

AIR TRANSPORT AND THE CHALLENGES FOR 2010

Terry Markman

Terry Markman Consultant, P O Box 785121, Sandton 2146

ABSTRACT

This paper discusses the airline policy that needs to be introduced for the airline industry to cope with the growing demand and be ready for 2010.

The paper argues that, for the airline industry to become more responsive to market forces, SAA should be privatised. This will create a more stable environment and encourage more airlines to enter the market. The management of a privatised SAA and the private airlines will be able to focus on running their airlines rather than be concerned with political issues or spend senior management time dealing with matters such as the Competition Commission. The Government will become the referee and not be an operator and regulator at the same time. The paper draws lessons from the international trend towards privatising of state owned airlines. Unfair competition will be eliminated as SAA, unlike the private sector, is allowed to make losses. The paper discusses the cost of subsidizing SAA and question whether this is a sound policy.

The policy should also allow more competition from international airlines. This would benefit all passengers, the tourism industry and increase employment in the tourism industry. It will be argued that, just as passengers have benefited from deregulation of domestic air transport, so will international passengers benefit from more competition from international airlines.

1. INTRODUCTION

The South African airline industry has undergone a major change— probably the biggest change in its 70-year existence - since deregulation of the domestic airline industry in the early 90's. At that stage it was estimated that SAA had more than 95% of the domestic airline market. Since then SAA has lost market share to airlines such as Comair (which in 1990 had 1 or 2% of the market) and other newcomers and is now estimated to have between 50% and 55% of the domestic airline market.

Passengers have benefited enormously from the increase in competition arising out of the deregulation. Prices of air travel have reduced dramatically and frequencies have improved. More passengers than ever before are now flying, many of whom could not afford to do so before the deregulation of the industry.

At the time of deregulation it seemed likely that SAA privatisation would follow to level out the playing fields. This was partially done in 1999, when 20% of SAA was sold to strategic equity partner Swiss Air for R1,4bn giving SAA a value of R7bn. When Swiss Air went bankrupt the South African Government bought back the shares in 2002 for R382m. Whilst this might appear to reflect a 'profit' of R1bn, it is really a reduction in the value of SAA of about 72% - from R7bn in 1999 to R1,9bn in 2002.

SAA's operating profit and loss figures over the past six years do not reflect a healthy airline. It is not easy to obtain consistent figures as every year the disclosure is changed (either sale and leaseback of aircraft, or exchange gains, or other revaluations) to reflect the most positive situation. For the purpose of this paper it is sufficient to note that SAA has lost billions of rand. This is in stark contrast to Comair, which has made a profit every year since 1946 when it commenced operating in.

In March the Minister of Public Enterprises told a parliamentary briefing that as the second-oldest commercial carrier in the world SAA was 'a national asset that had to be preserved' (Financial Mail 9.3.2007). In the light of the substantial losses, it is difficult to understand how SAA can be referred to as an asset rather than a liability.

In July last year Transnet decided that SAA was not part of its core business and, realising that SAA was a liability, it decided to cut its losses and sold SAA to the Department of Public Enterprises for R2bn thus ignoring or writing off an R8,4bn loan. The SAA Bill to be passed some time this year will formally sever the airline's links to Transnet. (Financial Mail 9.3.2007) A major concern about the transfer is that the Department of Public Enterprises will not produce future financial statements and thus there will be no accounting for future losses.

There is a growing consensus that SAA should be privatised to save taxpayers billions of rand. The CEO of SAA is on record as saying that he would like to see SAA privatised. However the Minister of Public Enterprises has said that SAA should remain state-controlled. He says that selling shares on the stock exchange is an attractive idea but the timing is not right as SAA is financially weak and will take a few years to turn around. His priority is to stabilise SAA's finances and recapitalise it. (Financial Mail 9.3.2007) The Minister has also written to SAA chairman Jakes Gerwel stating that SAA "cannot and will not be supported at all costs".

In the light of the above, the advantages and disadvantages of privatising SAA are discussed below.

2. ADVANTAGES OF PRIVATISING SAA

There are numerous advantages of privatising SAA. Some of these are as follows:

2.1 Taxpayers will not have to subsidise SAA.

It is estimated that SAA's losses have exceeded R20 billion. These losses, paid for by the South African taxpayer, are made up of an accumulated loss of R11,2 bn and an outstanding loan to Transnet of R8,4 bn. The loan is from R6bn recapitalisation in 2004 and a R4bn loan in 2006 of which R1,6bn was repaid to Transnet and R2,4bn was converted to equity i.e. recapitalisation.

