Ownership and Control Liberalisation

a discussion paper

CAP 769

Economic Regulation Group

Civil Aviation Authority

CAP 769

Ownership and Control Liberalisation: A Discussion Paper

www.caa.co.uk

October 2006

© Civil Aviation Authority 2006

All rights reserved. Copies of this publication may be reproduced for personal use, or for use within a company or organisation, but may not otherwise be reproduced for publication.

To use or reference CAA publications for any other purpose, please contact the CAA at the address below for formal agreement.

ISBN-10 0 11790 686 7
ISBN-13 978 0 11790 686 0

Published October 2006

Enquiries regarding the content of this publication should be addressed to:
Economic Regulation Group, Civil Aviation Authority, CAA House, 45-59 Kingsway, London WC2B 6TE

This document is available in electronic format at www.caa.co.uk/publications.

Published by TSO (The Stationery Office) on behalf of the UK Civil Aviation Authority.

Printed copy available from:
TSO, PO Box 29, Norwich NR3 1GN
Telephone orders/General enquiries: 0870 600 5522
Fax orders: 0870 600 5533
www.tso.co.uk/bookshop
E-mail: book.orders@tso.co.uk
Textphone: 0870 240 3701

Contents

Executive Summary

Safety concerns 2
"Free-riders" 5
Regulatory convergence 5
Delivering reform 6
Other important issues: safeguarding employees and national security 7
A clear pathway to liberalisation 8

Chapter 1 Introduction

Structure of the paper 2

Chapter 2 The international context of airline ownership and control

History of ownership and control 1
Partial liberalisation: the move toward "Open Skies" 2
Beyond "Open Skies" – an Open Aviation Area? 2
Existing regulation of ownership and control 4
The increasingly anomalous airline industry 5
Summary 7

Chapter 3 The arguments in favour of ownership and control liberalisation

Mergers and acquisitions 1
Cabotage 4
Cost of capital 4
Managerial expertise 5
A better deal for consumers 5
Positive impact on employees 5
International precedents 6
Summary 8

Chapter 4 The arguments against ownership and control liberalisation

Safety and "flags of convenience" 1
The current ICAO safety structure 2
Clear lines of responsibility 3
The trade dimension: protecting against "free-riders" 3
Protecting competition 3
Protecting the interests of national carriers 4
Protecting national security 4
Safeguarding the interests of employees 5
Maintaining the global system of international Air Service Agreements 6
Summary 6

Chapter 5 Options and conclusions for the implementation of ownership and control liberalisation

Regulating safety and safeguarding against "flags of convenience" 1
Selective liberalisation 1
Safety blacklists 2
Strengthening "principal place of business" 3
Closer cooperation between safety agencies on international aviation 5
Conclusions on safety 7
Protecting against "free-riders" 8
Conclusions on "free-riders" 9
Regulatory convergence 10
Conclusions on regulatory convergence 10
Delivering reform 11
Option I: the unilateral approach 12
Option II: the bilateral approach 13
Option III: the multilateral OAA approach 14
Option IV: the global trade approach 15
Conclusions on delivering reform 16
Summary 16

Annex 1 Regulatory options and the risk of "free-riders"

Glossary

Executive Summary

1 The airline sector is one of the most international of industries, and has facilitated the rapid growth in trade in goods and services over the last 50 years. Yet, paradoxically, it has some of the most restrictive rules on international ownership and control. In other sectors of developed economies, the freedom to invest is considered essential to the efficient functioning of the market. There are exceptions - and protectionist policies do return periodically - but in the main, investment restrictions are increasingly rare. In most industries the default position is that individuals and firms are free to make investments and business decisions as they see fit, subject only to compliance with laws on employment, health and safety, competition, etc. For airlines, however, the situation is reversed. Aviation has therefore emerged as a particularly conspicuous anomaly in a world of widespread trade liberalisation.

2 The relative conservatism of the aviation sector can be partly traced back to the 1944 Chicago Convention, an international agreement drafted to govern the emerging international aviation industry. After Chicago, a complex web of bilateral air services agreements grew up, with countries exchanging freedoms to fly through government-to-government negotiations. Although the Convention placed no direct nationality-based limitations on ownership and control, individual countries and trading blocs have done, with the aim of excluding third-party carriers from accessing international traffic rights hard-won through negotiations with other countries.

3 The internationally agreed regime for the operation of international aviation services requires that an airline must hold an operating licence (certifying that the airline has met the economic and commercial demands considered necessary to operate) and an Air Operator's Certificate (AOC) (certifying an airline's compliance with safety requirements). In most jurisdictions, an airline's operating licence and AOC must be issued by the country where that airline has its "principal place of business". Where ownership and control restrictions remain, an airline's principal place of business is determined by the nationality of its owners. Consequently, cross-border mergers or acquisitions, which might threaten the "purity" of an airline's investor-base – and thereby its qualification for an operating licence from its home state – have effectively been ruled out. Either they are blocked *de jure* by ownership and control rules or ruled out *de facto* by the concomitant loss of traffic rights tied to the nationality of the airline's owners.

4 In the past, ownership and control restrictions arguably mattered less; airlines were generally state-owned and less commercially focused, with pooling agreements and revenue and capacity sharing common. However, with increased privatisation of airlines and the globalisation of industry more generally, ownership and control restrictions now create major problems for airlines seeking to access foreign capital or expand operations internationally. An imperfect solution to this problem has been found in airline alliances, which enable coordination of some elements of business practice and services. But this falls far short of enabling the commercial benefits of foreign ownership or control.

5 In the area of traffic rights regulation, international aviation policy has begun to change significantly over recent years, with a number of initiatives taken to open up the aviation market. Some of the impetus has come from US-style "Open Skies" agreements, which typically involve the removal of all restrictions on frequency and destination of services for international routes between signatory countries. However, "Open Skies" agreements only go part way to normalising the industry, as they continue to restrict access to domestic markets and leave ownership and control

rules untouched. An Open Aviation Area (OAA) agreement, as already implemented within Europe, goes beyond "Open Skies" in removing all restrictions on ownership and control (for EU citizens in the case of Europe). This has enabled airlines such as Ryanair and easyJet to emerge – carriers focused on operations to destinations within the liberalised boundaries of Europe, often operating services with no connection to their licensing country. For these commercially successful airlines, the question of which European nationalities have a stake in the company has become irrelevant, as has the question of which EU country is the airline's principal place of business other than for determining which country has regulatory responsibility for them. Ownership and control liberalisation has also occurred in Australia and New Zealand, where domestic airlines (as well as international airlines in the case of New Zealand) have been opened up to foreign investment.

6 The evidence from Europe and Australasia suggests such changes are positive for the industry and its users. 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 airlines, access to foreign capital and management resources, combined with opportunities for restructuring, would provide options already available to most other global industries, but denied to airlines. For employees, liberalisation of ownership and control rules should enable efficient airlines to grow, increasing sustainable employment opportunities. These advantages are likely to be replicated on a greater scale should liberalisation occur more widely.

7 A key question for policy-makers keen on realising the benefits of greater capital mobility and commercial freedom is how the complex framework of inter-dependent bilaterals might be unwound whilst maintaining effective regulatory control over safety.

Safety concerns

8 The most powerful argument against ownership and control liberalisation in the aviation sector would be if it were likely to lead to any diminution of safety standards. A possible consequence of liberalisation may be that airlines will become more footloose, allowing them *actually* to re-base themselves in countries offering lower regulatory standards and thereby eroding safety and employee standards.

9 Then, there is a possibility that an airline with open access to a number of markets and no ownership and control restrictions might pursue a policy of "flagging for convenience" by *notionally* basing itself (i.e. "brass-plating") in the country with the lowest level of safety compliance costs. Although there are significant reputational risks to a passenger airline in pursuing such a strategy of regulatory arbitrage, such "soft" disincentives cannot necessarily be relied on to guarantee continued high levels of safety.

10 This issue has arisen even in the relatively homogenous regulatory environment of Europe, where airlines have relative freedom to access all markets only fettered by the need for the majority of investors to be European and for the airline's licence and AOC to be issued by the country where it has its principal place of business. In these liberalised conditions, some commentators have raised concerns about the effect of carriers establishing their principal place of business (and hence their regulatory home) far from their centre of operations, to reduce their regulatory burden. These concerns could be greater in a fully liberalised global environment with less regulatory homogeneity and a less established framework for international cooperation. However, greater standardisation (such as could be achieved through regional bodies such as EASA) could mitigate this risk, if robustly carried out.

11 The best way of nullifying any incentive to flag for convenience would be through achieving full global regulatory convergence. Realistically, however, such convergence of safety standards and enforcement is probably unachievable in the foreseeable future, not least because the resources and political commitment needed are considerable. ICAO has established a clear set of minimum global safety standards, although differences remain in the level of resources, maturity of institutional structures, and degrees of accountability of safety authorities around the globe. Thus, for some countries, meeting the minimum standards for safety has proven difficult. For others, regional initiatives such as the European harmonisation of safety standards and the creation of a nascent European safety agency (EASA) have arguably raised European safety standards above those set by ICAO. Consequently, there will inevitably continue to be variations in safety standards across the world, which could mean some airlines seeking to take advantage of laxer regimes.

12 Practical issues relating to the regulation of a globally liberalised aviation sector will also create significant challenges. Traditionally, an airline's entire operation would radiate out from no more than a handful 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. For example, an airline licensed by country A, but predominantly operating services within country B, or between countries B and C, could pose problems to its licensing authority.

13 This paper explores a number of ways in which the effective regulation of safety standards might be maintained or enhanced in such a liberalised world, including the option of relying on the current system of ICAO safety audits. The paper concludes that in a world where ownership and control restrictions are removed, foreign safety authorities will have to demonstrate that their 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.

14 The UK CAA also notes that there are strong arguments for insisting on a significant level of a carrier's operations being in the country where it is licensed and regulated. Current regulations governing the licensing of European carriers within the European single aviation area state that an airline can seek a licence from the country in which it has its principal place of business. Most carriers have simply chosen their main operational centre as their principal place of business. However, there is a perception that carriers could choose other countries within Europe as their base, simply in order to reduce their compliance costs. In Europe, relatively high levels of regulatory harmonisation mean that the safety problems associated with such action may be significantly reduced. However, as the European single aviation area expands to incorporate more countries outside the European bloc then the scope and consequences of any flagging for convenience could increase. Although concerns will principally be dealt with by the requirement that these candidate countries meet the safety standards already in place in Europe, the UK CAA believes that establishing a closer link between a carrier's operations and regulatory home would strengthen lines of accountability and facilitate effective day-to-day regulation of the carrier.

15 The paper acknowledges that, in the longer term, national and regional safety authorities will need to cooperate more closely to share information across national boundaries. In a future free of ownership and control restrictions, it will be possible for a carrier to have a truly global reach, with some of its services never touching down in the country from which it has been granted its licence. Proper regulation of these detached services will need the cooperation of foreign safety agencies. The evolution of regional safety agencies or forums such as EASA should help in this regard.

Conclusions on safety

In principle, the nationality of an airline's ownership and control should not in itself pose any threat to safety standards. However, safety arrangements need to take account of the practical reality of a wide variation in global standards, and while significant effort is being made at an international level to raise global safety standards (through ICAO in particular), this will not ensure complete equivalence in the near future.

Removal of ownership and control restrictions, combined with liberalised traffic rights, could open up opportunities for airlines regulated by countries with lower safety standards to fly services between and within other countries. As a safeguard against a situation where such enhanced access to markets within an Open Aviation Area could lead to a diminution in safety standards, this paper therefore suggests that OAAs should be developed through a process of selective liberalisation. Access to the enhanced market opportunities available would only be open to carriers from countries able to demonstrate a level of safety compliance equivalent to that within the OAA grouping. Indeed, auditing of candidate countries' safety regulation has been a prerequisite of any new Member State's incorporation into the European single aviation area. However, despite these efforts, when achieved safety rates are compared, there remain wide variations, even within Europe. We would nevertheless expect this approach to be applied to safety considerations in talks involving the UK or Europe and third countries in the future. Such an approach has a dual benefit. In addition to increasing the pressure for high safety standards for airlines operating within the group, the presence of such a strict requirement should incentivise higher safety standards within candidate countries and airlines wishing to gain access to an expanded OAA.

Another issue that faces safety regulators within an OAA is the prospect of increased geographic detachment of the airline from its safety authority, either because an OAA allows for dispersed operations, or because of temptations to "flag for convenience". The UK CAA would support calls by ICAO and the European Commission to require a closer link between an airline's regulatory home and its operations, as this would strengthen lines of accountability and facilitate effective day-to-day regulation.

Finally on safety, the paper has also explored ways in which safety authorities might be able to share safety responsibilities in the future. This will necessitate closer cooperation between safety authorities and a clear delineation of responsibilities if clear lines of accountability are to be maintained.

To summarise, regulating an airline whose operations may be based in a number of states within a liberalised OAA may require a subtly different set of safeguards to those traditionally used:

Member States within an OAA must be able to demonstrate:

- ongoing compliance with the standards of safety regulation expected of those within the OAA grouping. This may logically suggest the development of supranational safety organisations such as EASA, which encourage closer cooperation between safety authorities operating within the OAA to ensure that safety standards are maintained to a consistently high standard.

Countries wishing to join an OAA must be able to prove:

- they meet safety standards equivalent to those already within the OAA grouping, probably through audit processes (akin to the US FAA's safety audits of foreign safety authorities and the EU's tests for applicant states' safety authorities).

Countries outside of the OAA will be subject to:

- application of other methods of safety regulation, including the maintenance of safety blacklists for airlines not meeting the necessary standards.

This combination of measures should ensure that safety standards are at least maintained, and at best improved, as a consequence of ownership and control liberalisation.

"Free-riders"

16 The paper identifies the issue of "free-riders" as another potential concern for ownership and control liberalisation. In this context, free-riding describes a situation where a third party exploits the advantages created by a liberal inclusive agreement between other states, whilst withholding comparable opportunities from foreign investors. This raises strong commercial, strategic and presentational concerns about the fairness of allowing ownership of domestic airlines by nationals from countries which do not have broadly equivalent open investment rules.

17 On one hand, it is arguable that the benefits of allowing domestic airlines greater access to capital should prevail against other considerations. However, opening up ownership and control to third party investors from illiberal countries could erode the pressure on those countries to make equivalent reforms, hindering progress towards full liberalisation of the sector. A preferable approach might therefore be to offer ownership and control liberalisation only to those countries prepared to institute similar arrangements.

18 Such "non-circumvention" agreements would remove the concerns associated with 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.

Conclusions on "free-riders"

The issue of "free-riders" is frequently cited by opponents of ownership and control liberalisation. As this paper has shown, there is a legitimacy to some of these concerns that necessitates a sensitive handling of the liberalisation process. To recap, "free-riding" describes the situation where a party not subject to an agreement exploits the ownership and control advantages created by a liberal inclusive agreement with two other states, despite not offering similar opportunities to investors of the signatory states. This raises strong commercial, strategic and presentational concerns about the fairness of allowing the ownership of airlines by nationals from countries without broadly equivalent open ownership and control rules.

To avoid exploitation by free-riders, the UK CAA concludes that ownership and control rights should be open only to investors from countries that have signed up to equivalent, liberal Open Aviation Agreements. Although this approach may limit the sources of capital available to a carrier in the short-term, it should provide added incentives for the expansion of OAA-type agreements as excluded parties seek both investment and market opportunities in the liberalised OAA markets.

Regulatory convergence

19 There are a number of other areas apart from safety where liberalisation may create concerns about the distortionary impact of different regulatory approaches applying to competitors operating in the same market. Such differences could be biased in favour of particular competitors and threaten the efficient operation of the market. The principal concerns relate to the operation of different regimes governing state aid and competition. However, they 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 fully to harmonise regulation of aviation across a number of countries. The UK CAA believes that a pragmatic approach is needed that accommodates these differences whilst establishing broad principles governing what is acceptable. This is best described as "regulatory convergence".

Conclusions on regulatory convergence

Another key area that is liable to give rise to problems is the existence of regulatory differences between potential members of an OAA. There are clear parallels to the "flag of convenience" arguments raised in the context of the discussion on safety regulation. The threat of competition within the OAA being harmed by the unfair allocation of state aid or significant differences in regulatory standards in areas like competition enforcement is real enough to justify general conditions of regulatory convergence being placed on participating countries.

