

Office of the Commissioner  
Received 25 108/2006



**Air Niugini**

25<sup>th</sup> August 2006

Mr Stanley Alphonse  
Special Projects Manager  
The Independent Consumer & Competition Commission  
P.O. Box 6398  
Boroko...NCD.

Dear Mr Alphonse

**Air Niugini Submission – 2<sup>nd</sup> Report**

As per my earlier letter regarding the above, please find attached the correct updated further submission.

Yours sincerely

**WASANTHA KUMARASIRI**  
Chief Executive Officer

**INDEPENDENT CONSUMER & COMPETITION COMMISSION**  
**AIR NIUGINI LTD'S SUBMISSION IN RELATION**  
**TO**  
**DRAFT REPORT OF THE PNG AIR TRANSPORT INDUSTRY**

Air Niugini Ltd (ANG) has received the Draft Report of the ICCC in relation to the PNG Air Transport Industry. Air Niugini will respond to the draft report with particular reference to:

1. The national development context within which the airline operates.
2. The principles of competition policy both national and international and how they apply to the aviation industry in PNG in general and ANG in particular.
3. The international and national regulatory regimes that currently operate and have an impact on ANG.
4. The operational and financial issues associated with the PNG aviation industry that influence or impact upon the industry and ANG in particular.
5. Factual matters that arise within the ICCC Draft Report.
6. Recommendations.

# **DRAFT**

## **RESPONSE BY AIR NIUGINI LTD**

**To**

### **DRAFT REPORT OF**

#### **INDEPENDENT CONSUMER & COMPETITION COMMISSION**

##### **REVIEW OF THE PNG THE DRAFT REPORT OF THE PNG AIR TRANSPORT INDUSTRY**

**18<sup>TH</sup> JULY 2006**

Air Niugini Ltd is a company incorporated under the Companies Act of PNG and is a wholly owned government business enterprise. All the shares are held by the IPBC on behalf of the Government of Papua New Guinea.

Originally, following independence the airline was established as the National Airline Commission. It took over the operations of Australian based airlines that operated in the country at the time.

The Airline is a critical part of the services infrastructure of Papua New Guinea and along with its competitors operates to cities and towns including those that cannot be quickly or easily reached by road or sea.

The financial performance of the Airline since its establishment has been volatile and on several occasions it has had to rely on the support of the Government of PNG to remain solvent and operational. The most recent experience was four years ago when the airline was on the brink of insolvency and a Government guarantee was required to support the Company's borrowing from the Bank of South Pacific Ltd. That guarantee has been expunged and the companies foreign and national debt repaid.

In the context of the international aviation business the Airline's experiences are not unusual. Over the last decade at least three major U.S. airlines were in Chapter 11 bankruptcy; three major European, government owned airlines, Olympic (Greece), Alitalia (Italy) and Sabena (Belgium) were either insolvent or relied almost entirely on government funding and other protective measures to remain operational. In Australia the second largest airline, Ansett Airlines Ltd went into liquidation and a new start up airline Compass Airlines Ltd also collapsed. In New Zealand, in the aftermath of the Ansett Airlines collapse, the New Zealand Government had to inject

\$NZ 800 million to keep Air New Zealand flying. Its profitability has subsequently been re-established. (I do not believe this para is required if preceding is modified)

The purpose of this preamble is to reinforce the fact that owning and operating an airline is a very high risk business with the potential for external factors beyond the Airline's control to cause revenue and earnings after tax to fluctuate and for costs to rise suddenly and dramatically. Examples of the former are the impact of the SARS virus outbreak in the Asian region and the most recent impact of bomb threats on trans-Atlantic and European flights. An example of the latter is the 100% plus increase in the price of aviation fuel over the last 12 months. All these external factors are and over which individual airlines have no control.

In countries such as PNG the risk profile is increased due to:-

- (i) The geography and climate of the country which can often conversely affect schedules and load factors,
- (ii) The continuing inadequacy of airports and the implementation and administration of the regulatory regimes,
- (iii) The expectation of governments and the community at large that Air Niugini (because it is government owned) and to a lesser extent, its private sector competitors have a community service obligation especially in the provision of domestic services and to a lesser extent in the provision of international services, and
- (iv) The statutory and other obligations it has to meet because it is a government owned business enterprise e.g. appearances before the Public Accounts Committee and the maintenance of higher cost employment practices.

In its draft report the ICCC has recognised some of these factors. However, in the case of Air Niugini Ltd it has not examined or explored whether the return on shareholders' funds meets the benchmarks for the aviation industry and the impact of the Airline having considerably higher levels of accountability than its private sector competitors e.g. being required to appear before the Parliamentary Public Accounts Committee and having mandatory audit of its annual financial statements by the Auditor-General.

As a government business enterprise, Air Niugini Ltd fully understands the need for the public accountability and in recent years has strived to dramatically improve that accountability. While it has received legal advice that it is not required to appear before the Public Accounts Committee it has agreed to do so as a means of demonstrating its commitment to levels of disclosure that are consistent with best international practice for listed public companies.

However, in terms of one of the major criteria of competition policy competitive neutrality Air Niugini is required to disclose commercial information (which in some cases is commercially sensitive and could be valuable to competitors). In stark contrast its competitors, Airlines of PNG and Airlink as private and unlisted companies, have no such requirement. In fact it is doubtful if either airline has filed audited annual reports for the latest financial reporting period and certainly they are not required to appear before the Public Accounts Committee.

In addition, because it is a government owned airline there are pressures exerted on it in relation to its operations and employment arrangements that are not imposed on or expected of any of its competitors.

The ICCC report has referred to the advantages that Air Niugini has as the largest and incumbent PNG registered airline but does not appear to have taken account of the disadvantages that flow from its ownership.