SAA's balance sheet remains weak and it is dependent on taxpayers funding. A good indication of the serious financial crisis that SAA is facing is that last year the CEO said that there was a need for the government to bail out SAA yet again with a R4 billion 'recapitalisation package' as a turnaround strategy. And it appears as if he has the support of the Minister.

Instead of a 'turnaround', SAA's external auditor, Deloitte & Touche, says SAA spent R283 million 'without proper controls' in 2004-05. According to SAA Chairman, Jakes Gerwel, he has 'never, or seldom, entered an organisation where systems were so lacking'.

Privatising SAA will not only save taxpayers from the cost of subsidising SAA's losses, but taxes could be reduced because of increased tax revenue from a privatised SAA.

2.2 The poor will no longer subsidise the rich

Subsidisation of SAA's losses means that taxpayers are subsidising those who travel by SAA. It should be borne in mind that those who travel by air are amongst the wealthier section of society and hence there is a strange anomaly of this wealthier section of society being subsidised by taxpayers many of whom never travel by air and are amongst the poor. Whilst this is surely not an intended government policy, it nevertheless is the de facto situation.

A fundamental question is whether Government should run an airline serving predominantly rich people at massive losses when private operators can and, when permitted, do provide all the economy's needs efficiently and profitably? The answer must be a resounding 'NO'.

2.3 Unfair competition from SAA will be eliminated.

At present the state-owned SAA competes with the private airline industry. However, unlike the private sector, SAA can and does make losses with the certain knowledge that Government will bail it out. This can only be described as 'unfair competition' as the private sector does not have this luxury. When the private sector makes losses it goes out of business. With privatisation unfair competition by SAA will be eliminated.

2.4 Depolitisation

Privatisation of SAA will mean that the new management of SAA will be able to focus on running the airline rather than be concerned with political issues or spending senior management time dealing with matters such as the Competition Commission.

2.5 Misallocation of resources

Losses are a signal from the market that something is wrong – that the business should not be in business as it is either inefficient or not providing what the consumer wants. However Government ignores these market signals, as it does not allow SAA to go out of business. This means that SAA can continue to operate unprofitably or inefficiently or provide a service for which there would be no demand but for the subsidisation. SAA is also keeping the existing airlines from further expansion or new airlines from entering the market and providing passengers with what they want. This results in a misallocation of resources.

With privatisation misallocation of resources in the airline industry will be eliminated.

2.6 Privatisation will encourage more airlines to enter the market

At present there is a great deal of uncertainty about when and how SAA will be privatised. It has recently moved in the opposite direction by starting a low fare airline, Mango, which is competing directly with the low cost airlines initiated by the private sector. SAA should not be doing this anymore than Government should be opening up new supermarkets. At the time of writing this paper there is much debate about whether Mango is profitable or not. Whilst it has been stated that Mango has been ring fenced and will not be subsidised, it is unlikely that the taxpayers will ever know if SAA subsidises Mango.

Senior management of the private airline industry spends valuable time addressing the activities of SAA and its new subsidiary Mango or dealing with matters such as the Competition Commission. It will be much more productive for them to focus on running their business and to provide the passengers with what they want once SAA is privatised.

Thus privatisation of SAA will create a more stable environment that will encourage more airlines to enter the market, as the private airline sector will 'only' have to deal with the market and not unfair competition from SAA.

2.7 Government will not have a conflict of interests

At present the government is both player and referee. This is particularly so for international services where it is an airline operator and also responsible for allocating routes. It often means that the demand for new routes by other airlines are refused because SAA objects. Clearly the travelling public is at a disadvantage. The tourist industry is also concerned that this has a negative impact on the number of tourists visiting SA.

With privatisation the Government will become the referee only. Privatisation of SAA will mean that government will no longer have to contend with the conflicting interests of maintaining a just dispensation for all airlines in the interest of consumers and government ownership of SAA.

2.8 A positive impact on tourism

As mentioned above the tourist industry will benefit from privatising SAA, as there will, in all likelihood, be more airlines flying into SA making it easier and cheaper for tourists to visit SA. The increase in tourism will create more jobs in the tourism industry. It is estimated that about 7 to 8 tourists create 1 job.

2.9 Consumers will benefit from improved service

The fact that state-owned SAA is heavily subsidised means that their airfares are lower than they would be without subsidisation. Thus if SAA's subsidy were removed it would appear that airfares would have to be increased. However, the evidence throughout the world is that, following privatisation, consumers benefit from improved service and lower airfares largely as a result of increased efficiency.