Requiring candidate 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. Such a commitment would prohibit, amongst other things, anti-competitive behaviour and the granting of state aid capable of distorting competition. To enforce 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 OAA members tasked with examining and investigating complaints.

Delivering reform

20 Another key question is who should take the lead in liberalisation discussions. The current basis of international aviation is the series of bilateral agreements between countries; bilateral negotiations remain the main forum for discussion of aviation liberalisation, although in some jurisdictions the picture is becoming more complex. Liberalisation within Europe has been driven by action at the supranational level, including measures to free up constraints on ownership and control. Although Member States have retained much of their authority to negotiate agreements with countries outside of the EEA, partial transfer of powers by European Member States to the EU institutions has led to pressure for further remaining elements of aviation policy to be transferred to Brussels. Similar trends - albeit less advanced - towards regionalism in aviation are observable elsewhere. For example, regional groupings such as ASEANA (in South East Asia) and CARICOM (in the Caribbean) have begun to liberalise aviation relations within their trading blocs.

21 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. To take a purely hypothetical example, if the US and Canada were willing to liberalise ownership and control between themselves, the existence of continuing bilateral ownership restrictions between the US and a third country might mean that an airline from the US risks losing nationality-based rights to fly to the third country if it becomes majority-owned by nationals from Canada. As international aviation gradually becomes more liberal, ownership and control reform will inevitably move up the agenda and the potential benefits of supranational structures will increase.

22 Arguably, in Europe, which has pioneered the OAA concept, the balance of benefits has already tipped in favour of supranational bodies leading negotiations on liberalisation. For the UK, this might mean that air services negotiations should be dealt with on a national basis where reciprocal concessions on ownership and control are unlikely to be a key component of the liberalising deal. Conversely, where a reciprocal agreement on ownership and control is essential to achieving the UK Government's stated objective of the normalisation of aviation - and a comprehensive deal - the granting to the European Commission of mandates covering both traffic rights and ownership and control would make sense. 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.

23 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). However, in practice, wide differences between regional blocs, differing Governmental positions on liberalisation, and the varying levels of development within the aviation sector makes progress through such forums extremely difficult.

Conclusions on delivering reform

Full normalisation of the airline industry requires the liberalisation of ownership and control, implying that the authority with legal competence for establishing or changing ownership and control rules should play a more active role in negotiating future liberalised agreements.

For most countries, with no separation of legal competence between national and supranational bodies, this will prove uncontentious. However, for some, this would mean granting an open mandate to a supranational body such as the European Commission (relevant in the EU because the Community has exclusive competence in the regulation of ownership and control) to negotiate future OAAs with the region's partners.

Other important issues: safeguarding employees and national security

24 The paper also examines the labour and security arguments against ownership and control liberalisation and concludes that these do not present obstacles to liberalisation of the aviation sector and, in particular, removal of ownership and control restrictions. Labour organisations claim that employment standards are likely to suffer from liberalisation as footloose airlines seek out lower-cost locations with lower staffing costs. Previous work on this issue by the UK CAA has found no evidence that liberalisation hurts the interests of employees. In fact, the opposite appears to be true. Firstly, it is very difficult for cheap labour to "undercut" and ultimately supplant crew in other countries; 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 occurred in the maritime sector. Operational requirements also mean that labour needs to be located near the airline's "centre of gravity" – e.g. its operational centre. For example, if an airline wants to offer services to passengers living in the London area, then it needs to have a centre of operations somewhere nearby, and this will in part drive the location of its staff and reduce the degree to which it can take advantage of cost savings by relocating labour supply. Secondly, the experience from Europe and elsewhere is that liberalisation drives innovation and growth in aviation services, to the benefit of employees. Employment in aviation across Europe increased considerably over the first ten years of liberalisation.

25 On the issue of national security, the paper finds 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. In any event, the law on mergers and acquisitions in the UK and elsewhere typically provides powers for the Government to block a deal where it is considered to pose a threat to national security. As in other sectors of the economy where the foreign ownership of strategic assets has been allowed (including water and power in Europe), this veto should be sufficient to ensure that national security concerns do not present an obstacle to ownership and control liberalisation.

A clear pathway to liberalisation

26 The economic advantages of the liberalisation of ownership and control are clear from the experience of other sectors and in aviation markets such as Europe's. However, it is also clear that removing such restrictions raises issues as to how critical areas such as safety could best be regulated in the future, and how to ensure, in the pursuit of a fully liberal global industry, that countries are incentivised to offer reciprocal concessions.

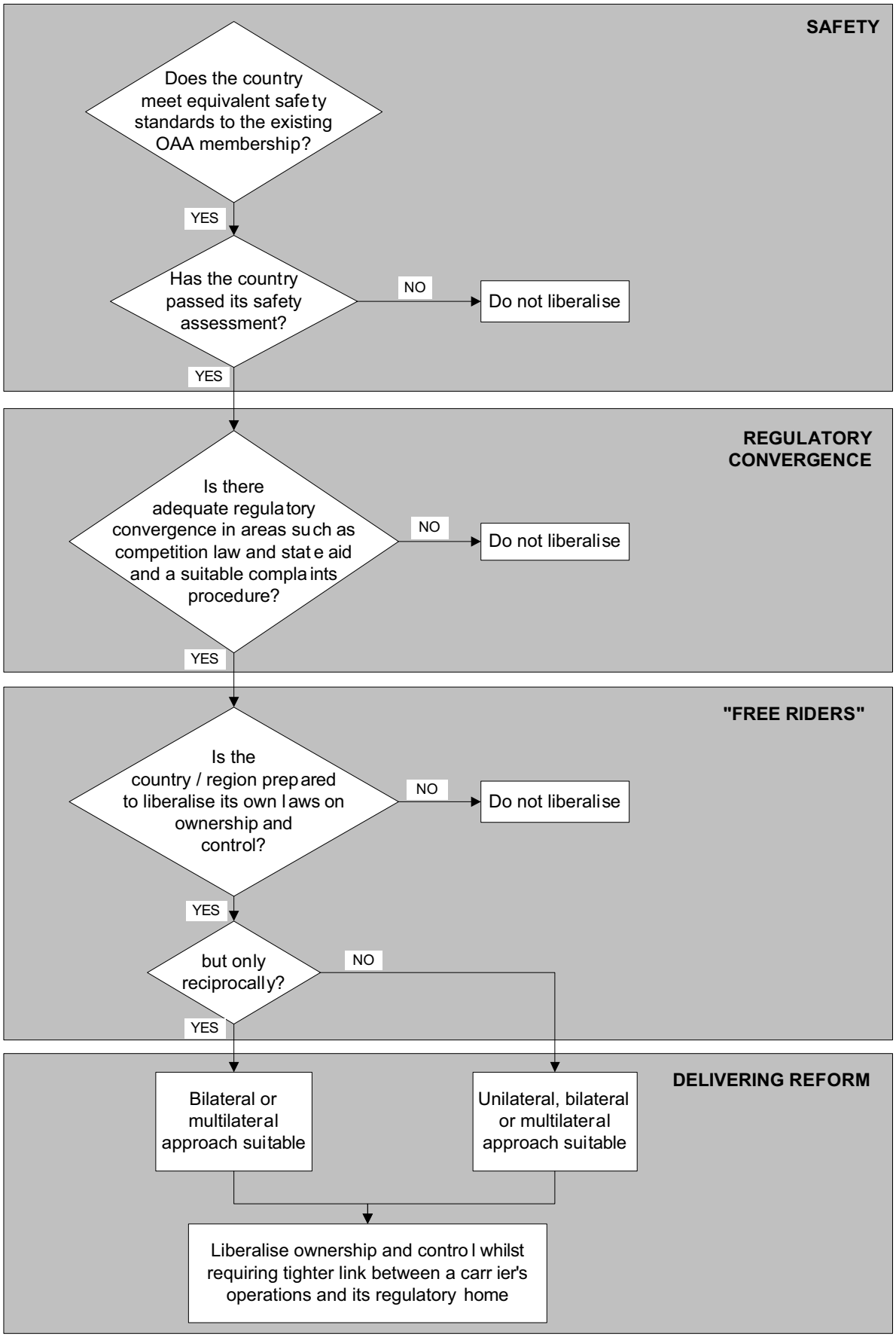
27 The combination of the removal of ownership and control rules and the general opening up of traffic rights would increasingly give airlines freedom as to where to locate their businesses. In this business environment, regulatory convergence and the link between an airline's operational centre and its regulatory home are key to controlling the degree to which airlines are incentivised to relocate to reduce regulatory costs. This paper outlines some possible regulatory solutions.

28 This paper shows that restrictions on investor nationality have a profoundly negative effect on the development of the industry and provide no benefits in terms of safety or labour standards that cannot be replicated by other, less onerous, means.

29 The paper does not attempt to tackle the much wider issue of aviation's effect on the environment. However, the CAA is committed to the sustainable development of aviation, and is supportive of efforts to get the environmental framework right, so that aviation meets its full costs, including those related to the environment. The conclusions of this paper, if followed, would encourage a better alignment of capacity to demand, easier access to capital for earlier fleet renewal, and enhance the efficiency of the sector as a whole, something that may in itself bring some secondary benefits in terms of environmental impact.

30 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, but this paper suggests that this should be possible with some adjustments to the traditional approach. Figure 1 sets these out in diagrammatic form. Ultimately, it is up to governments and regulators to implement the necessary changes in order to enable the industry to develop safely whilst meeting the increasingly global needs of its customers.

Figure 1 Pathway to liberalisation



Chapter 1 Introduction

1.1 Aviation is amongst the most global of industries. Long-haul airlines offer services that span the world, transporting people and goods vast distances quickly, and thereby linking cities and continents. The sector has facilitated the growth of globalised business and opened up new destinations to the benefit of tourists and their hosts. Aviation is therefore a critical facilitator of the globalisation of commercial activity. Yet airlines operate within one of the most constrained regulatory frameworks of any major industry, governed by an intricate network of bilateral agreements between states that constrain their freedom to pursue commercial strategies considered normal by most other international industries.

1.2 Typically, these "bilaterals" only allow services to be operated by a limited number of airlines designated by each side. In addition, they restrict the type of services those designated airlines can provide. Market access constraints include:

Tight controls on "traffic rights":

- Limiting the number, size and destination points of flights that can take place between countries;
- Restricting the type of direct connecting services or code-share arrangements that airlines can offer;
- Limiting the airlines' freedom to set their own fares, often requiring fares to be approved by one or both of the contracting nations;

In addition – and the main subject of this paper - almost all bilateral agreements (and many national laws as well) place limitations on the constitution of the designated airlines themselves by:

- Requiring majority investor ownership and effective control to reside with nationals of the relevant country.

1.3 These restrictions have had a profound effect on the way that the industry has grown and evolved. The speed and pattern of traffic growth has in the past been dictated more by governments' willingness to loosen existing bilateral restrictions than by airlines' response to the market demand for air travel, with spillover effects for other sectors of the economy. However, governments are increasingly recognising the benefits that the removal of constraints – and subsequent enhanced competition, increased economic activity and heightened consumer benefit - can bring, with the consequence that limits on traffic rights, tariffs, frequency and destination points are gradually being eased or lifted entirely.

1.4 Despite this growing consensus in favour of liberalisation of traffic rights, there appears to be greater reluctance to reform ownership and control rules, and progress on this front has been much slower.

1.5 In the past, ownership and control restrictions arguably mattered less; airlines were generally state-owned and operated in a less commercially orientated world, which in some cases included collusive agreements, such as revenue and capacity sharing. Furthermore, access to markets was so limited that entry by foreign airlines was effectively barred by capacity ceilings. However, the general move toward liberalisation of traffic rights outlined above, combined with the widescale privatisation of airlines, has focused attention on the remaining restrictions on airlines' commercial freedom, including those relating to ownership and control.

1.6 There have been some important examples of ownership and control liberalisation, some of which are explored later in this paper. However, the vast majority of countries have retained limits on the level of ownership and control that foreign investors can have in their airlines, with these limits, embedded in bilateral agreements[1], restricting traffic rights to airlines conforming with the statutory ownership limitations. There may also be national law relating to ownership and control. This means that several layers of national and international law may need to be reformed by a country in order to liberalise ownership and control. In the meantime, airlines continue to face major obstacles in pursuing mergers or acquisitions, for fear of losing these essential rights. Ownership and control constraints also prevent access to domestic markets by foreign investors, preventing airlines from setting up a subsidiary to operate within the territory of another country.

1.7 Airlines have sought ways around these restrictions in an attempt to expand and consolidate. The phenomenon of the airline alliance is perhaps the most visible manifestation of the industry's desire to find a workable solution to the regulatory morass in which they operate. Such close cooperative agreements, often encompassing widespread code-sharing, are generally the closest thing to a standard merger that international airlines have dared to attempt[2].

1.8 This paper explores the reasons for the continued application of ownership and control restrictions in the majority of the world's bilateral Air Service Agreements, and examines the arguments for and against their removal.

Structure of the paper

1.9 The paper starts with the history of ownership and control constraints, before moving on to examine the arguments for and against the liberalisation of ownership and control restrictions, relying heavily, but not exclusively, on evidence derived from the experiences of partial liberalisation in the US and Europe. This emphasis reflects the relative maturity of these markets, as well as the current interest in this issue in the context of negotiations on an EU/US Open Aviation Area. The views and experience of other stakeholders from further afield are also included to try to give a broader perspective to this global issue. In particular, the report includes experience from countries which, like Europe, have undertaken reform of ownership and control restrictions.

1.10 Chapter 5 of the paper includes an examination of the methods and approaches that might be used to liberalise ownership and control – drawing on the arguments and evidence set out in the earlier part of the paper – and the recent experiences of liberalising countries. The paper ends by drawing together conclusions for policy-makers.

1. Bilaterals, or Air Service Agreements (ASAs), are the set of negotiated agreements between countries, which set out how aviation traffic will be treated. For example, the UK currently has about 110 ASAs with various countries around the world.
2. There have been occasional examples of airlines prepared to go further, such as the recent KLM and Air France merger, although the companies have often been forced to structure the resulting company so as to satisfy bilateral ownership and control rules. The KLM – Air France case is examined in more detail later in this paper.

Chapter 2 The international context of airline ownership and control

History of ownership and control

2.1 In most other parts of Western economies, the free movement of capital is considered to be vital to an efficient market. There have been exceptions, but in the main the trend over the last half-century has been to remove regulatory restrictions governing nationality of ownership from most sectors of the economy.

2.2 Yet most countries still insist that the majority of an airline's investment capital be sourced domestically and that effective control remain with their nationals. These restrictions on ownership and control are long-standing, and reflect a protectionist framework that has been applied to the sector since the 1944 Chicago Convention framed the current system of bilateral agreements governing international air travel (see Box 1 below).

Box 1 Regulatory requirements for an international air carrier

The 1944 Chicago Convention and its implementing body, the International Civil Aviation Organization (ICAO), established common standards for the operation of international commercial air carriers. These requirements state that an air operator must hold the following:

- **an Air Operator's Certificate (AOC).** An air operator's certificate is a requirement of public air transport operators and is issued by the relevant safety authority where the airline has been able to show that the aircraft and aircrew registered in that country have met necessary *safety standards*, that the organisation has demonstrated that it is competent to secure the safe operation of an aircraft, and that it has measures in place to ensure continued compliance.

- **an Operating Licence.** An operating licence is granted to the airline if it is considered to have met the *commercial requirements* considered necessary for the viable operation of an airline. For a commercial passenger carrier, requirements will typically include evidence that the airline has its "principal place of business" in the issuing country, is properly financed, has adequate passenger and third party liability insurance, holds a valid AOC, and can prove that ownership and control of the airline rests with its own nationals.

- **a Route Licence or Permit.** A route licence is issued by the relevant authority when giving permission for the operation of particular domestic or international services.

The majority of bilateral agreements typically state that a foreign carrier wishing to serve its territory must hold a valid operating licence and that an operating licence or a permit will only be issued to a carrier if it is majority owned by its own nationals. The combined effect of these requirements is that bilateral rights can only be exercised by nationally owned carriers.

2.3 The post-Chicago world is one characterized by strict control of airlines' access to foreign markets regulated by a series of international agreements. Controls were usually imposed on capacity and tariffs, and limited market access concessions were made available only to those airlines majority owned and controlled by nationals of the partner state. In this way, ownership and control restrictions underpin the system of restrictive bilateral agreements.