There is a reference in the ICCC report on investment needs (pps 6-7) but it relates overwhelmingly to the CAA of PNG and airport and associated facilities. However, in addition for any commercial airline to remain operational and profitable there is also a continuing demand for new capital investment in aircraft, supporting spare parts and the infrastructure that enables an airline to meet its safety and security obligations as well as meeting market demands. There is also a continuing demand on the international sector of the business to continually upgrade its software systems to be able to meet passenger booking and freight forwarding requirements, payments and the other services related to an international operation. Although Papua New Guinea is a developing country many of the systems that are put in place are dominated by the demands of major airlines from high volume passenger and freight traffic countries which in the main are the advanced western economies such as the USA and Europe. Airlines in countries such as PNG are expected to

either meet the demands in their own right or hang off a major international airline such as Qantas or Singapore Airlines. E-ticketing is such an effort that the industry is moving towards which requires investment.

In responding to the report, Air Niugini wishes to deal with it under the following headings.

### **1. The National Development Context:**

Throughout the report the ICCC recognises the national development roles played by the aviation sector.

However, in approaching its business the Airline must take an overwhelmingly commercial approach to avoid having to rely on government financial support and become a drain on Consolidated Revenue. Air Niugini notes that where national carriers have become instruments of government policy they have drawn on substantial taxpayer funds and ultimately have gone out of business or been privatised e.g. Sabena, Olympic Airways and Lufthansa. Thus while accepting a government owned airline can make a contribution to national development it should not be at a cost to the taxpayer. In this context it is essential that in its long term interests and those of the country's development it must assess its priorities and the commercial risks associated with them.

In the view of Air Niugini the risks fall into four main categories. These categories are listed in order of significance i.e. if one or more fails it could close down either all the airlines or an individual airline.

- (i) airports and related operational and safety facilities and services,
- (ii) financial position of the aviation sector as a whole and individual airlines and airline services providers e.g. fuel suppliers,
- (iii) government's policies, and
- (iv) Continuing private sector investment .

In the terms of reference for the ICCC's review items 1(a); 1(b); 1(c) and 1(e) deal with the matters (i) – (iv) listed above..

In its comments on the operating environment (pps 20, 31-34, 36-45) the ICCC deals with the issues of infrastructure.

There is no discussion in the report on the need for continuing private sector investment in aircraft types that are commercially suitable to PNG. For example there is a demand in PNG for the use of jet aircraft with seating capacity of between 70-110 passengers. The Fokker aircraft which have been eminently suitable to this role are no longer in production and the availability of high quality second hand aircraft is diminishing. The turbo prop aircraft such as the Bombardier DHC-8 (Dash 8) meet some of the requirements and the smaller end of the Boeing and Airbus range are too large. There is a Brazilian aircraft company, Embraer producing suitable replacements for the Fokker 100 and Fokker F28-4000 but no second hand market has been established as yet for the Embraer aircraft. The cost of buying or leasing new aircraft would require a very substantial increase in airfares to justify their purchase or lease.

Port Moresby International and Lae airports are currently the only two PNG airports that are capable of taking either Boeing B737 or Airbus A320 and the potential loads from to and from other airports would not justify aircraft of this size.

In addition any new aircraft types to be placed on the PNG register require a substantial investment in spares provisioning, staff training (particularly pilots and engineers) and meeting the PNG regulatory requirements. The estimated total direct and indirect costs of introducing a new aircraft type such as a B737 onto the PNG register is about K2-3 million. In terms of competition policy this cost could be regarded as a barrier to entry for a PNG airline.

It needs to be pointed out that a foreign registered airline flying to and in PNG is not faced with these costs although there are CAA PNG limitations on the period of time a foreign registered aircraft can operate to Port Moresby or domestically. It is also important to note if such foreign registered aircraft flying assist training of citizen staff in their skills and Nation building, a responsibility that Air Niugini has undertaken.

In terms of critical factors what needs to be made abundantly clear is that for an international and domestic airline such as Air Niugini with obligations under IATA and ICAO as well as having to meet conditions imposed by the Civil Aviation Safety Authority of Australia in relation to its aircraft, pilots, servicing

facilities and standards, the inability or unwillingness of CAA PNG to meet the minimum standards required by the international regulators can close down **all** the operations of Air Niugini. The same situation will apply to Airlines of PNG and any other operator that flies commercially to or through Australia or to any other country with a similar regulatory regime to Australia.

It is a condition of the code share arrangements with Qantas that the operational aspects and airports which a code share flight operates to and from **must** meet Qantas's safety and security standards. Similar conditions would apply to any other internationally code shared airline such as Virgin Blue (Australia), Air New Zealand(NZ), Air Pacific(Fiji) or Singapore Airlines (Singapore).

Safety and security are what might be described as 'drop dead' issues in terms of compliance.

From October 2002 to April 2003 Air Niugini was under threat from the Australian regulators in relation to the safety and security arrangements in PNG. There was a real threat of an imminent 'cease flying' situation. Had there not been intervention at the most senior Australian and PNG governments' levels Air Niugini (and any other internationally accredited PNG airline operating at the time) could have had its services grounded until the Australian requirements were met. The threat was real and the commercial impact on Air Niugini and any other PNG airline operating Australia would have been disastrous. As it was the CASA only extended Air Niugini's AOC for 90 days until further audits and compliance work were undertaken by CAA PNG.

Under the IATA rules and as a matter of commercial prudence, Air Niugini Ltd is comprehensively insured. A condition of all the insurance policies in relation to aircraft, airline staff and passengers is that the airline and the facilities it uses meet all the regulatory safety and security requirements.

It should be noted by the ICCC in terms of meeting the 'competitive neutrality' criteria of competition policy, Air Niugini is the only PNG registered airline accredited by IATA. Airlines registered in PNG but who are not accredited have a cost advantage. This is dealt with later in this submission.