2.10 Job creation

The CEO of SAA has acknowledged that privatisation of SAA will result in job losses. This is not surprising as state-owned enterprises (SOEs) are mostly, if not always, less efficient and employ more people than private enterprises per unit of production. However, whilst some SAA employees will lose their jobs and this must be fairly dealt with when SAA is privatised, there will be other jobs created in both the new and existing airlines as well as the tourist industry.

2.11 The only way to 'save' SAA

No one wants SAA to disappear. On the contrary, SAA's experience since domestic airline deregulation fifteen years ago shows that it cannot survive without perpetual wealth-consuming subsidies, which the Minister said would no longer be available. Like his predecessors, the Minister assured Parliament the Government would not 'bale out' SAA or other parastatals in future. No one knows if the Government will stop pouring money to keep SAA afloat, but we do know that SAA will survive only if it is emancipated before that happens.

Privatisation would enable SAA to survive and prosper like other privatised airlines as discussed below. The self-interests of our 'national asset', its management and staff are for SAA to be privatised before being forced into 'liquidation'.

3. DISADVANTAGES OF PRIVATISING SAA

3.1 Strategic argument

It is sometimes argued that SAA needs to be retained as a state-owned airline for 'strategic' purposes. However the exact strategic reason is seldom stated. Is SAA a strategic industry? Does SA need a 'national flag carrier'? Are certain routes strategic? It is imperative that the Government provides a clear definition of what is 'strategic' so that it is not an excuse for covering up SAA's failures. Certainly there should be a 'compelling reason' and 'exceptionally pressing circumstances' for the cabinet to divert R4 billion from health, housing, education and policing to SAA just three years after the preceding bailout?

One possible strategic reason is that the private sector will not be able to handle the **demand**. There is really no basis for this argument as the private sector has shown that it is more than capable of providing airline services in South Africa and elsewhere throughout the world wherever there is sufficient demand and it has been allowed to do so. The Government may decide that **certain routes**, which would not be served by the private sector because of insufficient demand, should be served. This is not a reason to have a state-owned airline. Such routes could be put out to tender. This would be far cheaper and the Government would know the exact cost of the 'strategic' route.

It should also be borne in mind that the method of privatising SAA could take into account that the Government may not want to allow **foreign ownership** of SAA. Whilst this view is not supported by the author, there are mechanisms that can be introduced to ensure that the airline is retained in South African hands. One such mechanism that was introduced when BA was privatised is to have a 'golden' share. This allowed the British government to veto the sale of the airline to foreigners. This 'golden' share has since been removed.

Another argument is that control is necessary in case the Government needs to commandeer planes during a **national crisis**. But all that's required – if sufficient charter flights cannot be purchased from international operators - is for there to be other locally owned airlines.

Another reason given by the Minister in Parliament on 2 March 2007 is that SAA is a 'national asset that had to be preserved' because it is 'the **second-oldest commercial airline** in the world'. Were this true, critics can be forgiven for not regarding the romance of history as sufficiently compelling. As it happens, SAA was established in 1934 when Union Airways (1929) was nationalised. The oldest commercial airline (with its original name) is KLM (1919). Lufthansa was created in 1926, and Air France in 1933 (when French airlines were nationalised). Many USA airlines pre-date KLM. After mergers and acquisitions they were consolidated into some of today's airlines during the 1920s and 1930s.

3.2 The need for a flag carrier

Most countries have or used to have state-owned airlines. America is one of the few exceptions. One of the reasons often cited is the need to have a flag carrier and that privatisation will result in the loss of a flag carrier. There is no logic to this argument. Any country can have a flag carrier more economically by entering into a contract with a private airline to operate as the country's flag carrier. Thus privatization would not have to mean the demise of the flag carrier.

3.3 Job losses

SAA currently has about 11000 employees. As part of the restructuring process SAA wants to retrench staff with up to 3000 jobs being at stake (Fin Mail 9.3.07). This is to increase efficiency and reduce the losses. If SAA were to be privatised any job losses would have to

be addressed as part of the privatisation process. Aer Lingus, which is discussed below, provides an example of what can be done. It is understood that many jobs have already been lost in SAA, as the employee-passenger ratio has fallen. However deregulation has already contributed substantially to market growth, so that there are more employers and more jobs in the airline sector. In addition, as discussed above, the privatisation of SAA will result in additional jobs being created in the tourist industry and by the new airlines. It is extremely probable that the privatisation of SAA will result in jobs being created.

4. METHODS OF PRIVATISING SAA

There are a number of different ways to privatise SAA. This paper only briefly summarises these. The final decision should be based on a more thorough analysis of the various methods.

