agreement, but some is still possible. To continue the same dominance by the two airlines of domestic air transport, it would be necessary for the government to use its discretion to pursue the same policies towards potential competition as it has in the past.

The Strength of Potential Competition

If a government were to decide in favour of greater competition, within the confines of the Iwo Airline Policy, there is considerable doubt as to how it might work. Suppose that there are no legal difficulties in allowing operators to offer specialised services. There are doubts as to whether

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they would be able to actually enter, and as to whether sufficient firms would be willing to attempt to enter to make any appreciable difference.

If a potential entrant offers a "specialised" service, the major airlines can stop it from doing so if they are able to offer the same service to the satisfaction of the Minister. Assuming that a service is economic, it is most likely in their interest to do so. Even if their hand has been forced on pricing, it is probably in their interest to hold on to the service rather than lose out to the new airline. If this happens, there is little incentive for a new airline to even suggest services, as to do so will involve it in preparation costs, for which it can expect no return, as it has little or no chance of being allowed in. To have an impact the potential entrant does not actually need to enter; if it forces the hand of the major airlines, it will have had the desired effect. The difficulty is that for the threat of entry to be credible, and to have an effect, it is necessary that it become actual entry sometimes.

There are at least some circumstances under which the major airlines would not be able to block all proposals for entry. One is where potential entrants are able to offer a given service at lower cost; the major airlines would not be able to respond unless they cross subsidised the service. Cross subsidisation has been made more difficult since the Holcroft recommendations were implemented, but it is certainly still possible, especially where only a few routes are concerned. The other circumstance is where there is a plethora of service proposals across the network, probably by many different airlines. The major airlines might feel that they did not possess the equipment or resources to offer all the proposed services, and they might leave the less attractive ones to new entrants. This circumstance presupposes a strong fringe of airlines with access to appropriate equipment.

New airlines might be able to offer services at lower cost if they were more efficient, had equipment more suited for a particular task, or paid less for their inputs. In the U.S., many new airlines are able to compete effectively because they do not need to pay the normal union rates for labour (Forsyth, 1981 a). For example, pilots are happy to offer their services at well below union rates. It is problematical whether this would be possible in Australia. New entrants would have to pay at least as much as the major airlines for non labour inputs. Except for very small routes, they are unlikely to have any equipment advantages - the major airlines, and especially Ansett, possess most of the appropriate equipment for all but minor routes. It is possible that they would be more efficient; thus could be the case of a new airline starting up, with access to appropriate technology, and no need to employ excess labour, or for an existing airline operating different types of services. As it stands, there are no existing potential competitors which are more efficient at operating services of the type which the major airlines specialise in.

Until recent years, there were few innovations in the fare structure of Australian airlines. The First-Economy pattern, with discounts for children and other selected groups, was maintained, and there was little innovation. Over the past few years, the airlines have put forward and implemented more types of fares, including standby and selected off-peak fares. The old arrangements did not prevent new fares from being offered, but they made it difficult for an individual airline to implement its own ideas, and they gave little incentive to innovate. The use of the Rationalisation Committee made unilateral moves to change fares unlikely to succeed, and competition, by its nature, is a matter of unilateral behaviour. The new Agreement ends the Rationalisation Committee, and makes it easier for an airline to get a discount fare accepted. The airlines are required to consult each other over the settling of core fares, and may be required by the Air Fares Committee to consult each other over discount fares. Depending upon the attitude taken by the Air Fares Committee, there is a fair degree of latitude for the airlines to compete on price structures. Price competition can only take place with respect to the "discount" fare. This is a major limitation as it excludes competition in fares which most of the traffic use. Discount fares are, however, used by a significant, and growing proportion of the traffic.

The scope for price competition is also constrained, substantially, by the retention of the capacity controls. On the competitive routes, the two airlines are required to offer the same capacity. This means that if one airline is more efficient than the other, it will not be able to expand its business by offering more generous discounts and carrying more traffic; it will not be allowed to schedule more capacity to enable this. At best it will only be able to carry more passengers by increasing load factors, and this makes it a less convenient airline. Price competition is thus of positive, but limited, value when neither airline can gain appreciably or in the long run through being more competitive. It may mean that a price structure which suits passengers better may come into being, but it gives no encouragement for increases in efficiency, and the lowering of fares overall.