If any PNG airline is to make a contribution to the development of the tourist sector in PNG as well as facilitating travel to and from and within the country for business and investment purposes there are preconditions that are required:-

- (i) the airline or airlines should be accredited to meet the regulatory requirements of the PNG Civil Aviation legislation (which in turn must meet the standards set down by ICAO) and extraterritorial regulatory bodies such as CASA,
- (ii) the airline or airlines must be able to meet all insurance requirements for passengers and freight,
- (iii) the safety and security procedures of the PNG registered airline or airlines must meet the requirements of international airlines that book passengers on PNG airlines after they transfer from other airlines. For example Singapore Airlines' passengers travelling from Frankfurt to Port Moresby via Singapore who would travel the first sector on Singapore Airlines and the second sector on Air Niugini. There will be a single ticket issued for the entirety of the travel. To make an interline ticket, both airlines must be IATA accredited and have the IATA settlement arrangements.
- (iv) there must be certainty and continuity of schedules as well as commercial support services, and
- (v) passengers and freight forwarders must be satisfied that the infrastructure that supports the airlines' operations meet acceptable international standards.

While a small segment of travellers can be regarded as 'adventurers' prepared to accept higher than normal risks, the vast majority of business and tourist travellers demand safety, security and certainty. This is increasingly the case at a time when the level of terrorist threats has increased.

In addition an airline that did not fully insure or is uninsured would leave itself exposed to very substantial damages claims in the event of an accident where a passenger is killed or injured.

While the Qantas code share agreement will be dealt with in another part of the response, its existence indicates to passengers on the Sydney and Brisbane to Port Moresby and Cairns to Port Moresby services, that the aircraft used by Air Niugini meets Qantas's very high safety and operational standards. The assurance

is regularly verified because Qantas undertakes regular audits of Air Niugini and the airports to and from which the code share flights operate. Age of the aircraft is highly linked to its performance and safety. It is also important to note that more newer and younger the aircraft lease or purchase cost will increase. This in turn is translated to the airfare charged.

As with the code share agreement, the issue of airfares will also be dealt with later in this response. However, from the point of view of the majority of business travellers (private and public sector) non price factors are as important as the cost of airfares. In this respect the business class airfares charged by Air Niugini compare favourably with the range of business class fares charged in Australia and New Zealand and within the region.

In relation to business investment in PNG, Air Niugini submits that it is issues such as the perception of security, law and order, the availability and reliability of supporting infrastructure such as electricity, roads, public services and the commercial returns on investment that will be the main determinates of new investment in PNG and not the cost of airfares.

From Air Niugini's and the aviation sector's, view the critical factor is the lack of investment in airports and associated services and the consistently poor management of the CAA PNG. The Draft ICCC Report suggests some opportunities for improvement.

As will be discussed in more detail, Air Niugini's view is that action is urgently needed to rectify the problems at Port Moresby International Airport and the other major airports (Lae, Madang, Wewak, Gurney, Tokua and Kavieng). Until such action is taken there will be continuing reluctance by the tourist and other industry sectors to make substantial infrastructure investments and tourists will be reluctant to select PNG as a tourist destination.

In summary, Air Niugini agrees with the ICCC's observation (at page 4) that "the mobility of people, goods and information is a vital prerequisite and building block for economic development".

Air Niugini agrees that the PNG Government's policy of an 'open skies' is the correct one both in terms of national economic development generally and

competition policy specifically. It allows entry of a new operator who sees commercial opportunities in PNG and as such, maintains the prospect of additional competition for Air Niugini (and the other airlines). Air Niugini submits that so long as the safety and security requirements are met and an airline demonstrates that it can honour its ticket and freight carriage obligations entry should be allowed. The market should then be the determinate of the airfares and schedules.

In conjunction with the Pacific Islands Air Services Agreement it should also allow Air Niugini and other PNG registered airlines that meet the international regulatory requirements to compete in all the regional markets whose countries are signatories to the PIASA agreement e.g. Australia and New Zealand.

It should be noted by the ICCC that as a consequence of improved operating results in 2005, the airline raised with the Government commencing the payment of dividends or the investment of part of its profits (after providing for asset renewal) in the purchase of airport facilities. Although such action has implications for competition policy in the PNG situation so long as there is a well understood and consistent access regime applied and administered it could help overcome the funding problems of the CAA PNG.

Such an approach amounts to hypothecation of revenue to which the Department of Treasury may raise objections. However, in the light of the parlous state of PNG's airport assets and associated facilities it may be a sensible approach as the airlines have a strong commercial incentive to ensure that the airports are kept operational and meet all the regulatory requirements. Over the last decade Air Niugini has been meeting airport and related security costs that should have been met by CAA PNG. At the same time the smaller airlines have had what can be regarded in competition policy terms as 'free carry' for services and facilities paid for by ANG. Unlike Air Niugini Limited whose profits are known and whose accounts are open to public scrutiny those of the smaller airlines are not and it would be necessary to either gain access to their accounts or arbitrarily determine a level of charges. Another option would be for the government to treat the airports as 'regulated assets' and have the ICCC regularly review the financial performance of the airports and set the charges.

There are two risks in this approach unless all airlines contribute to the costs of maintaining the airports. The first is that of 'free carry' and the second is that of 'game keeper and poacher'.

In relation to the tourist sector Air Niugini submits growth of the overall business and discretionary travel market should be a key objective of the National and Provincial governments and the existing tourist PNG sector. Airfares (plus taxes and charges) are one part of the total cost for both business and tourist travellers but in many cases they are not the major cost.

Air Niugini agrees that there has to be greater effective cooperation between airlines and hotels/tourist operators in terms of both the prices and logistics. One of the reasons for the success of Fiji, New Caledonia and Vanuatu is the ready availability of competitive, combined air travel and accommodation packages. This has been the result of decades of co-operative action between the airlines, hotels and tours operators and governments. That degree of cooperation has not been consistently forthcoming in PNG and there is anecdotal evidence of existing tourist operators resisting such cooperation because they are fearful of losing market share rather than contributing to growing the tourist market.

