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PAROCHIALISM IN INTERNATIONAL AVIATION: THE PARADOX OF AIRLINE OWNERSHIP AND CONTROL

**DAN EDWARDS, SENIOR POLICY ADVISER ON INTERNATIONAL AVIATION,
UK CIVIL AVIATION AUTHORITY (CAA).**

Aviation ownership and control: a global anomaly

Open the business pages of any newspaper and mergers and buyouts are everywhere; in every major sector of the economy, companies are driving and adjusting to change by partnering with or acquiring others. Steel producers, oil companies, telecommunications and airports are all fair game (with a few high profile exceptions!). Airlines seem to feature frequently too. News at the time this piece was written included Continental and United Airlines in merger talks; and a consortium led by Macquarie bank, seeking to acquire the Australian flag carrier, Qantas. However, one doesn't have to read too far before a subtle but important distinction between the deals being done in other sectors and those determining the future structure and performance of international airlines; they just seem that little bit..., well... "parochial"; US airline buying US airline, Australian bank buying Australian airline.

This is more than coincidental. The global airline industry's structure is governed by ownership and control rules which forbid foreigners from taking control of "national" airlines. These rules exist in two "planes" (forgive the pun): the first being national laws which prevent foreigners owning or taking control of airlines. In Australia, the Qantas Sale Act forbids ownership of Qantas by foreigners. In the US, the Civil Aeronautics Act states all airlines must be 75 per cent owned and controlled by Americans. European licensing regulations, whilst allowing cross-border acquisition within Europe, still require that European airlines must have majority European ownership and effective control. And similar laws exist in most countries.

The second plane of limitations is the myriad of bilateral agreements that enshrine ownership and control restrictions by tying the hard-earned traffic rights negotiated between two countries only to airlines whose owners share the nationality of one or other of the negotiating countries. This is what Professor Brian Havel, Director of the International Aviation Law Institute at De Paul University in Chicago, calls the "double lock" of regulation on the aviation industry's commercial freedom.

The airlines' response has been to form alliances which stop short of full merger, in an attempt to mirror the advantages other sectors perceive can be achieved through mergers. Typically, the benefits of such agreements are limited largely to marketing advantages, more extensive integration that could yield operational or strategic advances are not usually feasible.

For an industry that takes pride in connecting the world and facilitating business, such restrictive nationality-based rules and regulations seem paradoxical. The concept of foreign ownership and control of assets has been accepted by most market economies, even in sensitive sectors such as oil and defence. However, airlines have always been treated as being that little bit special. But, as the tide of ownership and control restrictions has receded in these other sectors, so airlines have been left high and dry, exposed as a particularly conspicuous anomaly in a world where trade liberalisation has become the norm.

Such an obvious anomaly deserves closer examination, particularly when partial market access reforms such as “Open Skies” now seem widely accepted by Governments in the western world and have stripped away many of the other traditional regulatory controls on frequencies, destinations, and the number of airlines allowed to operate. This is why the CAA recently published *Liberalisation of Ownership and Control: A Discussion Paper*¹ looking at the issue in detail and focusing on the aforementioned regulatory barriers to change. The paper examined in turn whether strict ownership and control rules bring benefits to the industry and its passengers; whether any objective justification for such strict controls exists, particularly in the all-important areas of safety and security; and whether liberalisation in this area can be achieved in a way that is fair, safe and sustainable. The paper’s conclusions are summarised below.

Reform has brought benefits where introduced

The first thing the paper found is that reform of ownership and control has already been achieved in some areas and that, where attempted, liberalisation has brought benefits to the industry. The European Single Aviation Market is the biggest and best-known example of a cross-border “Open Aviation Area”. The EU model goes beyond the more limited “Open Skies” model, in that all restrictions on ownership and control (at least for EU citizens in the case of Europe) are removed as well as lifting limits on traffic rights. Liberalisation in Europe has enabled new airlines such as Ryanair and easyJet to emerge – carriers focused on operations to destinations within the liberalised boundaries of Europe and operating services with no connection to the country granting their operating licence, e.g. easyJet operating services outside of the UK. Established airlines have also taken advantage of the added flexibility created by these changes to restructure; arguably, Air France’s merger with KLM in 2004 was only possible because of the emergence of the concept of European rather than national designation, although lack of third country recognition of the merged airline’s “dual nationality” means that the company is still structured as two separate operating units under a parent board. Ownership and control liberalisation has also occurred in Australia and New Zealand, where domestic airlines have been opened up to foreign investment. For the managers of these commercially successful airlines, the question of which nationalities have a stake in the company is irrelevant.