Partial liberalisation: the move toward "Open Skies"

2.4 The need for the removal of frequency restrictions to enable growing demand to be met, the benefits to the wider economy that this entails, and the enhanced efficiency of the airline industry (to the benefit of passengers) is now widely recognised. This trend is perhaps best reflected in the spread of "Open Skies" agreements, pioneered by the US with its bilateral partners. "Open Skies" deals typically sweep away the majority of traditional limits on traffic rights and pricing freedom (Table 1 below).

2.5 These changes are beginning to put the airline industry on more of an equal footing with other sectors of the economy in terms of market access, and have been considered by some to represent the last necessary adjustments to an international regulatory framework that has long been subject to outdated controls.

'Substantively, the United States remains firmly committed to serving the public interest – both in the United States and abroad – through the elimination of governmental barriers to entry and regulations that distort international commercial aviation markets. We believe strongly that the "Open Skies" template constitutes the most effective international legal vehicle to that end, and stand ready to negotiate such agreements with any trading partner.'

(*Source*: Speech to International Aviation Club by Karan K. Bhatia, US Assistant Secretary of Transportation for Aviation and International Affairs, May 2004.)

2.6 The welcome focus on removing artificial limits on frequencies and other elements may have meant that securing reforms to allow for the free movement of capital has been a lower priority for policy-makers and airlines.

Beyond "Open Skies" – an Open Aviation Area?

2.7 "Open Skies" agreements fall short of full market liberalisation. But in removing the majority of traditional restrictions, they serve to highlight those areas where airlines' commercial activities remain fettered. Most notably, ownership and control liberalisation, and the ability to operate domestic services in a foreign country (cabotage), are not elements of the standard US "Open Skies" model agreement. These additional freedoms tend to be included in fully liberal Open Aviation Area (OAA) agreements (see Table 1 below).

Table 1 Summary of restrictions in traditional bilateral, "Open Skies" agreements and Open Aviation Areas

Type of agreement	Open service capacity and frequency ?	Freedom in setting fares ?	Extended traffic rights (e.g. onward 5ths)? (see Note 1)	Foreign ownership and control allowed ?	"Cabotage" (see Note 2)
Traditional Bilaterals	x	x	x	x	x
"Open Skies"	✓	✓	✓	x	x
Open Aviation Area (OAA)	✓	✓	✓	✓	✓

Note 1: 5ths are the right to pick up passengers from a foreign country (B) and fly them to another foreign country (C).
Note 2: "Cabotage" is the right of a foreign carrier to operate purely domestic services in another country.

2.8 Such agreements are rare, but there are a few examples. In the case of the European Economic Area (EEA), liberalisation has created, in effect, a single market for European aviation, but majority ownership and effective control must still remain in the hands of EEA nationals – a broader definition than the nation-state definition it replaced, but still restrictive. Moreover, European carriers still face the problem that

a number of bilateral agreements governing their international air traffic rights still discriminate on the basis of the nationality of their owners. This means that for long-haul airlines, the ability to merge with other EEA airlines whilst preserving the rights provided in their bilaterals is placed in doubt. Another example is Australia, where ownership and control restrictions have been removed for domestic aviation but not for international carriers[1].

2.9 However, perhaps the most liberal arrangement is New Zealand's. In New Zealand, the Government has been prepared to remove all restrictions on ownership and control for some of their bilaterals, thereby enabling domestic and international routes to be operated by airlines owned by foreign nationals. This shows that such liberalisation can be achieved. Importantly, however, the decision by New Zealand was taken unilaterally after concluding that it was in the national interest to allow full foreign ownership of their carriers.

2.10 These examples of liberalisation remain scattered exceptions to the general rule that airlines must be owned and controlled by nationals of the country where they are licensed.

Box 2 History of ownership and control in the US, Europe and the UK

In the **United States**, ownership and control legislation has evolved since the First World War. The 1926 Air Commerce Act was the first piece of statute to place a limitation on the ownership and control of airlines. The Act required that at least 51 per cent of an airline had to be owned by Americans and that the President and two-thirds of the board had to be US citizens. The Civil Aeronautics Act of 1938 strengthened the ownership and control provisions further by raising the minimum level of voting shares that needed to be in US hands from 51 to 75 per cent (a limit that remains in place today).

Current US ownership and control law was established in the Cold War era Federal Aviation Act of 1958, which stipulates that anyone wishing to operate an aircraft within the US must have a certificate of public convenience, which can only be issued to citizens of the US, and consolidated the minimum ownership and control requirements in place in the earlier Civil Aeronautics Act. The most recent amendment to the statute was in 2003, when the requirement for "actual control" to remain in American hands was inserted.

In the **United Kingdom** the concepts of ownership and control were not consolidated in a form that would be readily recognisable to current observers of the airline industry until the 1946 Civil Aviation Act.

The 1982 Civil Aviation Act updated the 1946 Act and placed a requirement on an airline to demonstrate that at all times it was effectively controlled by United Kingdom nationals. In that regard, consideration was given to the nationality of the beneficial owners of the company and to the composition of its board. Consideration was also given as to whether any non-qualifying third party had indirect influence, for example through the provision of services at non-commercial rates upon which a carrier could be dependent. Unlike in the US, the Act did not prescribe any level of permitted share ownership, nor the proportion of non-qualifying nationals that may serve on an airline's board. If the UK CAA is not satisfied that an airline can demonstrate UK control, then it is required to refer the matter to the Secretary of State for consideration.

1. The Australian experience is considered in more detail later in the paper.

Box 2 History of ownership and control in the US, Europe and the UK (contd.)

In the UK, the Control provisions of the Act have now been superseded by European legislation (see below). However, they still apply to Air Transport Licence holders (which are carriers incorporated in the Channel Islands or the Isle of Man which, being outside the European Economic Area (EEA), cannot draw on the benefits of the Council Regulation) and to UK airlines that hold Route Licences permitting them to operate outside the European single aviation market.

In **Europe**, ownership and control has been governed since 1993 by pan-European legislation, EC Regulation 2407/92, covering all European Economic Area members (including all EU Member States). The Regulation requires an Operating Licence holder to be able to demonstrate that it is both majority owned and effectively controlled by qualifying nationals. It places a duty on the Member State to be satisfied that the majority of the beneficial shareholders of a licence holder and those that exercise control over it are EEA nationals. In the UK, this role is undertaken by the CAA, which is required to establish whether any non-qualifying third party can exercise indirect influence over a licence holder that may amount to *de facto* control. There are no prescribed levels either for permitted share ownership or for the proportion of qualifying nationals that must serve on an airline's board. Furthermore, there is no option for the relevant Member State to conclude that the retention of an Operating Licence by non-EEA nationals is in the best interests of the State and permit it to remain in force.

Subsequent European Court of Justice rulings in 2002 made it illegal for European Member States' bilateral agreements to contain clauses discriminating between carriers from different EU countries. The process of correcting existing agreements entails changing the designation criteria from national ownership to ownership anywhere within the Community, subject only to the carrier being established in the designating State. This is a slow and difficult process, requiring the agreement of each non-European aviation partner.

Existing regulation of ownership and control

2.11 As described above, the system of bilaterals relies heavily on "substantial ownership" and "effective control" being in the hands of nationals of the designating state. International comparisons demonstrate that there are differing legal interpretations of what constitutes an acceptable level of ownership and control.

2.12 Such variation is clearest in the area of substantial ownership, where the permitted level of foreign ownership of stock or other equivalent investments in an international airline varies considerably. This ranges from 25 per cent in the case of the US to 100 per cent in the case of New Zealand. For EEA carriers, less than 50 per cent of their stock may be owned by non-EEA nationals. UK carriers operating outside the European single aviation market may also be required to demonstrate that they are effectively controlled by UK nationals if the relevant bilateral requires this, although these provisions which discriminate between European nationals are gradually being negotiated away in favour of a European ownership requirement[1]. In that regard, as effective control is normally (but not in every case) assumed to follow common stock

1. This follows judgments by the European Court of Justice in its 2002 rulings (see Box 2) that access to markets by airlines based within the European Economic Community must be on a non-discriminatory basis, in accordance with Article 43 of the Treaty of the European Community guaranteeing freedom of establishment (ECJ Judgments: C-466/98, C-467/98, C-468/98, C-469/98, C-471/98, C-472/98, C-475/98 and C-476/98). Regulation EC 847/2004 allows bilaterals not compatible with this ruling to be amended by the relevant Member State.

ownership, the company is usually required to demonstrate that majority ownership rests with UK nationals.

2.13 Comparing countries' treatment of "effective control" is more difficult. In some countries, majority ownership of the voting stock of a publicly listed company is sufficient to satisfy the authorities that control rests with their nationals. However, for many, including regulators within the EU and the US, examination of "effective control" comprises a more detailed study of both the powers and motives of investors in the company. For the UK CAA, examination of control includes an assessment of the beneficial owners of the company, the composition of its board and the directors' powers. A further evaluation of whether any non-qualifying national could exercise indirect influence, for example through the provision of services at non-commercial rates upon which a carrier could be dependent or any powers of approval or veto, is also undertaken. The UK CAA normally undertakes a detailed review of any relevant loan, lease or shareholder or supply agreements as part of that process. The UK CAA would also seek to ensure that, in cases where there was a large non-qualifying minority stockholder balanced by a larger number of disparate qualifying stockholders, the minority stockholder did not dominate the company[1].

2.14 Scrutiny of what constitutes control is largely a question of national interpretation, rather than being dictated by aviation law. Crucially, neither the Chicago Convention nor any other broad international agreements governing aviation place any restriction on airline ownership and control. This leaves nation states with a large degree of discretion to decide the limits of foreign control. The Department of Transport in the US, for example, recently undertook a process of consultation with stakeholders to discuss the issue of whether it should interpret its own statutory rules on ownership and control more liberally[2]. Even in Europe, where there is EU-level legislation on ownership and control, European Member States have considerable discretion in interpreting what constitutes "effective control" of an airline[3].

The increasingly anomalous airline industry

2.15 As noted previously, such intrusive regulatory scrutiny of the nationality of owners of a company is anomalous when compared with most other sectors of the economy, except possibly those with particular sensitivity to national security. The airline business community frequently stresses the importance of removing these out-dated controls.

'There is a growing consensus that liberalisation of airline ownership and control rules has become the most important regulatory issue facing airlines and government regulators at the present time.

The reason it is so important is that airlines, in an increasingly liberalised environment, need the same access to world capital markets and the same flexibility to structure their operations to serve global markets as those enjoyed by corporations in other sectors.'

(*Source:* IATA Policy Paper (2003) Airline Views on Liberalising Ownership and Control.)

2.16 The "growing consensus" cited by IATA covers a wide coalition of interests: airline leaders, consumer groups and reform-minded governments. Given this pressure to remove ownership and control restrictions, what lies behind the maintenance of the current interventionist approach?

1. *Source*: UK CAA (1999) Guidance on Criteria for Judging Nationality of Ownership and Control.
2. The US DoT issued a notice of proposed rule making (NPRM) in late 2005, proposing greater scope for control by foreigners over certain elements of US airline operations. A supplementary notice (SNPRM), revising the initial NPRM was issued in May 2006. At the time of writing, no final rule has emerged from this process.
3. Article 4(2) of EC Regulation 2407/92.

2.17 Whilst similar restrictions remain in other sectors of developed economies, and there are periodic examples of protectionist policies returning (e.g. the furore in the US caused by the Dubai Ports takeover in 2006, or the listing of protected "strategic assets" by France in 2005), they are now increasingly rare, particularly for comparably global industries. Examples of other industries with ownership and control restrictions include some strategic infrastructure assets, telecommunications, printed and televised media, and defence contractors. In most of these cases, ownership and control restrictions are founded on one or more of the following arguments:

- *Protection of national health*. For example, the European Treaty of Rome allows Member States to intervene in the ownership of national assets which are involved in "public security" or defending public health. This umbrella definition could be used to protect a wide range of industrial sectors, from pharmaceutical firms to utility companies.
- *Protection of national security interests*. The most obvious application of this principle is in the defence sector, where restricting access to advanced weapon technologies derives from national and global security concerns. Controls are often applied to other sensitive technology and knowledge assets that may pose an indirect threat to national security.
- *Security of supply*. In many sectors, concern about continuity and quality of supply is often the most important issue for lawmakers looking to secure the future of privatised firms. The privatisation and subsequent licensing of utilities in the UK, whilst not requiring control on nationality of ownership, did include provisions to ensure that supply continued in the event of a severe shock[1]. But there is little precedent for such controls in non-monopolised industries such as the airline sector[2].
- *Control of key strategic assets*. The protection of key assets considered essential to the orderly functioning of the economy, such as power, transport and communication infrastructure has often in the past been seen as being crucial to the national interest, although this concern is much more rarely cited nowadays by Western governments, particularly those that have privatised much of their utility and transport infrastructure.
- *Safeguarding democratic "plurality of voice"*. For sectors such as printed and televised media, foreign ownership and control restrictions tend to focus on national security considerations. However, this is closely linked to the protection of the media as a democratic voice. It is noteworthy that the UK Communications Act 2003, whilst retaining some "plurality" provisions, removed any constraints on foreign ownership of UK media companies.

2.18 These arguments have been applied in recent years in the debate on privatisation, where the capital requirements of a number of the utility sectors meant that access to foreign capital was an attractive proposition. In the UK, concerns were widely voiced that the privatisation and foreign takeover of national assets would have dire consequences for national interests. These concerns have been proven unfounded, with newly privatised sectors of the economy delivering productivity and output

1. In the UK, the privatisation of utilities, e.g. water, was accompanied by the Government retaining a "golden share" which enabled it to block foreign ownership of those assets. These golden shares have since been sold. In the event of the financial failure of the owners, the regulations governing the water utilities, for example, allow the industry regulator, OFWAT, to appoint a special administrator, whose primary responsibility is to ensure the continued operation of the company.
2. One notable exception to supply controls in the aviation sector is the US Civil Reserve Air Fleet (CRAF) legislation, which requires signatories to CRAF to make available their commercial aircraft and crews in the event of a defence emergency. In exchange for this commitment, signatories benefit from Department of Defense contract payments in times of war and the "*Fly America*" policy (all Federally-sponsored air travel at home and abroad has to be made on US-owned airlines wherever possible) during peacetime.

improvements to the benefit of consumers, often coinciding with transfer of ownership into foreign hands[1]. If foreign control of sensitive utility assets such as energy and water supplies – and indeed airports – can occur without difficulty, then such control of airlines should be less contentious.

2.19 Even in particularly sensitive areas, such as defence research and contracting, governments are increasingly looking abroad when commissioning new technology, whilst allowing greater foreign ownership of domestic firms. This is despite the existence in many countries of laws enabling government to restrict the ownership of firms with particularly sensitive technologies where they consider this to be in the national interest. The result of these changes is that there is a blurring of what comprises, for example, the "domestic" defence industry.

'An increasing number of companies with foreign parentage now have British boards and workforces. Likewise, traditionally UK-based firms have growing operations outside the UK industrial base. Foreign-owned companies that set up in the UK can bring benefit in creating technology, employment and intellectual assets in this country. Expansion abroad by UK-owned companies may also realise similar benefits here, if it provides a route for technology and economic benefit to flow back to the UK. The UK defence industry should therefore be defined as where the technology is created, where the skills and the intellectual property reside, where jobs are created and sustained, and where the investment is made.'

(*Source*: UK Ministry of Defence (2002) Paper Number 5: Defence Industrial Policy)

2.20 It is clear that governments are increasingly recognising the benefits of a more open approach to foreign ownership, control and influence, even in the most sensitive sectors of the economy. It would therefore appear *prima facie* advantageous for the airline sector to move in this direction. However, it is important to examine whether there are arguments unique to the airline sector that make ownership and control liberalisation a less attractive proposition, or suggest particular modification of the approach to such liberalisation. The next two chapters of this paper examine the arguments both for and against ownership and control liberalisation in the aviation sector.

Summary

2.21 There is no absolute requirement under international law that airline ownership and control restrictions be maintained.

2.22 Ownership and control restrictions were partly imposed to control competing airlines' access to scarce traffic rights. The ever-accelerating erosion of other bilateral restrictions over recent years may be chipping away at the foundation stone for ownership and control rules. However, even legislators in otherwise commercially liberal countries remain reluctant to remove ownership and control restrictions for airlines.