The increased price flexibility will be crucial, however, to the balance between the two airlines, granted that they have been moving in different directions with respect to equipment choice. TAA will have larger aircraft to fill, and it may have some cost advantages, depending how the newer Boeing 767 compares with the larger Airbus. Ansett will have a frequency advantage (which it is already seeking to enplant) and TAA will have to counteract this with the only other attribute which is free to vary - price. It cannot charge different core fares, and it will need to use different (lower) discount fares, or to use the same discount structure more extensively than Ansett (for example, by allocating more seats to APEX passengers). If the Airbus possesses no per-seat cost advantages over the Boeing 767, this will be possible only if TAA operates at systematically higher (not necessarily much higher) load factors. It will need to use more intensively the types of discount fare which enable high load factors to be achieved. This in turn has

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implications for the way Capacity Determinations are made and enforced. The two airlines will differ more in the markets they serve, IAA becoming more oriented to the lower fare, leisure traffic. If per seat costs are similar for the two airlines, Ansett can match TAA's discounts at the same load factor, and it will capture a greater proportion of the higher fare traffic because of the frequency advantage. It will then be more profitable. If the costs on the Airbus are lower, Ansett can be expected to continue orienting itself towards the high fare traffic which values frequency, and the specialisation of the airlines into different markets will be a stable one. Given its equipment choice, TAA will need lower per seat costs and flexibility with discount fares to be as profitable as Ansett. If it does not possess these, it will still survive, as the Air Fares Committee is required to set core fares which preserve the viability of the less efficient airline, and the capacity restrictions remove the incentive for the more efficient airline to cut fares and capture more traffic. If this is the situation, Ansett will take out its advantages in the form of higher profits.

The discussion above presupposes that the Air Fares Committee allows the airlines a fairly free hand in the setting of discount fares, and that it sets core fares at viable levels. The greater degree of competition in pricing which may be allowed between airlines will result in some net benefits to the community. These will not be substantial, because the more efficient airline will not be permitted to gain traffic significantly at the expense of the less efficient. Overall fare levels for a given type of service will not be forced down by competition between the airlines. The greater flexibility afforded to the airlines will, however, be very important to them, and especially TAA. Once they have decided to move in different directions with aircraft, and given that so many other variables are fixed by the Policy they will need some fare flexibility so that each can appeal to the markets which it is best equipped to serve.

Air Fares and Their Regulation

The Role of the Committee

In this Section, we are concerned not so much about the formal structure and procedures of the Independent Air Fares Committee, but rather with the control of the decisions it must make. The Committee's task is not at all straightforward. It must decide on the degree of intervention in setting fares; it may allow the airlines a fairly free hand, or it may regulate them closely. If it does the latter, it may find that there are problems of consistency with other regulatory controls, such as Capacity Determinations, which operate subject to the Two Airline Policy.

There are several objectives which the Committee might seek to achieve. It might try to ensure that fares are as low as possible. It could attempt even out fluctuations in the industry's profitability. This has been a major objective of fare regulation to date. Finally, it could seek to maximise economic efficiency. These objectives are not consistent with each other (except in special circumstances), and the Committee will need to make a choice between them (though it may not be explicit about what choice it has made). It could use its controls to further other objectives, such as the maximisation of profit, or of rents to factors employed in the industry. If it did, it would become a device which merely legitimises collusion. We shall suppose here that it adopts one of the first three objectives.

The Act governing the Committee is sufficiently vague as to enable it to pursue any of those objectives (and possibly others). The Committee when determining fares, is required to take into account a number of factors, including a need for fares being charged on a "consistent" basis (whatever that might mean), and the effect of fares charges on cost and revenue. It is also required to ensure that air services are operated on "an efficient and economic basis" though what this implies is not stated. There are constraints on the Committee, which come from both the Act governing it, and the Two Airline Agreement. The latter states that capacity provided by the Two Airlines on competitive routes is to be equal. According to the former fares are to be set "as closely as practicable to the cost of providing the services" (Section 14 (b)) but at the same time, at a level sufficient to ensure that both airlines are "economically viable" (Section 15(11) (e)). If the cost structures of the two airlines differ, as they could well do with different equipment, it will not be possible to satisfy all these requirements simultaneously. It is not possible to achieve both efficiency, and economic viability of two airlines if they differ in levels of cost and efficiency.