Evidence from Europe and Australasia suggests such changes are positive for the industry and its users. Airlines are complex, capital-intensive companies and access to cheaper foreign capital and management resources, combined with opportunities for restructuring, could provide opportunities for efficiency savings and synergies, available to other sectors but hitherto denied to airlines. For consumers, the possibility of closer integration between currently nationality-tied airlines and the emergence of new entrant airlines, all with better access to global capital sources, offers the potential for more competition, greater network connectivity and better value services.

For employees, the story is also positive. Common sense and economic theory (not always the same thing) suggest that an airline industry that is more able to respond flexibly to demand should create jobs, not destroy them. This is illustrated by the fact that employment in aviation across Europe increased considerably over the first ten years of liberalisation. It is not difficult to see why these jobs have been created close to home too; airline cabin crew and pilots are highly trained employees, with a close interface with the passenger. This makes it harder for airlines to recruit cheap, unqualified labour from third countries (as is perceived to have widely occurred in the maritime sector). Operational requirements also mean that the airline workforce needs to be located near the airline’s “centre of gravity” – e.g. its operational centres. The experience from Europe and elsewhere also suggest that liberalisation drives innovation and growth in aviation services, to the benefit of employees.

But what about safety and security?

So, removing ownership and control restrictions seems to make commercial sense to airlines, their employees and their passengers. But none of this would matter if there were any suggestion that safety regulation could not be effective in a world where airline ownership was opened up.

Undoubtedly, there could be practical issues relating to the day-to-day enforcement of safety in a globally liberalised aviation sector. For example, removal of ownership and control restrictions may lead to changes in the historical pattern of airline operations. In the past, an airline’s entire operation would radiate out from no more than a handful

¹ The full report can be found on the CAA’s website at <http://www.caa.co.uk/docs/33/CAP769.pdf>

of airports in the airline's home country. Regulating the airline was consequently relatively straightforward for the safety authority in terms of access to personnel and aircraft. In a future with fewer ownership and control restrictions and freer access to markets, airlines will be free to operate services which never touch down in the regulator's home country.

The paper proposes some changes to the way that the licensing process operates, which may in turn help to facilitate the regulation of safety. Current regulations governing the licensing of carriers state that an airline can only seek a licence from the country in which it has its principal place of business. The CAA believes there are strong arguments for insisting on a strengthening of this requirement so that a significant level of a carrier's operations must be based in the country where it is licensed and regulated. This would stop airlines simply "brass-plating" their operations in countries with no or little operational connection to the airline, and strengthen the lines of accountability and facilitating effective day-to-day regulation of a significant part of the carrier's operations.

In this environment, national and regional safety authorities will need to cooperate more closely to share information and functions across national boundaries. The paper examines some options for closer cooperation, including the possibility of agencies basing staff abroad to check these overseas operations, or the licensing authority "contracting out" its operations to safety authorities in those countries. To some extent, this already happens, with a number of European airlines licensed by one Member State yet operating largely from another. The evolution of supra-national safety agencies may be part of the natural solution to this problem, as common and homogenous standards can be set (but enforced by local safety agencies). But even in Europe where the concept - in the form of EASA - is most advanced, more time is needed before the system can be seen to be delivering consistent performance across the whole of the EU.

The airline industry is also taking steps to improve and standardise its own safety audits. IATA operates an operational safety audit programme (IOSA) that is mandatory for its members but is also applicable to any airline. IOSA audit standards are based on ICAO provisions, as well as those from key regulatory regimes and industry best practices. Several states are now using IOSA audit data to assist them in their discharge of their safety oversight functions, with IOSA becoming a key tool to help raise the safety bar on a global basis.

To avoid a dilution in standards, the paper proposed that foreign Governments wishing to join an existing Open Aviation Area, will have to demonstrate, as a prerequisite, that their safety standards are at least equivalent to those in place within the markets where controls have been lifted. Rather than seeing this as an obstacle to liberalisation, it should be viewed as an opportunity to provide an added incentive for third countries to raise their safety standards, as without improvement, countries and their airlines will not be able to fully access liberalised markets.