4.1 Commercialise SAA and set a programme

Whatever method of privatisation is finally adopted, it is essential that SAA remain a commercial entity and not be 'lost' in the Department of Public Enterprises. Most, if not all, of the successful airline privatisations that have taken place have followed the establishment of a company with the government being the sole shareholder. This provides prospective purchasers with the necessary financial history of the organisation. In addition a date must be set by which time privatisation must have taken place. Unfortunately, in the case of SAA, this has not been done.

4.2 Sell the entire airline (as a going concern)

This is a fairly straightforward method but unfortunately is not often implemented, as there is often reluctance on the part of governments to part with 100% of state-owned enterprises (SOEs). The reluctance to sell 100% of SOEs can sometimes be addressed by the 'golden share' discussed above in section 3.1.

4.3 Sell portion initially and the rest by a certain date

This is a variation of the above method. A possible advantage is that should the semi-privatised SAA do well, the Government will benefit from an increase in the value of the airline when it sells off the remainder. The disadvantage is that Government may decide to hold onto the remaining portion for too long or even repurchase the portion sold (as was done in 2002 when Swiss Air went bankrupt and the Government bought back the shares) and the advantages of privatising SAA, as discussed above, will be lost.

4.4 Split SAA into domestic and international airlines and sell each portion separately

This method of privatising SAA may have certain benefits that should be carefully evaluated. One possible benefit is that the market for a domestic airline is different to that for an international airline and thus there would be more interested parties bidding for each portion, which may result in a higher selling price. It would still be possible for one bidder to purchase both portions or for the domestic and international airline companies to merge at a later stage if there were an economic advantage in doing so.

4.5 Give or sell some or all of the shares to employees or blacks

Sono has argued that the fairest way of redistributing wealth is to transfer state owned assets to the previously disadvantaged. (Sono 1999) There is a curious national mindset which regards BEE as the transfer of assets from whites to blacks, yet by far the fastest, cheapest, most substantial and nationally most beneficial way to empower blacks is by redistributing the vast amount of assets such as SAA accumulated by and inherited from the apartheid regime. The Telkom privatisation is a case in point where a percentage of the shareholding was allocated to poor black empowerment investors.

Instead of using SAA for BEE purposes, nearly half of it has already been 'privatised' without blacks getting any shares or the government getting a single cent. On the contrary, billions of Rands have been diverted needlessly from taxpayers and the poor for decades.

4.6 Privatisation-by-default

The official line is that the government hasn't privatised SAA. In truth, nearly 50% of SAA's domestic arm has been 'privatised' since deregulation 15 years ago, yet this is never mentioned nor did the government get one cent for it. How this was done?

Most people would have expected the Government to sell the privatised share of SAA, which would have had the double benefit of converting dead capital to beneficial revenue and cutting losses. If this were not done one would have thought that the Government would have given shares directly to beneficiaries (BEE beneficiaries, competitors, investors, employees, politicians etc). Not many people realize that nearly 50% of SAA's market share was given away simply by allowing others to take it. In effect, when the Government allowed market entry, it gave about 45% of SAA to people it didn't know, some of whom weren't even in the industry.

The benefits of privatisation-by-default are obvious to all observers, as are the hazards of the Government giving away market share (by allowing competition) and then trying to recapture it (with subsidies and restructuring). This disrupts markets at the ultimate expense of consumers and, of course, competitors who cannot always survive the impact of the Government's unpredictable assaults on and withdrawals from the market.

4.7 Restructuring

There has been much discussion of restructuring SAA over the past few months. It is important to realize that this is **not** a form of privatisation. Whether the restructuring proposals will achieve the objective of eliminating SAA's losses remains to be seen. What is of concern is why it has taken losses of billions of rand before undertaking such a necessary step and how many more billions will be lost before further restructuring proposals are tabled. The answer lies in the very nature of SOEs whereby there is not continuous pressure on management to make profits, as is the case in the private sector. It is extremely unlikely that any measure other than privatisation will result in SAA being run profitably.

5. LESSONS FROM INTERNATIONAL AIRLINE PRIVATISATION.

Since British Airways was privatised in 1987 for \$1,37 billion there have been numerous other countries that have privatised their airlines. British Airways had started to make changes a few years before it was privatised to get its house in order and, as a result, changed from an unprofitable to a profitable organisation. Since privatisation, British Airways has become 'the world's favourite airline', carrying more international passengers than any other airline – 26.6 million in 1996. In 1994, BA profits amounted to one third of all profits recorded by IATA registered airlines.