2.23 The treatment of ownership and control in the airline industry is increasingly anomalous. For an industry that is so integral to the process of globalisation, the nationality constraints on airline ownership present a striking paradox.

2.24 Moves towards "Open Skies" agreements only go part way to normalising the industry, as they ignore ownership and control liberalisation and restrict access to domestic markets. OAA agreements, as already implemented in Europe, would encompass reform in this area. Other reform-minded nations, such as Australia and New Zealand, have implemented unilateral reforms on ownership and control, allowing foreign-owned carriers to operate as domestic airlines.

1. It is worth noting that these achievements have largely been arrived at in conjunction with the economic regulation of monopoly elements of privatised industry.

INTENTIONALLY LEFT BLANK

Chapter 3 The arguments in favour of ownership and control liberalisation

3.1 This chapter examines the arguments in favour of removing the current widespread restrictions on foreign ownership and control of airlines, including analysis of the benefits that may flow from the creation of new commercial opportunities for airlines, the associated increase in competitive pressure and the resultant consumer benefit.

Mergers and acquisitions

3.2 In the absence of rules on ownership and control, airlines would be able to pursue any commercially attractive options such as merger with another airline (subject to scrutiny by the relevant competition authorities). This could help to restructure the airline industry along more sustainable lines by removing duplicated costs, exploiting synergies and enhancing efficient operations.

3.3 Consideration of profitability within the airline sector as a whole is suggestive of underlying structural problems. The sector has continually under-delivered in terms of its return on capital employed. Over the last five years, this could be explained by the combined impact of 9/11, SARS and high fuel prices. However, returns have been consistently low since the early days of the industry before the Second World War. For example, statutory accounts filings by US airlines to the US Department of Transportation ('Form 41 filings') for the 65-year period, 1940 to 2003, show that although the US industry made a profit in 55 of those years, its average margins have been well below the returns on risk-free bonds, and therefore substantially below average returns on equity for all sectors (see Table 2 below).

Table 2 Average profit margins of US carriers since 1940

	Profit Margin	
	Operating:	**Net:**
1940-1950	9.09%	1.64%
1951-1960	6.93%	3.63%
1961-1970	7.35%	2.97%
1971-1980	3.37%	1.92%
1981-1990	1.80%	-0.18%
1991-2000	3.99%	0.90%
2001-2003	-6.28%	-6.95%

(*Source*: Form 41 Filings, 1940-2003. US Department of Transportation)

3.4 The US airline industry is one of the worst performers but is not alone in suffering from returns that in most industries would be unsustainable. Similar trends are observable amongst flag-carriers both in Europe and elsewhere.

3.5 Although a number of explanations exist for these poor margins, consistent underperformance by the sector suggests that this is a structural rather than a cyclical issue. Whilst it would be simplistic to conclude that bilateral constraints and ownership and control rules are the sole reason for this, their existence means that options such as buyout, merger or consolidation with international partners are off the agenda[1]. Loosening the regulatory structure would at least remove one characteristic of the sector that may contribute to structural overcapacity.

1. Over-capacity in the industry can also be partly attributed to significant barriers to exit in place in a number of countries. In many countries, flag-carriers are recipients of state aid support, enabling them to "limp on" indefinitely, despite the lack of a viable business model. Although the US has no flag-carrier, high barriers to exit exist in the form of flexible "Chapter 11" legislation, which makes it easier for bankrupt airlines to restructure, and in some cases, reduce their debts under protection from creditors.

3.6 Box 3 discusses the Air France-KLM merger, highlighting the difficulties faced by airlines looking to consolidate under the current ownership and control rules.

Box 3 Air France / KLM – *"Merger or Alliance?"*

In May 2004, two of Europe's largest network airlines, Air France and KLM, formally merged, creating the largest single airline by revenue. However, this is anything but a conventional merger, resting as it does on a complex set of agreements.

In the first instance, the airlines had to reach agreement on how to comply with a number of undertakings imposed by the European competition authorities and the US Department of Justice. The airlines then had to consider the impact that their merger would have on their continued ability to utilise their traffic rights as designated carriers under respective French and Dutch bilaterals. The bilaterals generally require that designated operating carriers be controlled by nationals of the countries party to the agreements. Lastly, overlaying these businesses' specific concerns were national concerns regarding the loss of jobs at Charles de Gaulle and Schiphol airports (the carriers' two main hubs) post-merger. For these reasons, it was essential that the deal was structured to preserve at least the appearance of majority national control for both halves of the merged entity. The result involved a number of structural provisions:

Company and board structure. The company is headed by a holding company, Air France/KLM, controlled by the former shareholders of the two merged companies (at the time of merger, the French Government held ownership of 44 per cent of the company with private shareholders in Air France and KLM holding 37 per cent and 19 per cent respectively). Below the holding company, the separate identities for the two halves of the merged company have been maintained, with both companies retaining their own management boards, appointed by shareholders from both airlines. A complex system gives each airline power of appointment to each of the main and sub-board/committee bodies.

Separation of economic and voting rights. To maintain national control of each of the airlines in the face of its complex international ownership, a number of measures have been taken to separate voting rights from economic rights. Firstly, a new share swap separated out economic and voting rights. The majority of the subsequent voting rights attached to KLM's shares will be in the hands of Dutch shareholders, split between two holding foundations and the Dutch Government. In addition, the State of the Netherlands also retains a call option giving it the right to acquire, under certain conditions, a number of shares necessary to provide the Government with an interest of 50.1 per cent of the share capital and voting rights of the outstanding capital of KLM.

The above provisions heavily restrict the possible depth of integration between the merged entities. In 2003, the deal was anticipated to lead to an annual saving of €385-495 million by the fifth year of the merger – a relatively modest 2-3 per cent cut in the group's combined €19 billion cost base. By 2006, this figure had risen slightly to an anticipated combined synergy saving of €580 million in the first four years of the merger.

Experience to date suggests that the compromises made on voting and control have been successful in convincing French and Dutch bilateral partners that KLM and Air France remain sufficiently separate national carriers. However, it remains to be seen whether authorities will stay convinced should the company pursue further integration in the future – an option allowed after a period of three years. The future shape and structure of Air France/KLM may therefore depend on whether there is sufficient progress in the next few years with the liberalisation of ownership and control restrictions.

(Sources: Airline Business, November 2003, *Two's company;* Flight International, October 2003, *Merger creates European giant*; Business Travel Europe, August 2006, *Air France KLM estimates €92m savings on sales*.)

3.7 The need to "square the circle" on ownership and control explains why mergers between international airlines remain so rare, and why those that have been attempted so resemble alliances. The effects on the industry are far-reaching. Standard company theory suggests that consolidation though merger or acquisition, or the threat of it, plays an important role in improving business performance by:

- encouraging good corporate governance through the replacement of under-performing managers; and
- capturing synergies between firms.

3.8 These efficiencies, over and above those that alliances can deliver, are one of the elements that make the OAA model more attractive than the "Open Skies" model. In a study of the potential benefits of an EU-US open aviation area, the Brattle Group estimated that such a deal would create €2.9 billion of cost savings annually, equivalent to about 4.2 per cent of overall costs. They estimated that this would in turn lead to €370 million of consumer benefits per year from lower prices for air travel and the consequent increase in passenger traffic[1].

3.9 Conversely, in cases where *ex-ante* regulations serve to prevent mergers or acquisitions even being considered, this is likely to lead to weakened corporate governance and less efficient firms. Applying these arguments to the airline sector would suggest that it could benefit from significant efficiencies were these restrictions to be softened or removed, leaving control of mergers, as in other sectors, to the competition authorities. The extent of the benefits from enhanced merger opportunities has to be placed in the context of continuing restrictions on market access and supply-side constraints, such as the lack of slots at congested airports. However, as market access restrictions are successively removed, potential merger efficiencies are moving from second- to first-order importance, with the result that key industry figures are increasingly calling for the chance to realise these benefits:

'The current rules of the game in our business hurt – not just the airlines – but our customers too. In other industries, globalisation is fuelling mergers and acquisitions and other sorts of business combinations. And since there are no flag chemical companies or flag shoe companies, these combinations are able to progress so long as they will create efficiencies in areas like R&D, the elimination of duplicative staff, economies of scale and so on – the benefits of which accrue to the customer.'

(*Source*: Speech by Don Carty, ex-CEO of American Airlines, to AAAE Conference, Texas, May 2002.)

'…the [US] Government should repeal the 1938 federal law that bars foreign ownership of more than one-quarter of a US air carrier. This restriction has emerged as one of the most significant barriers to this industry becoming more global. Is there something special about the airline industry that justifies these limits on foreign ownership? I come from the oil and gas business where British Petroleum was able to buy significant oil and gas reserves in the US with the acquisition of Amoco and Arco. Many other industries are also consolidating across borders. Are airlines more "strategic" than energy reserves? I don't think one can make that argument successfully.'

(*Source*: Remarks by the CEO of United Airlines, Glenn F. Tilton, to the Chicago Council on Foreign Relations, 21 April 2005.)

3.10 Studies have shown merger efficiencies in other industries to be between 1.5 and 2.7 per cent[2], and it could be claimed that similar gains might be replicated in a liberalised

1. Brattle Group (2002) The Economic Impact of an EU-US Open Aviation Area.
2. *Sources*: Cowling et al. (1980); Grabrowski et al (1995); Lichtenberg and Seigel (1987).

aviation sector. For an industry with global costs of many billions, this represents a significant potential saving. However, empirical evidence of the benefits actually generated by mergers and acquisitions is variable, with a number of experts suggesting that they can be value-destroying in the longer term (possibly because pre-purchase equity prices often rise considerably on news of possible mergers, reflecting the premium over the prevailing share price purchasers often have to pay to shareholders).

3.11 Putting aside the variable potential benefits of mergers, the key point is that ownership and control liberalisation would allow the owners of companies to have greater control over the strategic and economic future of their firms, something that should be in the best interests of the industry and its consumers.

'This leads to the greatest hole in any argument in support of protectionism: the economic patriots are not the owners of companies they chose to defend. They do not bother to ask shareholders or management whether it is a good idea to erect barricades against foreigners.'

(*Source:* Article by Francesco Guerrera, *'It is Wrong to Defend National Icons'*, Financial Times, 18 August 2005.)

Cabotage

3.12 One important benefit to be gained from full liberalisation of Air Service Agreements comes from the ability of airlines to operate cabotage services. Cabotage is the name given to the operation by a foreign carrier of purely domestic services in another country. Currently, it would be impossible for, say, a US carrier to operate services between Vancouver and Montreal, as the bilateral agreement between the US and Canada does not allow for such cabotage rights. Opening up ownership and control rules would provide another means of allowing carriers to operate domestic services. If these rules were removed, then the US airline might choose to set up a Canadian subsidiary, operate domestically and also to codeshare with the parent airline to link in to its US and international networks. This could enhance the value of the US business, as well as benefiting the Canadian consumer. Such a change would require no weakening in the Canadian authority's oversight of its designated carriers, yet would allow much greater commercial freedom. Another option could be to open up Canadian domestic markets to all carriers, or carriers from countries with equivalent levels of ownership and control liberalisation.

Cost of capital

3.13 In addition to greater restructuring opportunities, ownership and control liberalisation would be expected to deliver significant benefits in terms of financing costs, as airlines would be able to seek capital from any source, rather than being restricted at the margin to capital based in their home country. In many cases this should also result in a lower cost of capital – particularly in smaller countries with less developed capital markets where constraints would be more keenly felt.

'It is an industry paradox that in one of the most capital-intensive industries in the world, airlines are being starved by their own governments of the access to funds that they so desperately need. And this effectively hampers consolidation at a time when consolidation is one rational response to the serious over-capacity situation.'

(*Source*: Speech by Geoff Dixon, CEO of Qantas, to the UK Aviation Club, July 2005.)

3.14 In countries like the US, with large and flexible capital markets, the need for access to additional overseas capital may be less critical. However, even in countries with easy access to capital, the most likely investors may often be "strategic investors" (i.e. other airlines or institutional investors with specific portfolios in aviation businesses) which could be based abroad and would therefore be denied to a US

airline as a source of capital investment. Additional benefit is likely where an airline is struggling financially, when capital might be tight and access to as many different sources of finance as possible would be attractive.

Managerial expertise

3.15 As many countries interpret control in a way that limits foreign representation at board or at senior management level, liberalising control should have a significant effect on the freedoms available to a company when looking to recruit specialist expertise at these levels, with subsequent benefits for the company as a whole.

3.16 Taken together, greater restructuring opportunities, cheaper capital and an injection of foreign management expertise and new routeing freedoms, in particular in foreign domestic markets, should result in significant benefits for airlines considering strategies for growing or re-focusing their business. This is something that may be of particular importance for the so-called "legacy carriers" as they seek to respond to competition from no-frills carriers.

A better deal for consumers

3.17 Restrictive ownership and control rules currently serve to protect airlines from competition in many markets, particularly domestic. Removal of these restrictions, in addition to providing new opportunities for airlines, would also bring greater competitive pressure into the airline market at large, forcing inefficient airlines to improve their performance or lose business, or be taken over. It could be argued that the ability for dominant carriers to expand might lessen competition and hurt the consumer. However, evidence from Europe, where trans-border takeovers in the aviation sector have been possible for the last decade, suggests that this ability has simply led to greater rivalry for services, which has in turn delivered lower costs, keener prices and better service for consumers.

3.18 More opportunities for airlines to operate in different markets will tend also to create more choice for consumers, and to stimulate a more flexible and dynamic airline industry. The ability for innovative approaches to be adopted (as new entrants challenge existing orthodoxy) would also be enhanced as ownership and control rules are relaxed.

3.19 Countries such as New Zealand and Australia that have taken the step to liberalise ownership and control regulations have largely justified the move on consumer grounds, stating that it is in the long term interests of their industry and their citizens.

Positive impact on employees

3.20 The possible impact of liberalisation on employees of airlines was examined in detail in the UK CAA's publication "*The effect of liberalisation on aviation employment*" (CAP 749). That paper concluded, *inter alia*, that the removal of bilateral restrictions, including those on ownership and control, was not something that should be feared by employees. Notwithstanding the possibility of localised and/or temporary unemployment due to increased competition from market entrants, the experience of the UK aviation sector in the face of EU liberalisation had in fact been a positive one for employees overall – liberalisation facilitated a growth in the market which had created many more jobs in the sector. Liberalisation also creates significant employment in related industries. An independent report commissioned by Boeing in 2006 found that liberalisation of the European market created 1.4 million new full-time jobs, and European GDP grew by $US 85 billion[1].

1. InterVISTAS Consultancy (2006) The Economic Impact of Air Service Liberalisation. A report commissioned by Boeing. www.boeing.com/commercial/liberalisation/index.html

3.21 As noted above, in times of financial distress for companies, nationality-based restrictions on ownership and control of companies could in fact be a hindrance to their survival, as it significantly limits the number of candidates able to "come to the rescue". The removal of such restrictions is therefore likely to improve the chances of such companies staying afloat and continuing to provide employment.

International precedents

3.22 Proponents of ownership and control liberalisation can increasingly point to a growing number of examples where governments have taken the plunge in liberalising ownership and control. Restrictions on foreign investment have been removed across strategic sectors such as energy and even defence, the ultimate strategic sector in many respects. As we have seen, a number of countries have already taken steps to liberalise their aviation sector, and reaped benefits without negative repercussions.

3.23 Perhaps the best example of aviation liberalisation is the European single aviation market, whose Member States have removed barriers to ownership and control to citizens of the EU. This was an inevitable step in light of the EU's founding Treaty of Rome principles protecting free movement of goods, people, capital and services. However, in the traditionally closed world of aviation, the effects have been profound, with trans-European ownership of airlines now a common feature. For example, Ryanair has grown to become one of the biggest operators out of the UK and operates cabotage services, yet is owned and effectively controlled by nationals from across Europe. easyJet, by comparison, is one of the biggest operators in a number of continental European markets, yet is largely UK owned.

3.24 The European liberalisation example is perhaps the biggest in terms of the number of countries affected, yet it is still only a quasi-liberalised situation preventing, as it does, the ownership and control of European airlines by non-Europeans. Another significant comprehensive change of policy on ownership and control has been in Australia, where the Government has amended foreign investment guidelines to allow foreign persons (including foreign airlines) to acquire up to 100 per cent of the equity of any Australian domestic airline (with the exception of Qantas), subject to a "national interest" clause (see Box 4 below).