**SECTION OMITTED DUE TO CONFIDENTIALITY ISSUES**

Also after protracted and frustrating negotiations between Air Niugini and the CAA PNG and Australian authorities, Air Niugini was able to introduce three jet flights direct between Rabaul and Cairns to meet the requirements of the international tourist ship operator, Orion Cruises. Orion Cruises is a boutique cruise liner market catering to the high income traveller interested in the unusual. It is trying to develop regular tourist liner visits in the region and is the class of tourism that will bring investment with it.

In a similar vein, CAA PNG prevaricated for over nine months about allowing the introduction of an Air Niugini service between Tokua and Honiara and return.

These are specific examples of where **new** services with an obvious positive impact on tourism and investment have been delayed by various challenges and negotiations.

It is a strong recommendation of Air Niugini to the ICCC that if national development is to be a goal of the aviation sector it should be mandatory for the CAA PNG and other PNG authorities to fast tract approvals and for specific times to be set and observed for granting approvals and enabling asset upgrades where required.

If the airlines are able to respond promptly on a commercial basis further investment is likely to follow.

Air Niugini recognises that the PNG Government has limited financial resources and all avenues should be used that encourage private investment in infrastructure.

The Airline has also noted the ICCC's comments about the impact of the Napa Napa oil refinery and the additional costs of supplying jet fuel and the non availability of Avgas.

It is not for the Airline to comment on the appropriateness or otherwise of the decision to grant InterOil what amounts for an exclusive dealing arrangement under which users pay higher prices (even allowing for the recent international oil price increases). The only comment in relation to price is that if the aviation sector is able to secure aviation fuel from other sources at a lower price serious consideration needs to be given to either allowing importation of the cheaper aviation fuel (especially as aviation fuel is a small component only of Inter Oil's production) or a clearly identified surcharge being added to domestic airfares to cover the additional cost.

Alternatively, the government could open negotiations with InterOil to adjust the price of Aviation jet fuel to international parity prices that existed at the airports subject to movement in Crude Oil prices.

The declining availability of AVGAS and the state of many smaller local airports is of major concern to Air Niugini (and probably more so to Airlines of PNG and Airlink) because the smaller, local airports are an essential component in the development of 'hub and spoke' networks for air services. There is no real alternative to the existing light aircraft that service many of the small airports in the Provinces and which in turn supply passengers to the larger airlines operating nationally and internationally.

The smaller airlines also fulfil a significant community role in giving local inhabitants access to health services.

Telecommunications is the other area that impacts significantly on Air Niugini's operations (as with any other PNG airline). Increasingly business is done over the Internet and the introduction of E-ticketing and electronic payments depend upon an efficient and competitively priced international telecommunications system. Air safety is also dependent on a fully operational telecommunications system.

On at least one occasion Air Niugini has been forced to use aircraft High Frequency radio systems to secure aircraft clearance because the PNG telephone system was inoperative !

Currently the services provided by Telikom PNG are neither efficient nor competitively priced. To enable the air traffic control and safety and security systems to work as well as to provide the level of services for tourists and PNG citizens wanting to use E-tickets etc there will need to be a dramatic improvement in the level of telecommunications.

## **2. The principles of national and international competition policy and how they apply to the aviation industry in PNG and ANG in particular:**

The objectives of competition policy are to:-

- (i) provide consumers with a choice of goods and services,
- (ii) ensure prices of the goods and services are determined by an open, transparent market process that enables consumers to make a choice based on comparing like with like,
- (iii) provide consumers with the best quality at the lowest price
- (iv) facilitate ease of entry for new operators, and

- (v) ensure active competition between service providers.

As pointed out earlier in this response, the international airline industry over the last decade has produced uneven results with several U.S.A. airlines being in Chapter 11 administration, Ansett Airlines of Australia collapsing and Air New Zealand requiring a government capital injection for \$NZ 800 million.

In a developing country such as PNG with a very wide range of disposable income - subsistence farming and fishing to a small segment of the population with high levels comparable with developed countries, using normal indicators of affordability, operation of an open market, freedom of choice etc that are essential ingredients of a competitive market system has analytical problems.

An example is that relating to the choice of aircraft type and air fares. If GDP or disposable income figures are used as a basis for assessing the levels of service and prices then PNG's aviation sector should at best be a series of limited turbo-prop services.

However, there is a very strong demand for jet aircraft services internally e.g. between Port Moresby and the ports of Lae, Madang, Wewak and Rabaul with consistent pressure for a permanent jet service to Gurney. While the Airlines of PNG service from Port Moresby to Cairns and return appears to receive some customer acceptance the preference is clearly for the faster jet services. Therefore, in comparing airfares, it must be done in accordance with the types of aircraft used as well.

In view of the PNG government's 'open skies' policy it is also significant that no Australian or New Zealand airlines are operating to PNG either in their own right or on a code share basis. Ozjet, Virgin Blue, Alliance and Air New Zealand all have the aircraft types to operate a service and any one of the three could propose a code share arrangement to either Airlines of PNG or Airlink.

On the freight side of the business Hevi- Lift based at Cairns operated a seasonal freight service with turbo-prop aircraft into Port Moresby and Lae but the services appear to have failed to attract sufficient continuing business and has since terminated.

In terms of choice the range of aircraft types, classes of travel, ranges of fares and terms and conditions of travel is consistent with routes outside PNG between major capital cities and between capital cities and regional centres. For example first class travel within Australia and N.Z is no longer available and the predominance of travel between Australia and N.Z. is economy and business class travel with the latter declining following the introduction of low fare minimum service airlines e.g. Jet Star and Freedom Air.

Virgin Blue and Virgin Pacific as the second major Australian carrier and a relatively new entrant to the Oceania region offers economy class only with no in cabin service included in the air fares.