It is easy to suggest ways in which objectives might conflict, low air fares might be desirable, but if they are purchased at the expense of high load factors and considerable inconvenience to passengers, they may not be worthwhile, and economic efficiency suffers. If fares are set at some average cost level, and demand varies from year to year, fares will tend to be high in the slack years, and low in the good years. This will even out the airlines profit performances, but it will reduce efficiency - it would be preferable to have lower prices in the slack years, to use up the capacity which is available, rather than discourage passengers from using it.

The Committee could decide to use its powers to maximise the economic efficiency with which the industry operates, or at least pay serious attention to efficiency. It is a fairly complex matter to outline the theoretical

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structure of an efficient pricing system, but it is a considerably more complex matter to implement it. To do so would require data that only the airlines would have, and even they will not have sufficient data for a precise solution. The airlines, in the absence of competition from outside, have no incentive to implement the most efficient solution - it is in their interest to make use of the monopoly power which they jointly possess. The question of how much intervention is needed to serve the best overall result is not an easy one to solve. It may be solved by the Committee seeking to control the overall level of fares, and allowing the airlines freedom to choose the structure of fares which they feel is appropriate. While this has some merit, the question of level and structure are not independent, as some of the problems discussed later will indicate.

In the following sub-sections, we shall examine some of the problems the Committee will face in setting overall fare levels, in setting the route-by-route fares, and in setting the discount fare structure. Finally some specific aspects of fare setting will be considered.

Determining the Overall Fare Level

Possibly the most important fare setting function of the Department of Transport was the determination of overall fare levels, and this function will carry over to the Committee. The usual manner in which charges were effected consisted of the airlines, when they experienced cost increases, applying to the Department for across-the-board fare increases, and once this had been done, the Department would allow a level of fare increase which it considered to be justified. This was an unscientific procedure, and the result could have been either a squeeze on profit, or a temporary period of high profits. Over time, however, profits were quite even, and if stability of profits is the only criteria, it might be suggested that the Department got its calculations right.

The question of how the Committee determines, objectively, what fare increase to allow is an important one, but it is not easy to answer. The obvious answer might be to construct an index of airline costs, based on the various cost components such as labour, fuel, aircraft and so forth. It is a simple matter to produce an index, but there is no presumption, if the objective is economic efficiency (or anything else for that matter), that fares should increase in line with this index.

Airlines have one of the highest rates of technological growth of all industries. U.S. studies (Kendrick, 1968 and Caves, et al 1979) indicate that overall factor productivity growth has been of the order of 3-4% per annum, though there is some evidence that it has been slackening of late. This implies that it is possible to increase prices by 3-4% less

than input prices and still preserve profitability. If input prices grow at the same rate as prices in general, real air fares should be able to fall by about 3-4% per annum. We should expect much the same rates of technical progress in Australia as in the U.S.

This need not happen, and it is possible that in Australia, real air fares did not fall as rapidly as they might have. The benefits of technical change may have been gained partly by the labour force, in the form of wage rises which were greater than elsewhere. In this case, the technical change is still of value, but its benefits are not going to the consumer. Another possibility is that fares have been increased in line with input costs, and the technical change benefits have been lost in such things as slacker working arrangements, and some costs being allowed to be higher than they might be.

The problem is that there is no independent standard of what costs ought be. The Committee might calculate technical change in the Australian airline industry, say between 1960 and 1980, but this may be an underestimate of the change that has taken place, for the reasons noted above (for example, some of the change may have been included in wage increases). Even if it were an accurate measure, there would be no presumption that this rate of improvement will be continued - and there is a general belief that it may slacken off. Further, there is the question of supposing that technical change could be measured and accurately predicted for the short term, whether all the technical change should be passed on in the form of lower prices. It could be maintained by some that employees should share in these gains.

To make matters worse, technical change can influence the desirable structure, as well as level, of air fares. Some technical innovations, in the booking area have made particular types of discount fare possible. Others, such as the introduction of new aircraft, may mean that the desirable mix of fares will change. New aircraft which are large but cheap, per passenger, to operate, may make frequency costly to offer, but lower fares cheaper. The balance between normal and discount fares may have to change.