Box 4 Australia – Taking the lead on ownership and control liberalisation

One of the most liberal unilateral policies in the world can be found in Australia, which has led the way in removing ownership and control restrictions in its domestic market.

Australia's relatively isolated geographic location and its size (the sixth biggest country in the world by landmass) mean that it suffers from what Blainey coined the "tyranny of distance"[1]. The Australian Treasury Department carried out a study into the country's economic remoteness. They found that: '*In 1998, 94 per cent of world activity was within 10,000 kilometres of the United Kingdom, but only 34 per cent of world activity was within 10,000 kilometres of Australia.'* [2]

This remoteness means that quick, reliable international and domestic aviation links are critical to the competitiveness of its economy and the connectivity of its society.

With the aim of opening up its airlines to international capital markets and increasing opportunities for competition in Australia's domestic aviation market, the Australian Government set out four strands of their ownership and control policy for the new Millennium:

- 'The Government has amended the Air Navigation Act 1920 to free up current ownership restrictions without surrendering Australian control of Australian international airlines.

- The Government has amended foreign investment guidelines to allow foreign persons (including foreign airlines) to acquire up to 100 per cent of the equity of an Australian domestic airline, unless it is contrary to the national interest.

- Australia's bilateral negotiating strategy will, in all cases, investigate and aim to achieve a more liberal means of designating international airlines which does not rely on ownership restrictions, but rather bases designation on place of incorporation, principle place of business or other evidence of commitment to providing air services from the territory of the other country.

- The Government will seek to negotiate a more liberal framework for ownership and control of international airlines in the WTO.'

These changes have been partially successful in achieving the sought-after injection of foreign capital. Air New Zealand acquired its initial 50 per cent stake in Ansett Australia in 1996 and full ownership of the airline in 2000. However, it had to confine its equity in Ansett International to 50 per cent in order to satisfy the stricter ownership and control rules on international airlines.

The track record of Australian carriers since liberalisation could be described as mixed. Ansett, the major competitor to Qantas in the domestic market, liquidated in October 2001, precipitated by the events of 9/11. However, the emergence of the low-cost airline, Virgin Blue, with significant investment from the UK in the form of Sir Richard Branson's Virgin Group[3], has been a relative success story, with domestic passenger numbers growing to over 8.5 million in 2004-5.

1. Professor Geoffrey Blainey (1966) *The Tyranny of Distance*.
2. Australian Government Treasury (2005) *Measuring recent trends in Australia's economic remoteness*.
3. At the time of writing, the Virgin Group is estimated to hold around 24 per cent of Virgin Blue.

(*Source*: Australian Government (2000) Ownership and Control of Australian Airlines. Policies from statement by The Hon. John Anderson MP, Deputy Prime Minister for Transport and Regional Services. www.dotars.gov.au).

Summary

3.25 Large parts of the airline industry have gone on record as saying that they believe ownership and control restrictions need to be removed in order for airlines to achieve synergies and at least have the same commercial options as those open to their counterparts in other sectors.

3.26 There is evidence to suggest that the aviation sector has suffered from chronic over-supply and that consolidation may be a key to returning to sustainable levels of profitability in the longer term. Enabling mergers and acquisitions to take place could be part of the solution to this problem. What is certain is that lifting restrictions on ownership and control will enable greater flexibility for airlines seeking better access to managerial expertise and cheaper capital from overseas, with benefits to the industry. Consumers should also benefit from liberalisation as airlines consolidate, becoming more efficient and effective rivals, and thereby enhance competition. Certainly, the evidence from within Europe has shown that the removal of ownership and control restrictions has been beneficial to consumers, triggering lower prices and greater choice, both of airline and service.

3.27 Some governments have already demonstrated that they share this belief in the benefits of removing ownership and control limits, not least because it is likely that consumers and the wider economy will ultimately gain from a more competitive, more dynamic and more efficient industry.

Chapter 4 The arguments against ownership and control liberalisation

4.1 This chapter explores the various arguments that could justify retaining ownership and control restrictions.

Safety and "flags of convenience"

4.2 It is essential to ensure that ownership and control liberalisation has no negative impact on safety, i.e. that changes do not allow airlines to circumvent national safety standards through arrangements akin to the maritime sector's experience of "flags of convenience", where companies seek out – or are under-cut by operators based in – countries with lower regulatory standards. Safety standards in the airline industry are justifiably strict and the question needs to be posed whether it would be possible to gain a cost advantage from artificially switching an airline's base to a country where the rules are laxer, or simply less rigorously enforced, whilst operating the same commercial services.

4.3 In principle, a combination of "Open Aviation Area" agreements, associated with the removal of traffic restrictions, and the typical "principal place of business" model for the licensing of airlines, could open up the possibility of airlines locating their business (and applying for their operating licence and AOC) from the most lenient regulatory authority in the grouping. While it seems unlikely that an existing major passenger airline would be prepared to expose itself to adverse publicity by re-registering in a state associated with perceived lower standards of safety regulation, this would be no guarantee. Furthermore, a new-entrant airline may regard potential savings from lower regulatory costs as sufficient to outweigh the risks and negative publicity.

4.4 In liberalised markets, such as Europe, there has been an attempt to retain a close association between an airline's principal place of business and regulatory responsibility. EC Regulation 2407/92 requires that no undertaking shall be granted an operating licence by a Member State unless its principal place of business and, if any, its registered office, are located in that Member State. This requirement is further underpinned by a power for the Member State granting the AOC to insist either on the aircraft being registered on its own national register or on another community register in another state in the European single aviation area. In practice, all Member States are thought to have exercised the option of requiring that the licensed airlines place their aircraft on their national registers. However, this does not guarantee that an airline will have a significant operational presence in its licensing country.

Box 5 The UK's experience of European liberalisation

In the early 1990s, the EU embarked on a broad-ranging liberalisation of its aviation sector.

The rules of the European Common Aviation Area (ECAA) were substantially in place at the beginning of 1993, and were completed in 1997 with the removal of all remaining government-imposed restrictions in Member States' domestic markets.

The ECAA removed the majority of barriers on tariffs, market access and ownership and control for all European airlines, allowing any EEA citizen to own and control a European carrier. Once licensed by a country within the ECAA, the carrier is able to access the whole of the European market.

Box 5 The UK's experience of European liberalisation (continued)

Article 4.1(a) of the European Regulation 2407/92 covering the licensing of airlines provides that EU States may grant Operating Licences only to air carriers whose principal place of business and registered office (if any) are within their territory. Informally, the European Commission has suggested that principal place of business should include some consideration of an airline's place of operations. However, no formal executive or judicial judgement on this issue has yet been made. This has left a question mark over a number of airline licensing decisions where the airline's principal operations are predominantly outside the licensing country. For example, there are a number of airlines with 50-85 per cent of their operations in the UK whilst being registered elsewhere in Europe.

The current ICAO safety structure

4.5 Internationally, the ICAO framework of standards and inspections aims to achieve universally acceptable levels of safety. However, the application of ICAO standards in some countries could be inferior to that in others, leading to the emergence of "flag of convenience" countries in the aviation sector. This could become more likely if the link between "nationality" and traffic rights were broken.

4.6 This problem exists even in a non-liberalised world, although its effects are contained by virtue of the restrictions imposed by the bilateral system. The challenge in a liberalised environment will be to ensure that incentives are in place to maintain or enhance safety standards rather than let them fall. Ideally, the system for developing OAAs should be constructed so that there is a clear incentive for candidate countries to raise their safety standards.

4.7 The Chicago Convention requires an operator to have an AOC, to be issued by the State in which the operator's principal place of business is located. The AOC determines who is responsible for an airline's safety oversight. It ensures that a single set of safety regulations is applied to each airline, and encourages the formulation and operation of a coherent safety management system. Safety oversight of that AOC by one State ensures clear lines of responsibility and accountability, giving other States the necessary assurance that they can call a specific State to account if they have concerns over the safe operation of a foreign airline.

4.8 ICAO plays a central role through establishing safety standards and, more recently, auditing Member States' safety management systems. One weakness of the Chicago system has been that, until the mid-1990s, ICAO did not police the application of its standards by particular States. Instead, individual States had to rely almost solely on information gathered from ramp checks on foreign airlines to assess whether minimum levels of operational safety standards were being met.

4.9 ICAO's Safety Oversight Audit Programme has been in place since 1996, initially on a voluntary basis but now mandatory. It establishes whether States meet the requirements of relevant parts of the Chicago Convention and specific annexes, and requires action plans to be drawn up where there are deficiencies. Summaries of the audit findings and action plans are available to all other ICAO members. Audits have now been completed for all but a handful of States; the vast majority of States have been required to produce action plans. Although the audits do not assess the safety of individual operators, the programme has raised the level of compliance with ICAO minimum standards and given all States sound, objective evidence to help them assess whether AOCs have been correctly issued to foreign operators and adequately monitored by the regulator.

Clear lines of responsibility

4.10 The main cornerstone of the existing system is the clear line of responsibility that it gives to airline owners. Effective safety oversight requires clarity over who is the operator of an aircraft and who is responsible for regulating that operator's safety. The present system, by linking airlines to countries through the issuing of an operating licence (largely on the basis of ownership and control criteria), makes it clear as to which regulator is responsible for the safety standards of an airline's operations irrespective of where that aircraft may be in the world. For UK AOC holders, the CAA oversees their operations, wherever those operations take place. This can involve UK CAA employees travelling abroad to satisfy themselves of an airline's safety standards, with the associated costs charged to the airline concerned. It is also important to emphasise that the onus under the present system is on the operator to satisfy the regulator that it meets the requirements laid down by ICAO, regional bodies such as EASA, or the relevant national authority. Were the introduction of OAAs and ownership and control liberalisation to lead to a reduction in safety accountability, this would be a strong argument against such moves. Chapter 5 discusses this further and suggests how any concerns can be overcome.

The trade dimension: protecting against "free-riders"

4.11 Put simply, countries may be concerned that liberalisation could be "exploited" by third-country "free-rider" carriers looking to take advantage of liberalised deals whilst keeping their own markets closed. For example, an airline or investors from a country with restrictive ownership and control laws could buy an airline in a country where the laws have been relaxed, thereby accessing liberalised aviation markets whilst still benefiting from protectionism in its own backyard. There is some precedent for this within Europe, for example in energy liberalisation where some countries have been quicker than others to open up their markets.

Protecting competition

4.12 Although often difficult to prove given the lack of transparency of many airline accounts, there is a strong concern amongst many in the international aviation sector that their competitors are being unfairly subsidised by their host governments. These concerns are heightened by the prospect that an OAA may allow unfairly subsidised third country airlines to circumvent state-aid rules that prevent governments from subsidising their own airlines. Such subsidies to airlines with access to OAA markets could create significant distortions to competition on the routes affected, to the long-term detriment of consumers and efficient carriers, which become unable to compete. Greater commercialisation of airlines is associated with greater accounting transparency and a reduction in government support, which should help ameliorate the problem. However, it is likely to be the case that the state-aiding of carriers will continue to be part of the aviation landscape well into the future. It may therefore be necessary for any country joining an OAA to submit to some form of state-aid discipline to remove the possibility of such support distorting competition.

4.13 It could be argued that none of these concerns matter: the liberalised country's aviation sector and its consumers will gain from the injection of capital, which they might otherwise not have had. Furthermore, over time, a subsidised company may become less efficient as a result of it being shielded from competition and lose out to companies operating in more competitive environments. However, this is a difficult argument to sustain, as competition may, at least in the short-term, be distorted by an imbalance of rights and costs between investors in different countries. There would also be other concerns in allowing an unlevel playing field to continue. The effect of subsidised carriers could be to undermine industry support for liberalisation by threatening the interests of domestic carriers whose home markets would be subject to potential "unfair" competition from third-country owned airlines.

Furthermore it could jeopardise prospects for further liberalisation in these third countries should they no longer view liberalisation as an essential prerequisite for gaining access to foreign markets.

4.14 These concerns need to be taken seriously. The worst-case scenario from unconditional liberalisation of ownership and control might be entirely contrary to the long-term interests of consumers and the industry, and could hamper attempts fully to "normalise" the global airline sector. Thus, any approach that is adopted when liberalising ownership and control, including the conditions placed on countries able to utilise its benefits, needs to be carefully thought through to avoid this.

Protecting the interests of national carriers

4.15 Despite increasing privatisation of airlines and the consequent structural separation of the state from national flag carriers, the exposure of national airlines to competition from foreign-owned carriers is not always considered to be in the national interest. Airlines are large employers and can be large profit – and tax revenue – generators, although 9/11, SARS, high oil prices and structural overcapacity created by the rescue of chronically inefficient flag carriers have combined to ensure that the airline sector as a whole has been far from profitable over recent years.

4.16 There is consequently a temptation for governments to continue to shield their airlines from competition, particularly where they regard foreign carriers as being more competitive, perhaps due to cost or service quality advantages. However, countries do seem increasingly willing to remove bilateral restrictions and thereby expose national airlines to greater competition, recognising that competition is capable of honing a more internationally competitive domestic industry and acknowledging that more services to the country are likely to provide benefits to the wider economy. The appetite for reform is often closely linked to the degree to which all parties to an agreement consider the competition to be "fair". The presence of distorting or discriminatory factors, such as state aid, may radically affect this support for change.

4.17 To ensure a level playing field post-liberalisation, the contracting parties tend to insist on a high degree of regulatory convergence covering areas such as fair competition, safety and security. For example, much of the discussion in recent talks about liberalising the aviation agreements between EU Member States and the US, has been around the degree to which each side is prepared to adopt a more harmonized approach on issues such as security and competition law. The degree to which regulatory convergence is necessary is discussed later in this paper.

Protecting national security

4.18 Concerns have also been raised about possible risks to national security if airlines can be owned and controlled by overseas interests.

4.19 Many countries have some kind of veto on the foreign acquisition of companies regarded as important to national security. The US provides a good example. There, the Exxon-Florio amendment enables the Committee on Foreign Investment (CFIUS) to review, and potentially veto, any deal that is considered a possible threat to national security. In the main, this process is applied to transactions that involve sensitive technology, and because of the current constraints on foreign ownership of airlines, there has been no need for the committee to consider acquisitions in this sector. Should ownership and control restrictions in the US be relaxed, one would expect CFIUS to examine the national security case in the event of a merger or acquisition of a US airline. A similar system exists for national security issues within the UK merger controls, and could be mirrored in other countries[1].

1. The UK's merger laws state that a takeover or merger can be referred for assessment by the UK's Office of Fair Trading, under direction from the UK Government, if it raises concerns that the merger may not be in the national interest.

Safeguarding the interests of employees

4.20 One of the main arguments voiced by opponents of ownership and control liberalisation is that the opening up of aviation will result in a net loss of jobs. Such concerns mainly revolve around the fear that national carriers, faced with greater competition from foreign-owned carriers, may respond by employing cheaper staff from lower-wage economies. Another concern is that the incumbent national carrier may lose out to more efficient overseas competitors with subsequent impacts on employment.

4.21 These concerns have probably been expressed most categorically by the US unions in the context of discussions on liberalisation of the agreements between EU Member States and the US. The politically influential US Airline Pilots Association (ALPA) has expressed fears that their members may suffer if the transatlantic market is opened up. The main points of concern appear to be that, under an OAA:

- US airlines will decide to lay off US workers and substitute lower wage EU workers, either directly or as a result of moving more operations to a wet-leased basis;
- Airlines from EU countries may be able to exploit wage differentials to win business from US airlines (resulting in US employees, in particular pilots, losing jobs or seeing a deterioration in their pay, terms and conditions);
- A US airline which merged with an EU airline could substitute cheaper EU flight crew for its existing US flight crews; and
- US businesses could adopt "flags of convenience" and operate transatlantic services out of a low-wage EU country.

4.22 The above concerns have been raised in a context where the wage differentials between the two economic areas are relatively small. Indeed, using some measures, US employees could be regarded as being cheaper to employ. The issues will, however, tend to be similar in other cases.