In all cases the cheaper the fares the less the services and the more restrictive are the terms and conditions of travel at the extreme end absolutely no change in flights and total loss of the fare and charges if a passenger fails to travel.

The success of these low cost services depends on very high volumes, minimal cabin services, rapid turn around times at arrival and departure airports, very flexible employment conditions and the highest possible level of aircraft utilisation consistent with safety and engineering requirements.

ANG on its international routes provides both business and economy class travel with a wide range of discounted fares. On the domestic routes it provides business class service on the F100 aircraft.

ANG's competitors offer only economy class fares with a range of concessional fares. Domestically and in Cairns route these services are not Jet services. As a comparison, jet aircraft consume more fuel and generally a turboprop aircraft uses only around 40% of jet aircraft fuel consumption.

ANG faces a conundrum with air fare policy as the incumbent, dominant PNG registered airline. Its fares act as an effective 'floor price' for the smaller airlines and on domestic routes where there is competition competitors will pitch all or some of their fares just below the ANG fare. Thus to some degree the current ANG fares give competitors a degree of certainty about price

setting, margins etc. It could be argued in terms of competition policy that ANG fares provide a 'floor price'.

On the other hand if ANG starts to aggressively price into a particular market or into the markets generally it will be accused by its competitors of predatory pricing aimed at reinforcing its market position.

This situation is not uncommon around the world and in some instances governments have responded by trying to fix airfares – both for political and quasi-commercial reasons (ironically usually to protect the government owned airline). For many reasons government price fixing of international and domestic airfares has not been successful. In most cases it has been counterproductive because the fares have been kept at artificially low levels and the airline involved has usually gone into bankruptcy e.g. Alitalia, Olympic Airways and Sabena. As a means of avoiding government determined prices airlines have resorted to increasing fees and charges for auxiliary services.

The ICCC drew the comparison with airfares to Fiji from Australia and New Zealand. ANG submits that any comparison with Air Pacific and its services to and from Nadi need to be qualified. The following are the reasons:-

- i. The routes ex Sydney and Auckland are very high volume using Boeing B747-400, B767-300 and B737-800 aircraft,
- ii. All the airports they operate from (except Sydney) operate 24 hours a day and in the case of Sydney it operates from 06hr00 to 11hr00 which contrasts with Port Moresby and other PNG airports that basically have daylight operation only, (This is not correct)
- iii. These destinations do not have the Law & Order issues restricting their operations to limited number of hours in the night,
- iv. Infrastructure in these destinations (road, taxis, hotel accommodation, telecommunication, public and other forms of transport) are in a much higher standards than in PNG destinations,

- v. Nadi is a hub to other Pacific islands for the services arriving from Los Angeles and the Fiji Islands,
- vi. Qantas is a substantial shareholder in Air Pacific and is able to provide a wide range of advice and assistance to the airline(including distribution support services).In addition Qantas also code shares with Air Pacific on flights to Fiji,
- vii. The relationships between Air Pacific, the hotel and tour operators and the government is vastly superior to that between the tourist and aviation sectors in PNG,
- viii. Air Pacific does not have domestic routes as a substantial part of its business and consequently does not have the geographical problems or the community service element in its services, and
- ix. In spite of the intermittent coups in Fiji the actual and perceived security risk is considerably lower than in PNG.

Similarly in making comparisons with Australian and New Zealand operators it needs to be remembered that the volumes of passengers and under aircraft freight are considerably higher than on PNG domestic routes. With the exception of Sydney all major Australian and domestic airports are able to operate 24hrs a day with some exceptions.

A similar situation exists in New Zealand with the exception being Wellington that has similar curfew arrangements to Sydney.

The ICCC report referred to the opportunities on international routes that arise from Air Niugini's sixth freedom traffic rights. Initially, the sixth freedom traffic was valuable – especially between Japan and Australia, Manila and Australia and to a lesser extent between Australia and Singapore.

The value of sixth freedom traffic has diminished considerably. In the first instance a Qantas offshoot ,Australian Airlines started economy class only flights to Japan from Cairns and the Gold Coast. The fares were very competitively priced and

more importantly for passengers did not involve a stopover – such as is the case with services to and from Japan via Port Moresby. Unlike stopover ports such as Changi (Singapore), Dubai and Hong Kong Jacksons Airport is not an attractive stopover airport and offers transit passengers a minimum of facilities.

Subsequent to Australian Airlines low cost travel in the region other airlines such as Singapore Airlines offered highly competitive economy class airfares to Singapore. Qantas increased the frequency of its flights to and from Manila and priced its special economy class fares at levels below Air Niugini's sixth freedom fares to and from Australia to Manila.

The recent decision by Jet Star to enter the regional markets and for Qantas to code share with them such as on services from Eastern Australian capital cities to Asia will further reduce the amount of sixth freedom traffic.

Air Niugini in conjunction with the PNG government has been actively pursuing the opening of a new route from Port Moresby to Nadi via Honiara. In addition to providing a sixth freedom route to India that allows Fijian and other citizens to avoid what they see as less desirable treatment by Australian immigration it will also be marketed as a 'round the world service' that introduces to European and North America passengers some of the outstanding attractions of Oceania including PNG.

In the short to medium term Air Niugini does not assess sixth freedom traffic as likely to increase. On the contrary with the expansion of low cost airlines in the region such as Jetstar, Virgin Blue Pacific and Freedom Air (NZ) it is more likely that sixth freedom traffic and yields will fall.

The international air passenger market is highly competitive both in terms of fares and services. While demand for business class travel is price inelastic mainly because of its very nature economy class travel is to a large degree discretionary and is price elastic.

Air Niugini is very conscious that internationally and to a degree domestically it is competing in a highly competitive tourist market and that both fares in their own right and as part of total tourist packages will influence decisions about tourist destinations.