The privatisation of the Austrian airline began in the late 1980's when about a quarter of its shares were sold and the Netherlands also reduced its share in KLM.

Aer Lingus was privatised in April 2007 when the Irish Government sold off the majority of Aer Lingus through an Initial Public Offering. This was nearly a decade after it first announced its intention to privatise the carrier. Aer Lingus said it raised 472m euros (R4,7bn) through the floatation and the government said it would net about 200m euros (R2bn) from the sale of the airline. As part of the deal, the government earmarked

approximately 10,8m euros (R107m) for an employee trust, which benefits more than 6 000 current and former employees.

Australia used to have a most unusual airline policy, called the “two-airline policy”. There were two airlines: Tran Australian Airlines, which was state-owned, and Ansett, which was privately owned. The rules for the two airlines were absolutely identical. They had to buy the same equipment, serve the same routes and charge the same fares. The only difference was that the privately owned Ansett, was twice as efficient as the state-owned airline. This is a textbook case study – two competing businesses, one private, one state-owned – to show that the private sector is more efficient.

New Zealand airlines have been privatised, and the airline industry has been deregulated. The results are absolutely typical of what is happening wherever airline deregulation occurs. The door-to-door level of service has improved; the range of fares available to passengers has increased, with a variety of discounted fares; the frequency of services to most centres has increased; and the airport facilities have been improved.

49% of Air Botswana, the national carrier, was due to be sold to SA’s privately owned Airlink in May 2007. Airlink was selected as the preferred bidder in November last year and was expected to start operating Air Botswana in September this year. The sale, which was at an advanced stage, was blocked recently by parliament saying that the process was not fully explained to legislators. At the time of writing it is not clear whether the process has been suspended or a new round of bidding will be opened. Earlier initiatives to privatise the airline failed mainly due to the depressed conditions in the global civil aviation market after 9/11 six years ago. Air Botswana lost 19m pula during 2005-06 and a similar loss is expected for 2006-07. Other problems include an ageing fleet, unreliable schedule, and the inability to retain or attract qualified pilots. (The Weekender 7.4.2007) It appears as if the privatisation will proceed once the method has been resolved.

The loss making Kenya Airways was partially privatised in 1997 when the Kenya Government sold 26% to KLM and 14% to other foreign investors. The airline is now growing and profitable. Last year it made a \$126m (R900m).

The lessons from international airline privatisation are that the private sector turns loss making state-owned airlines into profitable ones, the service improves and the fares are reduced. Thus passengers are far better served by privately owned airlines.

6. FUTURE POLICY

For many years SAA has tried to reduce costs to become profitable. Contrary to what three successive managements have told the South African public, SAA has made massive losses and the current management doesn’t appear to be solving the problem. During this period, SAA bought R60bn worth of new airliners to ‘increase profitability’, which never came to pass.

Consultants have been brought in. The former head of Transnet, Saki Macozomo, brought in Coleman Andrews to restructure SAA and prepare it for privatisation. All these moves have not had the desired result. The restructuring currently being considered is likely to have the same results.

One commentator said that SAA needs privatisation, financial discipline and professional management. However, all that is needed is privatisation. Financial discipline and professional management will follow.

Jim Harris, an independent economic researcher, said that privatisation had failed in South Africa because of a case of too little too late. 'With privatisation, speed is essential. If you take your time, market conditions will have changed. Privatisation is working in New Zealand and Australia, and in countries in the former Soviet block. It is the only way of turning around failing government-owned industries.'

It has been argued that SAA does not need to be retained as a state-owned airline for 'strategic' purposes.

If taxpayers are to be saved from further funding of SAA and if SAA is to meet the challenges of 2010 and beyond then the airline industry must be free to respond to market forces and the privatisation of SAA must take place as quickly as possible.

In 2000 the African Economic Union met at Yamoussoukro to implement an open skies policy. Not much has happened since then. Having introduced a domestic 'open skies' policy in 1992, SA should lead the way in Africa and internationally. As a start we could enter into an 'open skies' agreement with the EU who want to have such an agreement with the USA. This would allow more competition from international airlines and would benefit all passengers, the tourism industry and increase employment in the tourism industry. Delta – the first large American airline to fly to SA – reported that demand for seats on its new service had been amazing. The recent International Air Transport Association survey showed that Africa was the region with the second-highest passenger growth rate. To meet the increase in demand, airlines must be free to be able to start new services without any barriers placed in their way. Just as domestic passengers have benefited from the deregulation of domestic air transport, so will international passengers benefit from more competition from international airlines.

The airline industry in SA was started by private sector. It is time to return it to the private sector.

7. REFERENCES

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