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Skirting the vortex of decline

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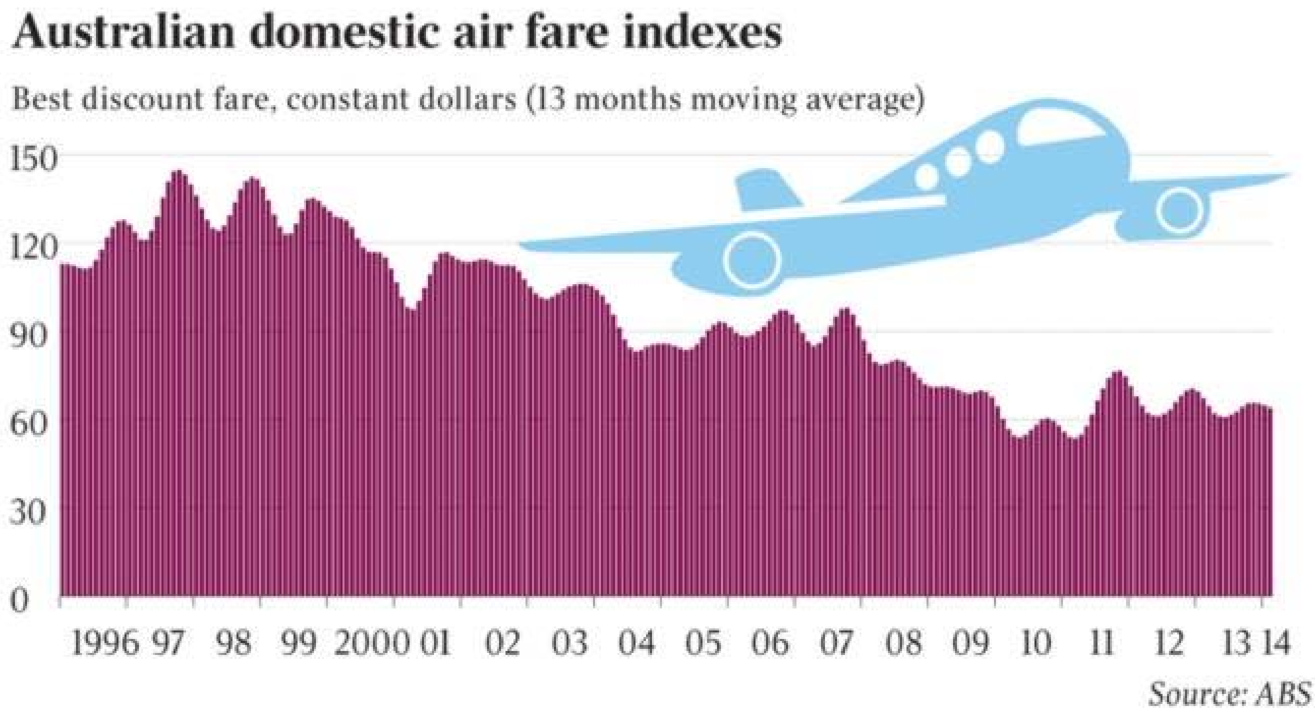

Domestic air fare indexes. Source: TheAustralian

IT has hardly been a stellar week for the flailing kangaroo. Not waving but drowning one day, it was not flying but soaring the next. If the aim was to confuse, Qantas's mixed messages did the trick.

But pirouettes worthy of the Air Force Roulettes cannot hide the depth of Qantas's difficulties. Nor can the messiness of the policy debate disguise a far greater determination in the government to reject corporate welfare.

Helped by Qantas's tin ear, the mood in the Coalition partyroom has gone decidedly dry, at least on assistance to firms; whatever the range of views, there was virtual unanimity in refusing the bail-out options.

Tony Abbott and Joe Hockey were as one: if the government does not show firmness now, it will be condemned to be ineffectual. How far that firmness extends will be tested by the Audit Commission report and by the budget. But it will also be tested by the uncertainties that beset Qantas's future.

For sure, Qantas's woes are partly transitory: its North American earnings should improve as recovery in the US, combined with a weaker Australian dollar, boosts demand. Its other problem areas, however, will not correct themselves as easily.

Internationally, Qantas struggles to compete with the high-quality Asian carriers, such as Cathay Pacific and Singapore Airlines, and their Middle Eastern equivalents, Etihad and Emirates. As well as materially lower costs, greater staffing flexibility allows those airlines to out-perform Qantas's cabin service, while their location at natural hubs means they can manage their fleets more efficiently than can a carrier at the end of the line.

Illustration: Eric Lobbecke Source: News Corp Australia

At the same time, Jetstar's Asian operations have been unable to compete with lower-cost local airlines. As a result, Qantas seems poorly placed to profit from the tourism outlays of the region's burgeoning middle class.

Compounding Qantas's problems is a savage capacity war in its domestic market. In the past two years, available seat kilometres have increased at twice their long-run rate, as Virgin has challenged Qantas's determination to maintain its two-to-one capacity advantage. With Qantas unwilling to flinch, rising supply has driven domestic fares to near record lows.

Virgin has certainly not been left unscathed by the battle. On the contrary, its unit revenues have declined even more than Qantas's. But Virgin's state-owned investors (Etihad, Singapore Airlines and Air New Zealand) have deep pockets; and they doubt a weakened Qantas can afford to maintain its stance.

The stakes are high. Qantas believes its capacity edge, reflected in greater frequency, connectivity and reach, is crucial to its 80 per cent share of the domestic business market, which translates into unit revenues 31 per cent above Virgin's.