It is for that reason Air Niugini introduced a range of special fares to match that competition predominantly from international tourist destinations such as Fiji. However, the fare structure and the after tax yields have to earn the Airline a profit so that it can reinvest in the business. Air Niugini's history has been that it ran at a loss and as at 31<sup>st</sup> December 2003 the Airline's accumulated losses had reached K160 million. It had used an increasing amount of both very short term credit and medium to long term debt to fund its operations. With the preceding fare and cost structure the Airline was not viable and could not have continued its operations.

### **3.The International and national regulatory regimes that currently operate and have an impact on ANG.**

Because of the risks associated with operating aircraft, international organisations whose operations are reinforced by government treaties and protocols, regulate the safety and commercial conduct of airlines around the world.

The two major organisations are the International Civil Aviation Organisation (ICAO) and the International Air Transport Association (IATA). The former deals with safety and security and the latter with commercial conduct.

ICAO is recognised as the core of the international air safety rules and national legislation governing air safety derive from the ICAO rules or protocols. PNG is one of the 189 contracting states to ICAO. While there are variations between countries to suit particular conditions in the application of the protocols, the ICAO rules and protocols are regarded and the 'Bible' of air safety.

With the increasing volume and intensity of civil aviation, the ICAO rules and adherence to them is a fundamental element of any commercial airline operation. Regularly, CAA PNG has not maintained its safety and security standards at the levels required by ICAO and the PNG Civil Aviation legislation that embodies many of the ICAO protocols. As indicated earlier in this submission on numerous occasions Air Niugini has had to undertake the work that should have been completed or consistently undertaken by the CAA PNG. (Is this pertinent to the ICCC report)

In addition to the costs imposed it presents both the Airline and CAA PNG with serious competition policy issues. Because CAA PNG is both the regulator and the asset owner for Air Niugini( or any other airline) to fund and undertake work that should be done by the CAA PNG creates a classic ‘game keeper - poacher’ conflict and in the case of safety and security can raise doubts about the integrity of the regulatory system.

It is Air Niugini’s strong view that these situations should be avoided. While understanding the financial and other restraints facing the PNG government the potential for the ‘game keeper – poacher’ to prejudice air safety and security could be overcome by separating the asset owner from the regulator. The separation needs to be real and not notional if the regulatory system is to have any integrity ( which is of particular importance for international airlines) – thus creating an internalized separation within the current CAA PNG is **not** a solution.

It is the Airline’s view that if the PNG Civil Aviation legislation is to have any integrity it is essential that the relevant authorities should act on proposals that have been with it for over two years to separate the asset owning and the regulatory functions of the CAA PNG (Is all this about CAA PNG necessary).

In addition and in terms of competition policy, the ICAO accreditation **with effectively implemented national regulatory regimes** gives passengers an assurance that they are travelling on a safe airline. Air Niugini’s accident record is very favourable and ranks with major airline operators in the region – in spite of the difficult flying conditions for domestic services. An effective regulatory regime that is well administered consistently over a long time period is also an inducement to new airlines wishing to enter the country.

Because it is externally imposed and the rules and regulations apply across the board to all airlines it is Air Niugini’s view that ICAO’s rules and protocols do not constitute a restraint on trade or impediment to entry. On the contrary, as pointed out in the preceding paragraph a well administered regulatory regime and supporting safety and security systems are a precondition to new entry.

IATA is an international organisation whose members are most of the credible civil aviation operators. A list of the IATA members in the Asia Pacific region

is attached as Appendix 1. It deals with the terms and conditions of carriage for passengers and freight. It also acts as a 'clearing house' for interline bookings where passengers travel several sectors on more than one carrier.

From time to time there have been criticisms that IATA is a restraint on trade. However, it provides simplified rules for international and, in some cases, domestic travel and also provides assurances about 'ticket security' to passengers holding IATA tickets or E tickets from an IATA accredited airlines. It also provides certainty to participating airlines for payments. It reduces the prospects of passengers losing out of disreputable travel agents and airlines.

Air Niugini Limited is the only IATA accredited airline in Papua New Guinea which provides international travel with inter-line options with other carriers. None of the other PNG registered airlines have accreditation which limits their ability to be involved in world wide distribution arrangements which are important for the development of tourist travel. It should be noted that although they are very much smaller airlines than Air Niugini that Solomon Airlines, Polynesian Airlines and Air Vanuatu are IATA accredited.

In addition to the international regulatory bodies Air Niugini's (as is the case for any other airline) is subject to the rules and protocols of the countries to which it flies. In the case of ANG the most important is Australia and the others are Singapore, Japan, the Philippines and Solomon Islands. ANG now runs a weekly service to China (Hong Kong) and flew to New Zealand for maintenance of the B767-300.

Australia operates a very high level safety and security regime which is mandated under its Civil Aviation legislation and administered the Civil Aviation Safety Authority (CASA).

The provision of air traffic and other services at Australian airports is provided by another Australian government agency – Air Services Australia. All the major capital cities airports are privately owned. Many of the regional airports are owned by the local council or private companies and several which serve also as military airports by the Australian government.

The determination of capacity on routes to and from Australia are assessed by the Australian International Air Services Commission( IASC). While the initial hearing of the IASC reached a view that the Code share between Qantas and Air Niugini meant that “Neither party is likely to price aggressively” Air Niugini submits that the IASC conclusion has not been the case. There has been and remain competition between the two airlines over the sale of the Hard block seats. It is also in competition to sell the soft block seats. In addition there has been strong competition by Air Niugini with Qantas to secure freight traffic between PNG and Japan and PNG and the Philippines.

In the case of both airlines there is always the challenge of another airline such as Virgin Blue, Airlines of PNG or Jetstar entering the route.

As has been pointed out in the ICCC draft report Qantas, for a variety of reasons, did not endeavour to operate its own aircraft and crews into PNG. Had the code share not been entered into Air Niugini may have been the dominant carrier with monopoly instead of currently competing two carriers. Thus, the current form of block code share arrangement maintains the competition.