One of the Committee's major tasks will be to determine the overall levels of fares increases. It is difficult to obtain an objective standard for determining how high these should be, and analysis of airlines' accounts will not provide the necessary information. By being too optimistic about technical change, the regulator may unnecessarily squeeze airline profits, and by being pessimistic, the regulation may cause fares to rise faster than they need. If this happens, higher profits, or higher wages, or higher costs may be the outcome. If the latter two are the case, it will seem, after the event, that the fare increases were justified, even though they may have resulted in the technical change benefits being wasted in unnecessarily high costs.

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Fare Structures Across Routes

During the 1970's, Australia adopted a system of flag-fall plus distance component for the determination of fares for rates of different lengths. As a simple system, this has a lot to commend it. There has been disagreement about the relative sizes of the two components. The Holcroft Committee considered that the flag-fall was too low, (Independent Public Inquiry, 1981 Cl. 17), and that short haul flights should be relatively more expensive. Its recommendations were more or less adopted, though many now consider the flag-fall to be too high, especially for short distance routes such as Sydney-Canberra.

The problems so far encountered indicate the difficulties in determining what costs are for a different distance; it is difficult enough to determine the direct operating costs, but handling the indirect costs is more difficult.

Reliance on a fare formula of this type would not result in fares being set at cost no matter how accurately the formula was estimated. There are determinants of cost other than distance. In particular, density is important (Forsyth, 1981 (b)). Dense routes may be served by large aircraft which, per seat, are cheaper to operate. Apart from this, there are probably economies on the ground operations side, though these are quite difficult to measure. With the arrival of wide bodies, the variation in costs of serving different routes of the same length will increase. With a constant formula, the dense routes will tend to cross subsidize the less dense routes. The extremes of this are avoided in Australia by having a different formula for the regional (F27) operations.

The pattern of flight scheduling in Australia is such that many flights on the less busy parts of the network take place between the morning and afternoon peaks. They can be regarded as off-peak flights, which use equipment and labour at a time when it might not otherwise be being used to its full capacity. The opportunity cost of these factors is low, so that the opportunity cost of operating these services is low. The extent of the difference between opportunity costs in peak and off-peak is difficult to estimate for any airline system, but it could be significant. The current policy of ensuring that all routes of the same length have the same fare may mean that these routes are priced greater than at cost. If there were systemwide off-peak reductions, this problem would vanish - but there are not.

There has been little analysis in Australia of how costs vary between routes. The Holcroft Committee started to examine the question, but only analysed route length as a factor in any detail. If the objective is to minimise cross subsidisation, and to set fares at cost, more information than is currently available is required. In the U.S., Deregulation has forced the airlines to estimate the costs of flying individual routes accurately. In Europe, where regulation prevails, there have been studies of how costs vary

between routes (ECAC 1979). While not definitive, these have identified the main determinants of cost and how they are likely to vary. These studies have relied on more evidence from airlines than the Air Fares Committee is likely to obtain from the Australian Airlines.

Until recently, the fare formula was arbitrarily set. There has been some examination of the way costs vary with distance, although there is still room for debate on how costs vary exactly. The levels of flag-fall and distance may not have been set correctly, and thus structure of formula may not be an accurate one if costs are more tapered with distance (as U.S. evidence suggests may be the case). The question of how costs of routes of similar distances can vary is one which has not been addressed in Australia, and could be just as, or more important, as that of how costs vary with distance

The Regulation of the Air Fare Structure

The structure of air fares - the pattern of normal and discount fares - is an issue which has developed mainly since 1970, and for most airlines, it is a critical one. As Australian international indicates, the proportion of travellers on non-discount fares can become quite small, and the situation on the domestic airlines is moving in this direction. The type of structure which is desirable would be one which is economically efficient, and which the airlines can operate profitably.