The CAA also examined the sensitive issue of national security. Here, it found no evidence to suggest that the security measures in place at present should be inapplicable in a liberalised world. In Europe, where discrimination between European investors is illegal, and foreign ownership of carriers is common, there has been no diminution of security standards and there is no reason why there should be; national security procedures are a matter of national sovereignty and are unrelated to the nationality of an airline's shareholders or their management. A mechanic, pilot or passenger should be subject to the same checks irrespective of whether Europeans, Asians or Americans have a majority shareholding. In any event, the law on mergers and acquisitions in the UK, the US and elsewhere typically provides powers for the Government to block a deal where it is considered to pose a threat to national security. A blanket ban on foreign ownership is therefore unnecessary on security grounds.

Liberalisation should be linked to a level playing field

There are a number of other areas apart from safety where ownership and control liberalisation may create concerns about the distortionary impact of different regulatory approaches applying to competitors in the same market. Such differences could be biased in favour of particular airlines and so threaten the efficient operation to the industry and ultimately its passengers. The principal concerns relate to the operation of different regimes governing state aid and competition but could also cover other areas such as environmental regulation. These concerns are not easy to tackle; differences in local law and practice may in fact make it nearly impossible to harmonise regulation of aviation across a number of countries. A pragmatic approach is needed to this problem that accommodates these differences

whilst establishing broad principles governing what is acceptable. This is best described as “regulatory convergence”.

Requiring partner countries to sign up to a commitment on competition and state aid is one solution that would enable a carrier’s behaviour to be measured against broad, enforceable principles. Prohibitions on, amongst other things, anti-competitive behaviour and the granting of state aid capable of distorting competition could be enforced through the application of this code of practice, a dispute settlement procedure would be necessary, either in the form of an ICAO-based arbitration process or the existence of a special committee of members tasked with examining and investigating complaints.

Another concern for policy makers is that a third party might seek to exploit the advantages created by a liberal inclusive agreement between other states, whilst withholding comparable opportunities from foreign investors. It therefore seems sensible to offer ownership and control liberalisation only to those countries prepared to institute similar arrangements. Such “non-circumvention” agreements would remove the concerns associated with such “free-riders” whilst broadening the pool of capital and management expertise available to airlines. However, it should be acknowledged that such an approach would require signatory states to continue to monitor the nationality of ownership and control to enforce compliance.

The future is multilateral?

So who should lead the way to this new world of airlines unshackled from unnecessary regulation? Well, reform of national legislation requires politicians and decision-makers to stand up to those vested interests that oppose change for the wrong reasons. Not an easy task but one that is solely in the gift of the country involved. For the second plane of restrictions – international bilaterals – a unilateral approach is impossible. Negotiation and agreement with other countries is needed and bilaterals remain the main forum for discussion, although in some jurisdictions the picture is becoming more complex. For example, within Europe, liberalisation has been driven by action at the supranational level, including measures to free up constraints on ownership and control.

The rationale for more supranational leadership in aviation is strong. The restrictions placed on airline ownership in bilateral agreements mean that reform at a national level is difficult. Arguably, in Europe, the balance of benefits has already tipped in favour of supranational bodies leading negotiations on liberalisation. This is not uncontentious; a number of countries within Europe have resisted the proposition that the European Commission should take more of a leading role in the liberalisation of aviation relations. Ideally, as the European Union is currently doing, peripheral countries could be added to the liberalised areas, gradually expanding the Open Aviation Area within which ownership and control would be open to all members.

A further development of this argument might be that the ultimate future of aviation lies in globally brokered agreements, possibly utilising international forums such as ICAO or the WTO (General Agreement on Trade in Services). In practice, however, wide differences between regional blocs, differing Governmental positions on liberalisation, and the varying levels of development within the aviation sector means that progress through such forums is likely to be extremely difficult. For the time being at least then, bilateral or region-to-region discussions such as those currently taking place on EU-US look like the best way forward.

Truly international airlines

In conclusion, liberalisation of ownership and control is essential to the healthy development of a truly global industry, introducing freedoms for airlines that should bring considerable benefits to the industry and its users and play a considerable role in enhancing related global economic activity. Care needs to be taken to navigate the transition to a world of liberalised ownership and control, and the paper suggests some adjustments to the traditional approach will be needed. These changes are not radical and have already been road tested and shown to work; it is therefore up to governments and regulators to recognise the benefits to airlines, passengers and the broader economy that these changes will bring. Without them, the airline paradox will remain, as will structural rigidities in the market that may contribute to poor economic performance, and airlines will be truly international only in name.