Airlines of PNG have proposed to the ICCC that “seating capacity on international services should be opened to tender”. There is nothing to prevent any travel agent or airline offering to buy some or all of the seats that are available on either the international or domestic flights of Air Niugini. This is done already with other international and domestic airlines by large travel agencies such as ‘Flight Centre’ and ‘Harvey Norman Travel’ in Australia.

One of the major problems with the proposal for open tender is that Airlines of PNG is not accredited with IATA and in terms of guaranteeing payments for onward travel on other airlines, administering terms and conditions for passengers that are different to those of ANG and Qantas the costs of administration would be high. In addition although the seats might be issued under the name of Airlines of PNG ANG and Qantas would end up taking the responsibility for Airlines of PNG passengers. Further, such a system will add more regulation than the market forces and competition driving the prices giving advantage to customers.

If Airlines of PNG is confident that its allegations about ANG's pricing are correct and it believes the market is large enough it should either lease or buy an aircraft for international services or enter into a code share arrangement with a competitor to Qantas. ANG notes that Airlines of PNG is leasing one of the over 30 year old Boeing B737 aircraft that were operated for a very short time by the failed OZJET airline in Australia. This aircraft has been manufactured prior to the Independence of Papua New Guinea. It notes also that it is single class and that while the fares are lower than those of ANG on introductory fares, the conditions attaching to making and fulfilling the bookings are much more restrictive i.e. has to be done on the Internet and if travel is not undertaken there is a total loss of the fare. Rest of the fares offered are in many cases more costly to the traveller than the ANG travel options.

As with the competition from Airlines of PNG on the Port Moresby to Cairns and return route ANG submits that the introduction of the services indicates that the PNG Government's 'Open Skies' policy works. In commercial terms the support for and the longevity of these services will verify in the aviation market place if the total market can be grown.

Meantime ANG will commercially match the competition and believes that the market should be allowed to operate.

In this respect ANG submits that the decision of Airlines of PNG onto the Cairns and Brisbane routes verifies that in terms of competition policy the criteria in (iv) and (v) above are met i.e. ease of entry of new competitors and active competition between competitors.

Because of the problems in PNG with the efficient and transparent administration of market regulations ANG submits that the Airlines of PNG proposal for tendering seats on international flights is far better handled in terms of competition policy by different airlines offering separate services that can be distinguished by the standard of the aircraft, the types of service offered and the fares.

In relation to the ANG – Qantas code share arrangement the history is well known and does not need to be restated. At the time the code share was signed

the imperative was the continuing existence of an airline that could meet both PNG's domestic and international requirements. In brief there was no alternative.

Air Niugini while understanding the arguments put by the Australian IASC supports the views stated by the Australian Productivity Commission and set out at page 66 of the ICCC draft report.

#### **4.The operational and financial issues associated with the PNG aviation industry that influence or impact upon the industry and ANG in particular.**

The ICCC report has dealt comprehensively with the :

- Significant and in some cases 'drop dead' problems associated with the CAA PNG and the administration and financing of the aviation sector assets and the regulatory regime.

For the greater part ANG agrees with the ICCC's observations about the CAA PNG and the operation of the regulatory regime and the funding and management of the CAA's assets. As indicated earlier in this response ANG submits that urgent effective action is needed to deal with the regulatory regime and the asset management .If urgent action is not taken competition policy will be irrelevant because there will not be a sustainable aviation sector in PNG

- Most of the constraints on ANG ( or any other airline) matching international competition are additional costs added because of historical policies such as adherence to a cumbersome award based system for the remuneration of airlines staff, a lack of an efficient telecommunications system, inflexibility in the issue of work permits for critical technical and operational staff that cannot be met in the short run from local resources, localised safety and security problems that cause restrictions on flying times and sluggishness in finalisation of legal and other disputes before the PNG courts e.g. unfair dismissal claims.

- An expectation that ANG as the incumbent airline will ‘free carry’ its competitors in the provision of terminal and other services, and
- Difficulties in extracting payments for passenger and freight carriage from some government departments.

The issue of training and development of pilots, cabin crews, engineering staff and supervisors and accountants and auditors is a major one. There are shortages of staff in a number of these categories and staff that have been trained by ANG are regularly recruited by other organisations both in PNG and overseas. For example there are at least four ANG trained pilots flying with Emirates and a number of the qualified engineering staff working overseas.

Building and maintaining highly qualified staff is a key objective for any successful airline.

The Airline accepts that there is no quick fix for any of these problems but as the largest PNG registered airline which is also government owned there is an expectation in some quarters that these functions should be carried out and the costs absorbed by the Airline. Any costs associated with core infrastructure issues such as this will inevitably find their way into airfares. The Airline is not a ‘Magic Pudding’ that can continually provide services for which there is no payment.

The Airline submits that if the State wishes to see the profitable continuation of a State owned airline and the growth of the a successful aviation sector it must implement policies that encourage international competitiveness and remove restraints that prevent or restrict the Airline from responding to cost pressures out of its control e.g. the recent increase in oil prices.

##### **5. Factual Matters that arise within the ICCC report.**

In general the ICCC has provided a wide ranging assessment of the PNG aviation sector. However, there are elements of the report that need to be commented upon in order to ensure that the ICCC has an adequate understanding of the problems confronting the sector and ANG in particular.

At page 10 the ICCC Draft Report suggests that “. . .it is important for both parties to agree on reasonableness of charges made for air services provided by the CAA.”. It is important to note that there have been numerous discussions, exchanges of correspondence between ANG and the CAA PNG about the nature, the levels and the reasonableness of charges. Without accurate and up to date data it would be impossible to make comparisons with international benchmarks. Having said this ANG submits that CAA is attempting their best efforts to meet their service obligations to serve its customers despite the resource constrains.

At page 11 the ICCC Draft report states there is merit “in considering a separation of the various roles and responsibilities of the CAA.” As indicated earlier in this submission ANG understand that the Government has given such a proposal consideration.