4.23 As cited earlier, the UK CAA's paper, *The Effect of Liberalisation on Aviation Employment*, published in 2004, examined the labour experience within the UK following the creation of the single EU aviation market. The paper showed that although wage differentials between some countries within the EU are relatively high, there was no indication that lower-cost European countries had benefited disproportionately from liberalisation. Indeed, labour interests appeared to have benefited, partly because the growth of the industry stimulated more employment. Between 1992 and 2001, direct airline employment across the Euro zone rose from 380,199 to 402,775, an increase of 6 per cent. Furthermore, there was no evidence to suggest that growth was at the expense of Europe's higher-wage economies, with France, the UK and Austria recording some of the highest rates of growth. Where countries did experience a net loss of jobs following the demise or rationalisation of national carriers such as Swissair, Sabena and Olympic Airways, these airline failures were linked more to the management and product offering of the airline rather than any factors linked to their nationality. Indeed, it is possible that the ownership and control rules barring foreign citizens from investing in these airlines' international routes contributed to their downfall by removing the possibility of a merger with an alliance partner or alternative saviour.

4.24 Of course, it would be wrong to attribute the growth in industry employment experienced in Europe over the last decade solely to the liberalisation of ownership and control restrictions. The main benefits arise from liberalisation of traffic rights. However, the burgeoning of new airlines and new and more frequent services stems at least in part from the fact that European airlines such as Ryanair and easyJet are

now unfettered by rules on ownership and control or cabotage. The key message from this experience is that ownership and control liberalisation has contributed to the level of investment in new aircraft and routes, to the intensification of competition, and to the resulting increase in employment.

Maintaining the global system of international Air Service Agreements

4.25 Ownership and control restrictions are closely associated with the web of bilateral traffic rights agreements that grew after the Second World War, and which are based on the framework formed by the 1944 Chicago Convention.

4.26 At the heart of this paradigm is the principle that a State should have proprietary control which airlines can use over the airspace and airports in its territory. Rights to use that airspace would only be given away reciprocally in exchange for similar rights in the co-signatory's airspace – thereby setting up a mercantilist system of bilateral agreements. For these agreements to have teeth, the rights they offered had to be prevented from being exploited by airlines from other countries. If a third country (or, by extension, investors from a third country) could gain access to the prized traffic rights agreed between the two countries this could undermine the entire system, and potentially open markets to everyone. Rules on ownership and control were one way of buttressing these restrictions.

4.27 In a world where countries are increasingly prepared to liberalise market access, the need for rules on ownership and control largely fall away. Nevertheless, liberalising countries may feel that liberalisation of ownership and control would upset the precarious balance of benefits that currently exists, particularly where moves to open up home markets may be exploited by third parties unwilling to make similar concessions.

Summary

4.28 It is noteworthy that, even without full regulatory convergence, the nature of the industry means that there are limits to the degree to which airlines can distance their operations from their main markets. Commercial factors create a "centre of gravity" for a passenger airline's primary operations, which limits an airlines' ability to reduce labour costs by relocating their operations abroad.

4.29 The prime concern in aviation is maintaining high safety standards. Nationality of ownership and control should not have any effect on an airline's safety record. However, it could allow airlines to seek an operating licence in the country with the lowest safety standards and associated costs of compliance. As the European experience demonstrates, under liberalised ownership and control, the geographical centre of an airline's operations might differ from the country granting its licence, or the nationality of its owners. This ability for regulation to be undertaken away from an airline's centre of operations highlights the importance of achieving regulatory convergence in the area of safety, and raises a question about whether there should be a closer link between an airline's operational and regulatory base.

4.30 It would be possible selectively to liberalise ownership and control restrictions with those countries capable of meeting acceptable levels of safety. This would certainly be a sensible step, both in terms of securing high standards of safety within the markets covered by the OAA, and also in providing an incentive for prospective members fully to ensure their own compliance with international standards. Mandatory programmes of safety audits under the auspices of ICAO, allied with ramp inspections by individual states, can play an important part in helping to provide some assessment of a country's ability to match *and sustain* the required standards. However, while the ICAO audit programme is extremely valuable, it does not itself guarantee minimum operating standards. Ideally, the incorporation of active safety

checks for new and existing members of an expanded OAA will bolster the effectiveness of the existing safety regime.

4.31 Recent experience in the EU illustrates the economic benefit that should arise from the removal of access restrictions on airlines and from airlines' ability to access financial markets free from the constraints of ownership and control rules. There is also a legitimate concern that the liberalisation of ownership and control rules will allow third-country investors access to markets whilst maintaining barriers to their own. This does not however appear to point to an absolute argument against liberalisation, rather it suggests a more measured approach to the way that ownership and control liberalisation is progressed.

4.32 The conclusion from these arguments is that ownership and control liberalisation should be actively pursued, but with due regard to relevant issues such as safety and the long-term healthy sustainability of the industry.

INTENTIONALLY LEFT BLANK

Chapter 5 Options and conclusions for the implementation of ownership and control liberalisation

5.1 This chapter examines how the removal of ownership and control restrictions could best be achieved in a way that manages a smooth transition from the *status quo*, with its delicate mix of interwoven restrictive international bilaterals, to a fully liberalised market, whilst maintaining strong safety standards.

5.2 It explores a number of options that are open to countries in renegotiating ownership and control restrictions for airlines to bring them into line with other comparable international sectors, and concludes with possible solutions to the "problems" of liberalisation identified in the earlier chapters (i.e. the possible erosion of safety standards, "flags of convenience" and "free-riders").

Regulating safety and safeguarding against "flags of convenience"

5.3 In considering solutions to the problem of regulating safety in a liberalised environment, it is clear that any changes must not permit the dilution of safety standards. Any new scenarios must therefore maintain effective enforcement, including a clear line of accountability between the licence holder and the relevant safety authority.

Selective liberalisation

5.4 One means of limiting the risk of the emergence of flags of convenience that could pose a serious risk in terms of safety is to liberalise only with countries in whose safety standards there is confidence.

5.5 This approach would be a natural next step from that taken by the US in its dealings with potential "Open Skies" partners, whereby the US Federal Aviation Administration (FAA) carries out its own audit of third countries' safety oversight and will only sign their version of a liberal agreement if the partner state is deemed to meet the category 1 safety standard (see Box 6 below).

Box 6 The US FAA's Safety Audits for foreign safety authorities

The FAA has established two categories of countries to signify the status of a safety authority's compliance with minimum international safety standards: Category 1 (in compliance with minimum international standards for aviation safety) and Category 2 (not in compliance with minimum international standards for aviation safety).

A country is defined as Category 2 where the FAA has assessed the country's civil aviation authority and has determined that it does not provide safety oversight of its air carrier operators in accordance with the minimum safety oversight standards established by the International Civil Aviation Organization (ICAO). This rating is applied if one or more of the following deficiencies are identified: (1) The country lacks laws or regulations necessary to support the certification and oversight of air carriers in accordance with minimum international standards; (2) the safety authority lacks the technical expertise, resources, and organisation to license or oversee air carrier operations; (3) the safety authority does not have adequately trained and qualified technical personnel; (4) the safety authority does not provide adequate inspector guidance to ensure enforcement of, and compliance with, minimum international standards; and (5) the safety authority has insufficient documentation and records of certification and inadequate continuing oversight and

Box 6 The US FAA's Safety Audits for foreign safety authorities (cont.)

surveillance of air carrier operations. This category consists of two groups of countries. One group is countries that have air carriers with existing operations to the US at the time of the assessment. While in Category 2 status, carriers from these countries will be permitted to continue operations at current levels under heightened FAA surveillance. Expansion or changes in services to the US by such carriers are not permitted while in Category 2, although new services will be permitted if operated using aircraft wet-leased from a duly authorized and properly supervised US carrier or a foreign air carrier from a Category 1 country that is authorized to serve the United States using its own aircraft.

The second Category 2 group is countries that do not have air carriers with existing operations to the US at the time of the assessment. Carriers from these countries will not be permitted to commence service to the US while in Category 2 status, although they may conduct services if operated using aircraft wet-leased from a duly authorized and properly supervised US carrier or a foreign air carrier from a Category 1 country that is authorized to serve the US with its own aircraft.

Source: US Federal Aviation Administration

5.6 Variations on the US approach have been adopted elsewhere. As a complement to the ICAO audits, ECAC[1] in 1996 launched its own SAFA (Safety Assessment of Foreign Aircraft) programme whereby individual member states carry out ramp inspections of foreign aircraft landing in their territory (the UK performed around 200 in 2005). Ramp inspections can by their nature allow only a limited inspection of the aircraft. The importance of such inspections should not therefore be over-stated but, as one of a range of measures, they can help to identify non-compliance with ICAO standards and may lead to action being taken where particular airlines or safety authorities give rise to concern. In addition, proposals currently being discussed in Europe include a revision to Regulation (EC) 1592/2002 on "Common Rules in the Field of Civil Aviation and Establishing a European Aviation Safety Agency" to include provisions to certificate third-country *airlines* wishing to gain access to the single aviation market.

5.7 These systems of auditing could be used as the mechanism for ensuring that all members of an enlarged OAA meet the required safety standards. As well as ensuring minimum standards were met, this approach would give applicant states a clear incentive to raise their standards to the requisite level. However, such audits of third countries' safety systems or carriers have always been controversial as it is extremely difficult to determine on a consistent, objective and on-going basis which safety regimes meet acceptable safety standards, and critics of the system suggest it can be used to intervene against a third-country carrier on separate political rather than safety grounds. Traditionally this type of approach has created some sensitivity amongst those countries under scrutiny, but in the context of a candidate country hoping to join an OAA, such sensitivities would seem less likely to exist. Moreover, such an approach does provide a level of reassurance to the auditing country, and would seem to be a sensible prerequisite to moving to full ownership and control liberalisation with any particular country.

Safety blacklists

5.8 As the US example illustrates, information from safety audits of *foreign safety authorities* can be used to refuse or revoke operating permissions on the grounds of

1. ECAC is the European Civil Aviation Conference, a non-regulatory organisation aimed at promoting a safe, efficient and sustainable European air transport system.

safety concerns. In the EU, information from the hundreds of periodic ramp inspections that take place across Europe has been used to form an assessment of the airworthiness of third-country carriers. This information has been used to compile blacklists of unsafe carriers (see Box 7, below).

Box 7 Safety blacklists

The EU has recently established an EU-wide safety "blacklist". The list bans airlines who do not conform with rules governing *inter alia* maintenance of aircraft, modernity of technical standards and safety management. The list, based on harmonised standards across Europe, has replaced the individual blacklists that were previously administered by individual countries. Prior to the reform, UK, France, Switzerland and Belgium all maintained separate blacklists. Now the European Commission publishes a consolidated blacklist on the basis of information provided by EU national safety agencies.

The EU blacklist has been made available to the travelling public and passengers have to be informed, at the latest on boarding, of the identity of the airline operating the flight. This is because airlines frequently lease or sub-charter flights to other operators when their own aircraft become temporarily unavailable. Such short-term changes are not subject to the same system of bilateral permits as longer-term arrangements and the operator of the flight might therefore be changed to a blacklisted carrier at the last moment.

Blacklists therefore represent one option for countries considering how to control safety in a liberalised environment. However, they are not uncontroversial. Firstly, they are seen as potentially confusing the lines of accountability between an airline and its regulatory authority, as an airline could argue that third parties such as foreign governments adequately regulate certain elements of its operations. Secondly, there is a suspicion that safety decisions by third-party partners could become politically motivated and used to control market access by foreign airlines (although this charge could equally be levelled at other forms of safety control). Thirdly, the process for deciding when to add or delete an operator to or from the blacklist must be seen to be transparent and fair, and operate swiftly both to protect the travelling public when standards decline, and to protect the operator's interests when confidence has been restored.

5.9 Both the US FAA's safety audit and the EU's blacklist policy create similar lists of "undesirables", the only differences being that the US system is based primarily on an audit of the safety authorities whilst the EU's relies, *inter alia,* on data on foreign airlines gathered from its Members' ramp inspections. A combination of these two methods could be used to screen potential applicants to an Open Aviation Area, in the event that ownership and control liberalisation was envisaged.

Strengthening "principal place of business"

5.10 This paper has discussed the importance of ensuring that safety standards are properly applied and that it is made clear to the airline and the authority granting the AOC that they retain accountability for safety regulation. The dangers of airlines "flagging for convenience" to sidestep regulatory burdens have also been set out. These concerns will be lessened if there are controls in place which require high safety standards of all carriers. However, there will still be advantages to ensuring a strong link between an airline and its regulator. Given this, it seems wise to alter the "principal place of business" definition to include a link to an airline's operations. This would go a long way towards ensuring that airlines could not "artificially" locate in states remote from their principal markets, simply for regulatory gain.

5.11 It is worth noting that there has been some controversy surrounding "principal place of business", partly because there is no commonly accepted definition for the term. In practice, many countries consider a company's principal place of business to be defined by where it is incorporated, and has its head office and senior management.

5.12 Although these requirements can be strictly enforced, this type of formulation means that an airline's principal place of business could be at a remove from its main operational centre(s). The notes to the recommended ICAO text on this subject explain "principal place of business" as a '*place where the airline has a substantial amount of operations and capital investment in physical facilities in the territory of the designating Party, pays income tax, registers and bases its aircraft there, and employs a significant number of nationals in managerial, technical and operational positions'*. (See note (i) in Box 8, below).

Box 8 ICAO recommended text on designation and authorisation

1 Each Party shall have the right to designate in writing to the other Party [an airline] [one or more airlines as it wishes] to operate the agreed services [in accordance with this Agreement] and to withdraw or alter such designation.

2 On receipt of such a designation, and of application from the designated airline in the form and manner prescribed for operating authorisation [and technical permission,] each Party shall grant the appropriate operating authorisation with minimal procedural delay, provided that:

a) the designated airline has its principal place of business [and permanent residence] in the territory of the designating Party;*

*b) the Party designating the airline has and maintains effective regulatory control** of the airline;*

c) the Party designating the airline is in compliance with the provisions set forth in Article X (Safety) and Article Y (Security); and

d) the designated airline is qualified to meet other conditions prescribed under the laws and regulations normally applied to the operation of international air transport services by the Party receiving the designation.

3 On receipt of the operating authorisation of paragraph 2, a designated airline may at any time begin to operate the agreed services for which it is so designated, provided that the airline complies with the applicable provisions of this agreement.

Integral Notes:

(i) *evidence of principal place of business is predicated upon: the airline is established and incorporated in the territory of the designating Party in accordance with relevant national laws and regulations, has a substantial amount of operations and capital investment in physical facilities in the territory of the designating Party, pays income tax, registers and bases its aircraft there, and employs a significant number of nationals in managerial, technical and operational positions.

**evidence of effective regulatory control is predicated upon but is not limited to: the airline holds a valid operating licence or permit issued by the licensing authority such as an Air Operator's Certificate (AOC), meets the criteria of the designating Party for the operation of international air services, such as proof of financial health, ability to meet public interest requirement, obligations for assurance of service; and the designating Party has and maintains safety and security oversight programmes in compliance with ICAO standards.

(ii) the conditions set forth in paragraph 2 of this Article should be used in the article on revocation and authorisation.

Source: ICAO (2003) Consolidated Conclusions, Model Clau.ses, Recommendations and Declaration from the 5th World Wide Conference on Air Services.

5.13 The European Commission recently published proposals aimed at updating the regulations covering the single European aviation area. These proposals also include the concept of making a stronger link in its principal place of business requirement to the location of the airline's operations:

> *'Where the licence is applied for to the authority of a Member State, its head office and, if any, registered office are located in that Member State, it carries out a substantial part of its operational activities in that Member State and, where the AOC is issued by a national authority, the same Member State is responsible for the oversight of the AOC.'*
>
> (*Source*: Proposal on Common Rules for the Operation of Air Transport Services in the Community; COM (2006) 396 final. http://europa.eu.int/eur-lex/en.)

5.14 It is clear that there is strong support for a closer link between an airline's principal place of business and its operational centre. However, for airlines operating from a number of equally important markets, their principal place of operation could change over time, suggesting that they would constantly face the threat of having to re-license the carrier, with undesirable levels of uncertainty and cost. There is therefore a certain counter-intuitive aspect to recommending greater reliance on a link between centre of operations and the concept of principal place of business in order to facilitate a trend towards more trans-national airline operations.