The Committee is very constrained in terms of what it can approve. If conditions are met, it is required to approve the suggested fare; if they are not, it is required to not approve it. It is arguable that the Committee would have been required to reject several of the new fares which have come into being in recent years, such as the standby and APEX fares. It is required to be satisfied that the discount fare improve the profitability of the operator (Section 17(4) (a)). This is a particularly stringent condition, and it is equivalent to stating that some fares must be set above cost. Fares such as standby probably have not improved the profitability of the airlines, but they have not worsened it either. This is especially true if airlines are being competitive between one another, and keeping fares as low as possible.

In addition, the Committee is required to ensure that a discount fare is "unlikely" to result in economy air fares being increased (Section 17 (4) (b)). This is an unwarranted restriction, which presumes that economy fares are at an efficiently high level. It may well be that an efficient fare structure would involve higher - or lower - economy air fares. It is at least arguable that the costs of providing the convenience and services associated with economy class travel are greater than the fares being charged - this was believed to be the case for international travel. The efficient level

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for core fares can be determined only as the discount structure evolves, and airlines observe the response of passengers to it. A structure which reduces all discount fares by 20% and raises economy fares by 1% could, strictly speaking, not be approved by the Committee. It is interesting to speculate on how a proposal for peak - off-peak differentials might fare under the requirement. While they can be introduced by giving "off-peak discounts", this invariably involves peak fares rising somewhat, as the lower off-peak fares will often not generate enough traffic to cover the costs of providing them. This is important because several airlines in Europe and the U.S. are moving to price structures with peak/off-peak differentials on normal economy services.

It is possible that the Committee will not take too much notice of the former of these requirements, and strictly insist that profitability be improved - something which is very difficult to test whatever it does, its method of proceeding is important. It may decide to adopt a case by case approach to fare proposals, and attempt to estimate the effects of each of them. Alternatively, it may choose to adopt broad guidelines as to the appropriate forms of fares to approve.

Some types of discount fares tend to enhance economic efficiency, at no loss to profitability, whereas others do not. A standby fare which effectively uses up capacity which would otherwise go to waste would be on of the former. An APEX fare which was offered in the same numbers, on all flights, regardless of demand would be an example of the latter. Fares which offer unlimited travel for a fixed amount must be regarded with suspicion, particularly if they are relatively unrestricted. Properly designed peak/off-peak differentials tend to enhance efficiency. Further, quite a lot depends upon the way airlines operate their fares. It is possible to use APEX fares to fill up otherwise empty seats, or it is possible to use them indiscriminately such that they neither result in lower costs nor better use of capacity.

The Committee will not be able to make an accurate judgement on whether a specific proposed fare will be well judged or not. This is partly because much will depend on how the airline operates it. However, also, it is unlikely that the Committee will have sufficient information to assess its effects. The Committee would need to have access to much information which the airlines regard as commercial property, and it would need to analyse it in considerable depth. The airlines themselves do not possess as much information as is strictly required, and the introduction of a new fare is, to a degree, a gamble based upon guesses.

For these reasons, it would be preferable that the Committee set out the criteria of what it regards as a desirable structure of air fares, and accept the airlines proposals if they conform to this structure. It is possible that most proposals will be consistent with an efficient fares structure, though new fares may have unnecessary restrictions. For

example, round trip and minimum stay restrictions on APEX fares cannot be justified on economic ground - they are ad hoc methods of separating markets. Airlines will make some mistakes in their estimates, and it is desirable that they be able to correct these readily. If the Committee wishes to foster an efficient fare structure, it is important that it develops its criteria as soon as possible.

Innovation and Predictions

The Committee can take a positive role in various directions. If it has devised what it believes is an efficient set of criteria for a fares structure, it will be in a position to make suggestions to the airlines. It may note that particular types of fares which are worthwhile are not being offered in Australia, though they could be. It can evaluate overseas experience in introduction of new fare types. Some of these are desirable, though many need not be. It can examine the airlines existing structures and may suggest that some restrictions are undesirable and unnecessary.

If the airlines were operating in an open, competitive environment, it would not need to do this. They are not, however, and they do not always have the incentive to take a risk which they will not gain from, but which some passengers may gain substantially from. Several of the innovations which were introduced in the 1970's were done so as a result of pressure from outside. Under the new Two Airlines Agreement, this will probably continue to be the case.