At page 13 the ICCC notes that in relation to the training of travel agents that there is ‘the potential for anticompetitive outcomes from this practice.’ As pointed out earlier in this report ANG is the National Distribution Centre (NDC) for Gallelio Global Distribution System in PNG. Consequently, as part of its responsibilities, all travel agents are trained by a separate section in ANG that deals with Gallelio. Contrary to the submissions by other airlines, ANG reconfirms to the ICCC that the system used by ANG to carry out its business is Computerized Reservation System (CRS) and not a GDS. Gallelio is a GDS which is governed by very strict and stringent competition rules applied in USA. Gallelio and all other similar GDSs provide equal access to all airlines and such access levels are controlled in USA by the system owners and not ANG. This myth must now be cleared. Airlines of PNG is operating in SITA systems and has not link to ANG. Airlink is sub-hosted with a separate partition in SITA and is managed by Airlink staff on their own. Very clearly, ANG do not control any Airlink system activities and except ANG charges them for sub-hosting and communication charges. Airlink schedule upload, airfare upload and all inventory management are done by their staff. ANG will be pleased to provide further information in this regard.

There is nothing to prevent any other PNG registered airline from obtaining another GDS implementation.

In relation to the domestic fares comparisons at pages 23 to 25 ANG has submitted earlier in this submission why the comparisons may not be valid

It should also be noted that over the last three years ANG has introduced an increasingly sophisticated yield management system but the extent to which it can do so is constrained by the reliability (or lack of it) of the telecommunications system.

At page 26 the ICCC suggests that there is no competition on the Port Moresby to Cairns route. Not only does Airlines of PNG operate a service to Cairns and return but also some of the charter services from the Highlands direct to Cairns and return constitute effective competition because they carry passengers who would otherwise transit in Port Moresby.

At page 28 the ICCC claims that ‘Air Niugini is able to charge at whatever rate it wishes with its main focus being on passengers which are able to pay these fares, that is mainly business travellers or travellers who are travelling to PNG as part of their employment’. As indicated earlier in this report this is not the approach to setting of air fares – both actual and threatened competition are taken into account . In addition to Board has deliberately taken the view that it is in the Airline’s and the national interest to set fares that encourage return travel by ‘discretionary spenders’ in the tourist market.

At page 29 the ICCC draft report implies that 58.1% average load factor over the past four years in high (see the immediately preceding sentence). ANG disagrees 58% would not be regarded as a satisfactory average load factor by any profitable international or domestic airline 70% plus would be the appropriate figure.

At page 66 the last paragraph states that the Qantas-ANG code share was never “independently assessed as to whether there were alternative options that could have been adopted . . . .” There was no formal consideration by the ICCC. However, there was a consideration by the Australian IASC and the ICCC draft report has referred to that determination by the IASC. ANG would regard the IASC as being independent. It recommended to the then Australian Minister for Transport that the code share should proceed.

In addition ANG has referred earlier in this submission to the Australian Productivity Commissions report on code share arrangements and submits that the APC 's conclusions apply to this particular code share.

**SECTION OMITTED DUE TO CONFIDENTIALITY ISSUES**

The Airline also had to take into account that it faced substantial upgrade costs on an ageing Airbus aircraft which if it did not enter into a code share arrangement the revenues would not be available to maintain a profitable, independent service on the Airline's international routes.

Enquires were made about possible other code share partners in the region and there was no interest.

Thus it is ANG's views that the conclusions on page 66 cannot be sustained.

In relation to the distribution network ANG currently operates in conjunction with several international software systems that enable outgoing and incoming passengers (and freight) to be offered a comprehensive, total booking service.

With the exception of former Communist countries no country operates a 'one stop shop' distribution system. Even Cuba does not do so.

Although it might be a 'not for profit' organisation it would be a monopoly provider and in a country such as PNG would require a great deal of goodwill and financial support to make it work.

Overseas travel operators would have strong reservations about having to deal direct through a monopoly provider and the medium to long term outcome would be contrary to the objective of growing the PNG tourism market.

At page 70 the ICCC offers some options for maintaining marginal routes in PNG. As indicated earlier in this report the phasing out or unavailability of AVGAS and the state of some of the smaller regional airports may determine an outcome that does not fall into any of the six options suggested.

While some aspects of the marginal routes issue are more urgent for smaller airlines it is still an important issue for ANG. There are several domestic services that are marginal but ANG continues to operate because of the 'national interest'.

Initially, ANG believes that the least worst and most transparent option is No.4. ANG would like to take further time to consider the options proposed by the ICCC in its draft report and make further submissions.

It is essential to point out that a fundamental element or condition precedent in making a decision about what is the best option is the reaction of the State and the CAA PNG to the ICCC's draft observations and recommendations about the CAA PNG and the action taken to deal with the airports and regulatory regime.

## **6.Recommendations:**

ANG recommends that:-

- Urgent action and funds allocation to deal with the CAA PNG and the state of PNG's airports and safety and security infrastructure,
- The asset owner and the regulator should be effectively separated and not just by internalize separation,
- The PNG government's 'open skies' policy should remain in place,
- The PNG government to negotiate a level playing field between PNG and Australia in the access of air services and in particular secure agreement from the Australian Government for the removal of the practice of cabotage,
- Air fares should continue to be set on the basis of market forces and not arbitrarily determined by regulatory body,
- That where possible there should be no cross subsidies between international and domestic services,
- A concerted effort should be made by the PNG tourist sector to develop a set of working relationships with the airlines similar to that with Fiji and New

Caledonia and that funding be made available from the sector for sustained promotion of PNG as a tourist destination, and

- The ICCC in conjunction with the aviation industry examine and make recommendations to government to achieve workable solutions to the problems of small regional airports and the decreasing availability and increasing prices of AVGAS in remote locations.