In turn, that revenue premium makes it possible for Qantas to survive even though its domestic unit costs are 19 per cent higher than Virgin's. Should Qantas scale back capacity, its revenue premium could fall more rapidly than its costs did, reducing a return on assets that is already barely half that investors expect.

Those fears cannot be dismissed lightly. Although there are few close comparators to Qantas, it is not difficult to find carriers that in retreating from initial dominance have been sucked into a vortex of decline.

Scandinavian airline SAS is a case in point. Having abandoned the mass market to "value based" entrant Norwegian Air Shuttle, and to carriers such as Ryanair and easyJet, its unit revenues are 40 per cent to 60 per cent greater than those of its rivals; but its unit operating costs are even higher, so its margins are one-third to one-sixth those its rivals achieve. Staggering from restructure to restructure like an 18th-century patient being bled to death: only the grave seems to lie ahead.

Faced with that risk, and with a credit downgrade to junk bond status, it is hardly surprising that Qantas sought a commonwealth loan guarantee or some other form of concessional finance. It is not that Qantas feared an immediate liquidity crisis; rather, the attraction of assured finance lay in the signal it would send Virgin's investors. By ensuring Qantas could ride out the capacity war, the loan facility would make it pointless for Virgin to prolong hostilities, thus encouraging it to back off. It would thereby entrench the 65 per cent domestic market share Qantas has set as its line in the sand.

But even putting aside the resulting damage to competition, that is scarcely a scenario with which government could feel comfortable. Yes, the ownership restrictions in the Qantas Sale Act unfairly hamper Qantas's ability to tap external funding, just as the restrictions on where it can undertake activities such as maintenance crimp its competitiveness; but loan guarantees would introduce far-reaching distortions of their own.

After all, loan guarantees and unsecured loans invite excessive risk-taking, as it is the guarantor that bears the risk of failure, while any up-side from the risk accrues to other investors. That is why banks whose deposits are government insured are tightly regulated: to prevent them from gambling in situations where profits are privatised but losses socialised. Yet Qantas was seeking privileges similar to those granted banks that are "too big to fail" without any form of prudential regulation to protect taxpayers' interests.

In practice, that situation could not have endured. Sooner or later, government would have been dragged into the firm's internal processes so as to monitor against rash decisions; and inevitably, political pressures would intrude on the government's involvement, making it even less likely that Qantas's efficiency problems would be addressed.

The international experience suggests that is not a road to which there are happy endings. In the EU, for example, state aids to airlines are subject to stringent control by the European Commission, with the goal of ensuring they are temporary, targeted and proportional; but even so, airlines that receive bail-outs in any one year are likelier than not to require further support three years later.

Little wonder both Hockey and Abbott turned against providing Qantas with concessional finance. Instead, Qantas has to get its house in order; and the primary burden in doing so must lie on the company itself.

That is all the truer as Qantas has not always used the scope it has to tackle its cost disadvantage. In the lead-up to Work Choices, for example, Qantas lobbied to ensure the legislation provided the ability to renegotiate legacy contracts; yet when Work Choices gave it that option, Qantas largely let matters stand, perpetuating the cost penalty that is now causing it grief.

Nor is it clear last week's restructuring plan goes far enough. It will leave Qantas with a simpler, more effective fleet and with lower overheads; but it does not reduce costs sufficiently to make the European and Asian routes profitable, while it retains the line in the sand for which Qantas is paying a heavy price.

That line in the sand may well be doing the company greater harm than good. In particular, Qantas's commitment to more than match its rival's capacity means it is Virgin, not Qantas, that determines the capacity Qantas must offer and hence the costs it must bear.

Moreover, when an airline expands capacity, the most immediate impact is on its own prices, not those of its rivals. The line in the sand therefore gives Virgin the ability to raise Qantas's costs while shrinking its revenues.

Qantas's concern is that without capacity pre-eminence, its domestic revenue premium may fall below the levels needed to offset its cost disadvantage. But that should make Qantas's board all the more determined to eliminate the airline's excess costs. With those costs gone, both Qantas and Virgin could be viable in a more symmetrical duopoly.

However, that outcome is hardly a sure thing: if Qantas's costs remain too high, its position could unravel. Australia's experience with the Ansett collapse suggests new capacity would rapidly emerge: it took Virgin less than two years to capture one-quarter of domestic traffic. And in no major market has the disappearance of the once dominant incumbent left a hole rivals didn't fill.

But it would be unrealistic to ignore the transition costs a crisis at Qantas would impose, as well as the damage to Australian tourism. That makes it crucial that Qantas be given the best chance to compete, which requires repealing the sale act.

Unfortunately, Qantas's stubbornness about its line in the sand is rivalled only by Labor's grim determination to keep its head in the sand on the sale act. Nor is the ostrich analogy misplaced: the opposition's stance is worthy of a creature whose brain, as a ratio to body mass, is 17 times smaller than a chicken's. And the ostrich is of course flightless, surviving mainly on farms where it is bred as a source of leather, feathers and burgers. If that is Qantas's future, it is not one worth having. But it may well encapsulate what Labor wants: a corporate landscape of evolutionary leftovers, sheltered on their way to extinction, providing taxpayer-funded fodder to its union mates.

Nothing could be further from Abbott's vision; nor could anything be further from what is needed to protect jobs and prosperity. But it will hardly be easy to retain the resolve the Coalition displayed last week.

As the stresses accumulate, Abbott will have to show he can be as consistent in pursuing that vision as he has proven tenacious in its defence.