5.15 Neither the ICAO nor European Commission proposals offer any guidance as to how the "substantial part of its operations" requirement should be interpreted, and this is likely to be an area where Member States might take different views if the proposal becomes law. However, it is certain that this type of formulation would rule out pure "flag of convenience" operations with few operational links to the licensing state.

5.16 A closer link to principal place of business will no doubt help regulators secure safety standards in a world of regional OAAs. However, the ultimate aim of liberalisation would be to facilitate truly global airlines, with several regional hubs serving different continental and trans-continental markets. In such cases, it will be impossible for a regulator based in one country to be close to all of a licensed airline's global operations. Although the vetting of countries' safety authorities should help ensure no diminution of safety standards, the increasingly dispersed nature of an airline's operations could create new problems for day-to-day regulatory oversight, especially if large-scale operations were being carried out entirely separately from the carrier's regulatory home. This suggests that, in such circumstances, safety regulators may also have to be more innovative in the way that they police safety standards in the future, and may need to consider approaches involving much closer cooperation. These are discussed below.

Closer cooperation between safety agencies on international aviation

5.17 Where a bilateral system continues to operate, the inclusion of effective safety clauses in an "Open Skies" agreement is an initial, relatively straightforward safeguard. Where the agreement covers airlines with distant operational "outposts", further arrangements may have to be agreed, ensuring both the satisfactory inspection of aircraft and maintenance facilities and the oversight of operational and personnel issues (e.g. the application of a coherent safety management system). For example, in May 2005, the UK and New Zealand Governments agreed to a widely liberalising agreement, including ownership and control liberalisation for New Zealand based carriers and rights for New Zealand airlines to operate cabotage services within the UK[1]. Under the agreement, designation as a New Zealand airline is restricted to airlines for which:

- *the principal place of business and place of incorporation is New Zealand; and*
- *New Zealand maintains effective regulatory control of the air carrier.*

5.18 Again, however, the opportunity to sign a completely liberal deal was frustrated by EU ownership and control regulations that limit the degree of liberalisation that can be agreed in this area. Consequently, the designation clause for UK airlines uses the standard European formulation, including the requirement that the airlines are majority owned and controlled by EU nationals.

5.19 For New Zealand carriers at least, this agreement broke the link between the nationality of ownership and the country of regulatory control. In the case of New Zealand and the UK, the safety record of both countries is good and the systems of safety regulation are well established. Under the agreement, responsibility for safety under the new arrangement would rest with the country issuing the AOC. However, the theoretical possibility of an airline registered in New Zealand operating stand-alone domestic "cabotage" services in the UK poses significant questions about how effective supervision might be secured by the New Zealand authorities. Regulating safety might incorporate one or more of the following possibilities:

a) the relevant aircraft regularly return to New Zealand, allowing for effective inspection by the home authority;

b) New Zealand safety regulators establish an outpost office in the UK, and/or send inspectors on a regular basis;

c) New Zealand "contracts out" safety inspection of relevant operations to the UK regulatory authorities; and

d) New Zealand "contracts out" safety inspections to a third country or another body acceptable to the UK.

5.20 None of the above arrangements would remove ultimate responsibility or accountability for safety regulation and oversight from New Zealand. There is another possible arrangement, although again this scenario would only be possible in Europe if European ownership and control rules were relaxed:

e) subject to the necessary changes to the EU ownership and control requirements, Air New Zealand (or another New Zealand airline) establishes a UK subsidiary, 'Air New Zealand (UK) Limited', with a significant amount of its operations and principal place of business in the UK. However, it continues to operate as a discrete UK airline subject to UK and EU safety regulation, despite being owned and controlled by New Zealand (and other) nationals.

5.21 To date, the question of how safety regulation of a carrier operating exclusively abroad has not had to be answered in practice, as no operation has yet been established to exploit the freedoms presented by the liberalised UK-New Zealand agreement. The precise arrangements for ensuring safety will therefore need to be agreed between the safety authorities of both jurisdictions in a way that retains the full accountability of the licensing authority whilst satisfying all parties to the agreement that safety standards are being – and will continue to be – met.

5.22 When examining which of the regulatory solutions discussed in paragraphs 5.19 and 5.20 is most desirable, some seem more sensible than others. Option (a) would clearly be impractical for operations which operate entirely away from the country of regulation, whilst option (b) would involve an element of duplication likely to involve higher costs. Option (e) would seem sensible, but is precluded by current regulations. Therefore, options (c) and (d) would appear to offer the best way forward within the

1. The agreement was subject to EU rules, which forbid "price-leadership" by non-EU airlines on intra-EU routes. This means that a New Zealand carrier could not undercut the prices charged by an EU-carrier for the same service. Responsibility for enforcing this rule rests with the European Commission. The UK CAA understands that this rule has, to date, never been tested.

current regulatory framework: namely the contracting out of day-to-day safety regulation to the local safety authority, with ultimate legal responsibility resting with the foreign state's CAA (in this case New Zealand's). However, it would be important to establish clear lines of responsibility in cases where one safety authority is effectively sub-contracting work to another.

5.23 Ultimately, a solution to the problem of ensuring seamless administration of safety requirements across national borders might be the creation of a pan-OAA safety authority. Such a solution, which would mirror what is happening on a smaller scale in Europe with EASA, would require significant transfer of powers from nation states and may not be politically acceptable.

5.24 This chapter has explored various solutions to the concern that in a liberalised world, regulating an airline whose operation may be based in a number of states within a liberalised OAA may require a different type of safeguard to those we are used to seeing in the existing world dominated by nationality-based bilateral agreements.

5.25 In an ideal world, the nationality of an airline's investors should be an irrelevance to the effectiveness of safety regulation, as airlines would be subject to the same safety standards and controls, irrespective of the nationality of their investors. Nevertheless, it is important to recognise that liberalisation does raise questions of safety regulation; the UK CAA believes however, that the conclusions set out below are well placed to secure safety under these conditions.

Conclusions on safety

In principle, the nationality of an airline's ownership and control should not in itself pose any threat to safety standards. However, safety arrangements need to take account of the practical reality of a wide variation in global safety standards and while significant effort is being made at an international level to raise global safety standards (through ICAO in particular), this alone is unlikely to ensure complete equivalence in the near future.

Removal of ownership and control restrictions, combined with liberalised traffic rights could open up opportunities for airlines regulated by countries with lower safety standards to fly services between and within other countries. As a safeguard against a situation where such enhanced access to markets within an Open Aviation Area could lead to a diminution in safety standards, this paper therefore suggests that OAAs should be developed through a process of selective liberalisation. Access to the enhanced market opportunities available would only be open to carriers from countries able to demonstrate a level of safety compliance equivalent to that within the OAA grouping. Indeed, auditing of candidate countries' safety regulation has been a prerequisite of any new Member State's incorporation into the European single aviation area. However, despite these efforts, when achieved safety rates are compared, there remain wide variations, even within Europe. We would nevertheless expect this approach to be applied to safety considerations in talks involving the UK or Europe and third countries in the future.

Such an approach has a dual benefit. In addition to increasing the pressure for high safety standards for airlines operating within the group, the presence of such a strict requirement should incentivise higher safety standards within candidate countries and airlines wishing to gain access to an expanded OAA.

Another issue that faces safety regulators within an OAA is the prospect of increased geographic detachment of the airline from its safety authority, either because an OAA allows for dispersed operations, or because of temptations to "flag for convenience". The UK CAA would support calls by ICAO and the European Commission to require a closer link between an airline's regulatory home

and its operations, as this would strengthen lines of accountability and facilitate effective day-to-day regulation.

Finally on safety, the paper has also explored ways in which safety authorities might be able to share safety responsibilities in the future. This will necessitate closer cooperation between safety authorities and a clear delineation of responsibilities if clear lines of accountability are to be maintained.

To summarise, regulating an airline whose operations may be based in a number of states within a liberalised OAA may require a subtly different set of safeguards to those traditionally used:

Member States within an OAA must be able to demonstrate:

- ongoing compliance with the standards of safety regulation expected of those within the OAA grouping. This may logically suggest the development of supranational safety organisations such as EASA, which encourage closer cooperation between safety authorities operating within the OAA to ensure that safety standards are maintained to a consistently high standard; and

Countries wishing to join an OAA must be able to prove:

- they meet safety standards equivalent to those already within the OAA grouping, probably through audit processes (akin to the US FAA's safety audits of foreign safety authorities and the EU's own tests for applicant states' safety authorities); and

Countries outside of the OAA will be subject to:

- application of other methods of safety regulation, including the maintenance of safety blacklists for airlines not meeting the necessary standards.

This combination of measures should ensure that safety standards are at least maintained, and at best improved, as a consequence of ownership and control liberalisation.

5.26 The solutions set out above provide a template for ownership and control liberalisation. There is some precedent for this type of approach, particularly in Europe, which has pioneered the international Open Aviation Area model (although there remains some considerable way to go before the EASA system can be declared to be delivering the full benefits of high levels of safety maintenance and continued improvement that the UK CAA would wish to see embedded). The structure suggested would create a hierarchy of standards through which countries could move up as they seek to access liberalised markets. This should have the effect of incentivising improvements in safety standards, making aviation safer as countries break down barriers to ownership and control liberalisation – a welcome dynamic that contrasts with concerns that liberalisation would lead to a diminution in safety standards.

Protecting against "free-riders"

5.27 Another concern highlighted in this paper is the treatment of third country airlines and investors in a liberalised scenario. One option is to open up the market in a way that enables all investors and airlines access to the liberalised market *even where similar opportunities have not been made available in their own market(s).* However, such an approach could remove some of the incentive for the illiberal country to liberalise its own arrangements. On the other hand, some may consider that the benefits to the liberalising nation of receiving greater capital investment outweigh the opportunities lost from conceding an opportunity for securing reciprocal rights.

5.28 With these considerations in mind, ownership and control liberalisation could take two forms:

i) **Inclusive** ownership and control: remove all nationality-based ownership and control restrictions for airlines from both sides. Under this scenario, investors from a non-signatory country/region would be able to invest in airlines from any of the signatory countries.

ii) **Exclusive** ownership and control. Ownership and control only possible for investors from countries that have agreed a similarly open arrangement with the country or bloc of countries.

(See: ***Annex 1:*** *Regulatory options and the risk of "free-riders"*).

5.29 The policy benefit of the latter approach is that it avoids the problem of offering benefits to "free-rider" countries unprepared to offer similar concessions for their airlines. By far the most desirable in terms of securing wide-scale liberalisation is option ii, as this allows for the growth of a pool of eligible investors and for merger opportunities to grow as liberalisation progresses.

5.30 It is assumed in this situation that once an OAA has been established, any additional OAA-type arrangement negotiated by a member of that bloc will be available to an airline within the bloc so long as it is owned and controlled by investors from within the OAA. For example, an airline established within a bilateral OAA encompassing countries A and B, and owned and controlled by nationals from country B should be able to exploit the freedoms opened up when country A negotiates a bilateral OAA with a third country C.

Conclusions on "free-riders"

The issue of "free-riders" is frequently cited by opponents of ownership and control liberalisation. As this paper has shown, there is a legitimacy to some of these concerns that necessitates a sensitive handling of the liberalisation process. To recap, "free-riders" describes the situation where a party not subject to an agreement exploits the ownership and control advantages created by a liberal inclusive agreement with two other states, despite not offering similar opportunities to investors of the signatory states. This raises strong commercial, strategic and presentational concerns about the fairness of allowing the ownership of airlines by nationals from countries without broadly equivalent open ownership and control rules.

To avoid exploitation by free-riders, the UK CAA concludes that investor rights should only be open to those from countries that have signed up to equivalent, liberal OAA agreements. Although this approach may limit the sources of capital available to a carrier in the short term, it should provide added incentives for the expansion of OAA-type agreements as excluded parties seek both investment and market opportunities in the liberalised OAA markets.

5.31 Such non-circumvention agreements would avoid the political and economic concerns felt by opponents to ownership and control liberalisation whilst broadening the pool of investor cash and management expertise available to airlines.

5.32 The approach also provides an incentive for third countries to reciprocate on ownership and control liberalisation. By ensuring that third country investors and airlines would only be able to take advantage of the benefits of liberalisation if their home country had undertaken equivalent reforms, it is hoped that the momentum for change will increase.

Regulatory convergence

5.33 Liberalised ownership and control rules will also create significant opportunities for carriers to exploit previously inaccessible new markets such as the operation of purely domestic services in the other foreign country. As this paper has set out, the experience of consumers and carriers more generally has been positive where ownership and control liberalisation has occurred. It is no accident, however, that full liberalisation has only occurred between countries with similar regulatory traditions and structures. As we have seen, one of the reasons for this is that liberalisation between countries that have different rules on issues such as state aid and the protection of competition, increases the prospect of unbalanced competition occurring between airlines based in those countries.

5.34 In an ideal world, full regulatory convergence would be necessary to secure a completely level playing field. However, any insistence on this as a prerequisite to expansion of liberal agreements would create an unrealistic and disproportionate obstacle to normalisation of the industry. Furthermore, it is no guarantee of success. Even within Europe, whose laws and regulatory systems are closely aligned, there are frequent complaints from industry about inconsistent application of the law, where discretion is granted to Member States.

5.35 A more pragmatic solution to tackling ownership and control liberalisation is therefore needed; one that provides a level of security for operators in a future, liberalised system, without placing unrealistic conditions on candidate countries. The most realistic option is to require countries within a bloc to sign up to a fair competition agreement that commits the signatory to abiding to a set of principles and rules governing the application of competition policy and the administration of state aid. Such an approach has recently been adopted in the UK's talks with New Zealand and Singapore respectively.

5.36 To be effective, such controls need to be accompanied by an appropriate enforcement mechanism. In a traditional bilateral environment, breach of the fair competition article or any other element of an agreement might trigger consultation between the parties or, in extremis, the initiation of the prescribed arbitration process. A similar procedure could be implemented in a multilateral agreement. In the case of negotiations between the EU and US, provisional agreement has been reached on setting up a "Special Committee" to deal with complaints between the parties at an early stage in order to reconcile any difficulties and avoid the need for a full arbitration process.

Conclusions on regulatory convergence

The existence of regulatory differences between potential members of an OAA is another key area that is liable to give rise to problems. There are clear parallels with the "flag of convenience" arguments raised in the context of the discussion on safety regulation. The threat of competition within the OAA being harmed by the unfair allocation of state-aid or by significant differences in regulatory standards in areas like competition enforcement is real enough to justify general conditions of regulatory convergence being placed on participating countries.

Requiring candidate 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. Such a commitment would prohibit, amongst other things, anti-competitive behaviour and the granting of state aid capable of distorting competition. To enforce 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 OAA members tasked with examining and investigating complaints.

5.37 Realistically, full regulatory convergence is unlikely to be possible for many states given differences in their legal frameworks. Where it has been possible, such as in the European single aviation area, this has occurred due to the existence of a pan-European system of laws.

5.38 It would therefore be unrealistic for candidate countries to an OAA to commit to full harmonization of their domestic laws. Consequently a proportionate solution that provides adequate protection of competition, whilst accommodating unavoidable differences in international law, is necessary.

Delivering reform

5.39 We have so far identified the main legitimate areas for concern that may exist when looking at liberalisation of ownership and control rules. This section examines the best vehicle for taking forward the liberalisation agenda.

5.40 The vast majority of aviation agreements tend to be negotiated on a bilateral basis. The UK alone holds over 110 bilateral agreements with other countries covering its aviation relations[1]. However, the last 40 years have seen the establishment and strengthening of multilateral regulatory structures in the aviation sector and more widely. For example, ICAO is recognised by the majority of countries the world over and, in Europe, the advent of the European Aviation Safety Agency (EASA) has begun to take some elements of safety regulation onto a multilateral basis. In addition, regional economic and political groupings such as the EU, the African Union and the Caribbean Community (CARICOM) have raised the prospect of negotiating aviation rights on a regional basis[2]. Perhaps the most economically significant example of this is the EU/US negotiations, where the European Commission has been given a mandate to negotiate a comprehensive new Air Service Agreement with the US on behalf of all 25 EU Member States. If successful, this agreement will cover the vast majority of transatlantic traffic and put all EU carriers on the same footing in respect of EU-US rights, regardless of nationality.