The Committee may also have to make decisions where predatory competition is a possibility. This will happen if the airlines attempt to force a new competition off a market which it has been permitted to enter. Regulation of predatory competition is a difficult matter, as it may not be clear that it is taking place, and the methods of controlling it need not be very satisfactory. The Committee probably does have the power to improve some controls over it, as to lower fares substantially in a given market will probably necessitate raising fares in other markets. Again, it is probably desirable that the Committee formulate an approach towards handling the problem. If it does so effectively, it may lessen the chances of the problem arising.

Can Air Fares be Regulated?

The task confronting the Air Fares Committee is a difficult one. The market it regulates fares in is one with a substantial degree of monopoly power, and fares, if completely uncontrolled, might be raised substantially above costs. However, the information required for effective regulation is very substantial, and there is no likelihood that the Committee will possess it. The task can be broken up into various aspects, but these are not independent.

COMPETITION AND PRICING UNDER THE NEW DOMESTIC AIRLINE POLICY

The regulation of the overall level of air fares may seem a straightforward task, but in the absence of objective standards on costs, it is not. The question of structure and level are not independent, which makes determination of the latter more difficult. As the structure changes, the appropriate level for core fares may change. While one set of fares may be set at a level to prevent the use of monopoly power, it may be exercised through another. Detailed regulation of the fare structure is inconsistent with efficiency; the regulation does not have access to sufficient information to enable correct decisions.

The experience of fare regulation of international airlines, operating to and from Australia, is instructive. The ICAP Review suggested a structure of air fares, and a set of levels. The structure appears to have worked moderately well, but regulation of the fare levels gave rise to serious problems. Eventually it was abandoned; it was not possible to take account of the changing circumstances in the regulatory process. In this case, the market was moderately competitive, and the scope for airlines to set prices at inefficiently higher levels was limited. In the domestic case, there is much less competition. This means that market conditions will change less rapidly, but the task of determining and regulating all fare levels is still an enormous one. The lack of competition makes the Committee's task of determining its level of involvement a particularly difficult one.

Conclusions

The ways in which the new Two Airline Agreement is likely to affect competition and pricing have been examined in this paper. The Agreement will probably have little effect on competition, which has been, and continues to be, severely restricted. Under the previous Agreement, the level of competition was determined not only by the terms of the Agreement, but also by the way the government chose to regulate matters which were strictly outside the agreement. The government could have allowed more competition than it did, whilst still holding to the terms of the Agreement. The governments scope for exercising its discretion is still present, but it has been reduced under the new Agreement.

There is a possibility of greater competition, if the government were to permit it, through other airlines operating "specialised" services. Then ability to do so is restricted by the major airlines option to offer a service instead. This need not make entry impossible, but it makes entry unattractive for the potential entrant. In addition, the ability of existing airlines to compete with the two major ones is not very great. Over time, a pro competition policy by the government could result in some competitive pressure on the airlines, but it is not likely to be strong or immediate. The position with respect to charter operations particularly clear, as they are not specifically regulated by the Agreement.

FORSYTH

Competition between the airlines is not as important as the scope for new competition. The ability of the airlines to compete between themselves has been increased, but it is still limited by other aspects of the Agreement, such as capacity controls. The greater flexibility in pricing, subject to the Independent Air Fares Committee, is likely to prove important. It may be a necessary method of preserving the balance between the airlines, given their different choices of aircraft. It will help to improve the fare structure; though probably not by very much.

The Independent Air Fares Committee has a difficult role if it seeks to moderate the monopoly power granted to the Airlines by the Agreement. It will lack objective standards for costs, and it will possess insufficient information for any detailed regulation. Granting the airlines more flexibility in pricing will result in better informed, and more up to date decisions, and thus will encourage efficiency, but it allows the possibility of the monopoly power being used. Detailed regulation of the price structure is likely to prove ineffective and inefficient, and the use of broad criteria would be preferable. It is desirable that the Committee address the question of what are the criteria for an efficient price structure soon. It should also be recognised that, with respect to discount fares, the Committee is very restricted by its Act in terms of what it can approve. As against all this, it does possess some scope for its own initiative, and it could use this productively, and it may be able influence the terms under which competition takes place. It may thus have some influence on the level and structure of air fares, and on the efficiency of the industry, though this influence is unlikely to be a major one.

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