5.41 Governments therefore face an increasingly diverse range of options when considering the way forward for liberalisation:

- Option I: the unilateral approach. A single country takes a decision unilaterally to reform the ownership and control rules for its airlines.
- Option II: the bilateral approach. Two countries come to a reciprocal agreement to reform ownership and control restrictions for airlines from both sides.
- Option III: the multilateral OAA approach. A group of countries agree to a common set of criteria for ownership and control.
- Option IV: the global approach. A global forum (e.g. ICAO or the WTO) is used to broker a broad agreement on ownership and control.

5.42 Each of these options has its own benefits and drawbacks, which are explored in detail in the rest of this chapter, illustrated using the experiences of a number of different countries.

1. IATA estimates that the total number of air service agreements worldwide exceeds 3,500.
2. Multilateral groupings have multiplied considerably over recent years. Groups created since 1995 are: the CARICOM Air Service Agreement of 1996 (14 Caribbean States), the Fortaleza Agreement of 1997 (6 South American States), the Banjul Accord of 1997 (6 West African States), the CLMV Agreement of 1998 (Cambodia, Lao PDR, Myanmar, Viet Nam), an agreement in 1998 among 16 Arab Civil Aviation Commission (ACAC) states, an agreement in 1999 between in 1999 between six States of the Economic and Monetary Community of Central Africa (CEMEC), an agreement in 1999 among 20 States of the Common Market for Eastern and Southern Africa (COMESA) and the Yamoussokro II Ministerial decision of 1999 involving 52 States. (*Source*: IATA (2004) Advancing the Liberalisation of Ownership and Control).

Option I: the unilateral approach

5.43 A number of countries have taken the decision that the benefits of ownership and control liberalisation so outweigh the disbenefits that significant liberalisation should not wait for the agreement of less liberal-minded countries.

5.44 Australia offers one example of this approach. Its decision in 2000 to liberalise ownership and control restrictions for its domestic airlines was taken on the basis that the benefit chain of greater investment, heightened competition and better consumer services was all strongly in the national interest and there was little to gain from delaying these benefits in attempting to leverage reciprocal liberalisation in other markets.

5.45 However, some of the limitations of the unilateral approach are clearly illustrated by the Australian example: whilst the Australian Government stated clearly its intention to remove all ownership and control restrictions applying to its domestic airlines, it stopped short of full liberalisation of ownership and control restrictions for its international airlines. As the Australian Government noted in its policy statement announcing the changes to Australian ownership and control regulations, it would not be possible unilaterally to alter the ownership and control limits for its international airlines. The logic is succinctly and effectively set out:

'Under the terms of existing bilateral air service agreements airlines can be unilaterally barred from a route if either of the partners is not satisfied that those airlines are substantially owned and effectively controlled by citizens of the designating party.

To meet these international obligations, Australian law contains statutory limits on ownership and control of our airlines. However, the Government can see no sustainable reason why all potential investors in our international airlines should not be treated equally.

The Government has therefore amended the Air Navigation Act to put those statutory requirements at the limit of what our bilateral partners will accept (49 per cent foreign ownership with no distinction between foreign airlines and other foreign investors).'

Source: Australian Government (2000) Ownership and Control of Australian Airlines. Policies from statement by The Hon. John Anderson MP, Deputy Prime Minister for Transport and Regional Services. www.dotars.gov.au

5.46 The path chosen by the Australian Government has its advantages: it enables its domestic airlines to enjoy the benefits of free ownership and control, including the injection of foreign capital and expertise, whilst avoiding the problem of "forfeiting" bilateral rights for its international carriers that might arise from unilateral liberalisation of ownership and control[1]. Passengers on domestic services benefit from open ownership and control arrangements through the injection of greater competition, greater choice as foreign start-ups offer new services and the subsequent improvement in service quality and prices. For international airlines, however, the picture is very different. The Australian Government has made specific commitments on the future ownership and control of its flag carrier, Qantas[2]. These would need to be addressed if the Australian Government were to remove the nationality-based ownership and control constraints for its international airlines.

1. Note that Australia and New Zealand are signatories to a Single Aviation Area agreement, which means that the domestic airlines referred to here are also able to fly between the two countries.
2. The ownership and control provisions for Qantas are dealt with separately under the provisions of the *Qantas Sale Act 1992*. At the time Qantas was fully privatised in 1995, the Government undertook that the *Qantas Sale Act* would ensure that Qantas would remain Australian. The Government would therefore be unable to change the ownership and control rules for Qantas without further and separate public consideration.

5.47 This twin-track approach is partly a reflection of the political sensitivity of ceding airline control to foreign nationals but also shows the limits of unilateral action on ownership and control for international services: it could be unwise for a country unilaterally to liberalise ownership and control for its international carriers if that country's airline(s) were consequently to lose the right to designation in the eyes of its international partners. This can be avoided if flexibility is incorporated into the bilaterals in advance (e.g. removing the link between principal place of business and nationality, or requiring that an airline need only be established in the designating country). However, this takes time and the cooperation of other states. For international services at least, engaging with other countries is essential. For this reason, the unilateral approach may only really be open to countries with a significant domestic market.

Option II: the bilateral approach

5.48 Engaging on a bilateral basis may remain the most common approach for most countries looking to liberalise ownership and control rules. In theory, where the markets are large enough, it would also allow the establishment of carriers with cross-border investment aimed at servicing these markets in isolation, thereby avoiding the "loss of traffic rights" effect of other bilaterals.

5.49 The UK, for example, has for a period pursued a general policy of liberalising its ownership and control restrictions in its bilateral agreements. Since 1997, the UK's model Air Service Agreement has been amended so that designated airlines of the other country would no longer be required to be majority owned and controlled by nationals of that country, but would be required to have their principal place of business in, and be subject to regulatory oversight by, that country. The UK Government has had reasonable success in persuading bilateral partners to accept this formulation. However, it is frequently frustrated by a number of factors:

- Many countries are often reluctant to relax their ownership and control restrictions for reasons of protectionism or national prestige;
- The EU's own rules, by which the UK is bound, require majority ownership and control by EU nationals. This makes it impossible for the UK to reciprocate where a bilateral partner is willing to take a liberalising initiative in this area;
- As with the unilateral approach, it would be extremely difficult to avoid the "inhibiting" effect of other bilaterals, which put traffic rights to third countries at risk for carriers seeking inward investment or cross-border management resource.

5.50 These frequently prove to be difficult issues in negotiations. Nevertheless, there are clearly a number of benefits to a bilateral approach. It enables rapid progress to be made where there is a meeting of minds and safety standards are considered by both sides to be high.

5.51 Should a significant number of countries take the route of designating their carriers on the basis of principal place of business rather than the majority of their owners, then the inhibiting effect of the remaining bilaterals should start to fade away.

5.52 However, the situation in Europe is unusual, in that a supranational agreement placing a ceiling on the level of non-European ownership of EU airlines effectively limits the degree of liberalisation that can be agreed by any of the individual 25 Member States. Further ownership and control liberalisation by EU Member States would therefore require an agreement to remove the limit on non-European ownership and control of European carriers, or alternatively the granting of a full mandate to the European Commission for the negotiation of a full agreement with a third country, which once enacted, would override the European law on 49 per cent. Either course of action would need the cooperation of the European Commission and the agreement of both the European Council and the European Parliament.

Option III: the multilateral OAA approach

5.53 Ownership and control restrictions are becoming more commonly defined in regional rather than national terms. This multilateral approach may be more effective in opening up aviation than bilateral engagement has been in the past.

5.54 The multilateral approach is increasingly being used across the globe as countries pool their interests for mutual advantage in order to try to gain greater leverage for deals with other international partners. The most active and advanced proponent of this approach is Europe, where the European Commission is actively taking a greater role in the negotiation of deals. There are a number of reasons why this is the case:

- *Past 'successes'.* The creation of the single European market for aviation in 1993 arguably represented the largest single breakthrough in airline liberalisation since the beginning of the Chicago convention. The European Common Aviation Area (ECAA) now applies to 29 countries and this number is expected to grow as neighbouring countries are brought into the OAA.
- *Legal competence.* The European Court of Justice's "Open Skies" judgements of 5 November 2002 found that bilateral agreements providing entitlements only for airlines owned by nationals of a single Member State contravene Community law, and also confirmed that the Community has exclusive competence in a number of key areas of European aviation law[1], including slot allocation, intra-Community fares and Computer Reservation Systems (CRS). This meant that only the European Commission is entitled to engage in multilateral discussions with partner countries on these issues (though it needs a specific mandate from the European Council to do so). A political agreement in 2003 created shared responsibility between the Member States and the Commission for remedying the large number of illegal bilaterals. Building on these competencies, the Commission has also sought mandates from Member States to negotiate full aviation agreements – to include traffic rights – with other international partners. The EU/US negotiations are the most significant of these. However, the Commission's strategy is ultimately to seek similar negotiating mandates for other strategic markets such as China and Russia[2].
- *Political leverage.* There is no doubt that the pooling of interests at a regional level can bring greater negotiating options to the table that are unavailable to individual Member States. International agreements on trade are increasingly negotiated on a multilateral basis (e.g. GATS) and Europe's influence on these broader political issues can be leveraged.

5.55 For this approach to be fully successful, it is important that the OAA is able to grow to incorporate new countries willing to liberalise ownership and control.

5.56 In general, the benefits of ownership and control liberalisation are likely to grow exponentially as more countries "sign up". Mergers or injections of foreign capital to existing airlines (who may fall foul of bilateral restrictions on non-liberal countries) will be easier as more and more members enter the club.

5.57 Europe has the most developed administrative and political structures for negotiating multilateral treaties, but is not alone in pursuing this approach. Groupings like the Caribbean Community (CARICOM), the Latin American Civil Aviation Commission (LACAC) and the African Union are increasingly involved in helping to shape aviation policy at a regional, rather than national, level. This raises the prospect of agreements being forged between regional groupings, or for additional countries to be incorporated within an existing grouping.

1. Cases C-466/98, C-467/98, C-468/98, C-469/98, C-471/98, C-472/98, C-475/98, C-476/98.
2. European Commission (2005) Developing the agenda for the Community's external aviation policy. COM(2005)79 final.

Option IV: the global trade approach

5.58 As greater strides are made towards a fully normalised global aviation industry, a more global approach on ownership and control might be possible.

5.59 ICAO has always been the recognised forum for discussions at a global level. The 5th World Wide Air Transport Conference on Air Services, in March 2003, adopted a number of recommendations on the way forward on the liberalisation of services, including ownership and control. The Conference found that:

> '*there is widespread support by States for liberalisation, in some form, of provisions governing air carrier designation and authorisation.*'
>
> *Source*: ICAO (2003) Consolidated Conclusions, Model Clauses, Recommendations and Declaration from the 5th World Wide Conference on Air Services.

5.60 However, the conference demonstrated the wide variation in approach and, in particular, the differing pace of change favoured by different countries. In recognition of this, the conclusion of the conference was that countries should be free to pursue their own paths to ownership and control liberalisation at their own pace.

5.61 Alternative ways of securing liberalisation at the global level have also been tried, albeit with little success, and with limited focus on ownership and control. For example, tentative steps have been taken to incorporate aviation in the General Agreement on Trade in Services (GATS), although to date, this has been staunchly resisted. An IATA paper published prior to the 2000 round of trade talks outlined the problems of pursuing liberalisation through the GATS forum:

- *Most states wish to be able to participate in air transport and hence, with few exceptions, wish to maintain a degree of control in this field by keeping arrangements on a sector-specific basis rather than making them tradable against other national trade interests;*
- *The lack of predictability, from an aviation standpoint, of outcomes under the GATS framework;*
- *The concern that unconditional MFN[1] under the GATS would hold back liberalisation; and*
- *The growing belief that a hybrid system based on multilateral and plurilateral arrangements and possibly incorporating certain GATS concepts could offer a more solid basis for continued liberalisation under a predictable set of rules.*

(Source: IATA (1999) Liberalisation of Air Transport and the GATS: Discussion Paper.)

5.62 In the main, these problems remain. Little progress within GATS has been made since the publication of the above paper; traffic rights, fares charged and the designation of airlines, including ownership and control, all remain outside of the scope of the GATS.

5.63 This suggests that there is limited prospect of meaningful reform at a global level, for the time being at least. This is unsurprising given the differing levels of development in the countries' aviation sectors and their frequently contrasting approaches to liberalisation.

1. The "most favoured nation" (MFN) concept refers to the general WTO/GATS principle that countries would be required immediately and unconditionally to accord to the services and service suppliers of any other Member, treatment no less favourable than that it accords to like services and service suppliers of any other country.

Conclusions on delivering reform

Full normalisation of the airline industry requires the liberalisation of ownership and control, implying that the authority with legal competence for establishing or changing ownership and control rules should play a more active role in negotiating future liberalised agreements.

For most countries with no separation of legal competence between national and supranational bodies this will prove uncontentious. However, for some, this would mean granting an open mandate to a supranational body such as the European Commission (relevant in the EU as the Community has exclusive competence in the regulation of ownership and control), to negotiate future OAAs with the region's partners.

5.64 As the previous chapter noted, the principal forum for discussion of ownership and control remains bilateral negotiation. Most countries have *de jure* powers over ownership and control policy, although, as discussed earlier, the restrictions of other bilaterals mean that their *de facto* power may be reduced due to the constraints posed by third-party stipulations on the ownership and control of airlines operating into their territory. In cases where the power to offer concessions on ownership and control has been transferred to a different body, such as the European Commission in the case of the UK, there is a clear legal basis for addressing ownership and control liberalisation at that level[1]. Whichever route is chosen, it seems clear that the body with the negotiating power on ownership and control should take the lead in discussions where ownership and control liberalisation is likely to be an important part of the deal struck. This may not be the case in discussions focusing, for example, solely on traffic rights. However, as international aviation gradually shifts to a more liberalised environment beyond "Open Skies", and towards OAA-type agreements, the issue of ownership and control rules is likely to move higher up the agenda.

5.65 In the case of the UK or the EU generally, this might mean that it should take forward its ownership and control discussions on a bilateral basis where discussions are unlikely to require reciprocal concessions (for example, New Zealand). Where a reciprocal agreement on ownership and control is essential to reach a broad deal, there is an almost irrefutable logic to granting the European Commission further negotiating mandates.

5.66 It would appear that the most realistic path to full ownership and control liberalisation involves the establishment of one or a number of OAA areas, which could be built on or combined. This way, candidates with the necessary level of safety compliance and regulatory convergence will be in a position to join and need not be hindered by other parties who are less able or unwilling.

Summary

5.67 Maintaining safety standards is the key priority for policy-makers in determining their approach to liberalisation of air services. The increasingly footloose nature of aviation clearly poses significant problems for safety regulators. However, there are a number of complementary solutions to the issues raised by liberalisation that could be implemented with relative ease. Pre-vetting airlines or aeronautical authorities prior to allowing access to the liberalised market is one solution, linked to the creation of

1. This point is often stressed by the European Commission, which is developing its own wide-reaching external relations agenda in relation to other States. However, this agenda can only be carried through with the support of European Member States, some of whom may not always favour the transfer of power to the Commission.

safety blacklists to monitor on-going compliance. There are also strong arguments for closer links, both between an airline's principal place of business and its centre of operations, and between safety authorities in cooperating more closely to share information on airlines' behaviour.

5.68 Policy-makers will also have to make a choice on how best to incentivise liberalisation and avoid the risk of free-riders exploiting liberalisation without offering reciprocation. The arguments suggest that conditioning liberalisation on a reciprocal deal appears the best way forward.

5.69 Maintaining conditions of fair competition in a liberalised OAA will also be important. However, placing a condition on regulatory convergence is unlikely to be realistic; a commitment to fair application of competition law and state aid is one option that strikes the balance between what is achievable and what is desirable.

5.70 Decisions will have to be made about how best to pursue liberalisation. Experience illustrates that there are limits to what can be achieved through unilateral or global approaches. Nevertheless, some scope for incremental progress is possible, either in liberalising ownership and control for domestic markets in the case of the unilateral approach, or in detailing the future parameters for future action in the case of global approach. The opportunities afforded here should not be dismissed, as the benefits from these changes could be significant (e.g. liberalising ownership and control restrictions for domestic carriers, on the Australian model). However, institutional and legal restrictions and the requirement to secure agreement across a number of related issues (e.g. regulatory convergence) mean that progress on ownership and control for international carriers may be best achieved through bilateral or multilateral measures in the near term.

Table 3 Summary of options available to Governments in pursuing ownership and control liberalisation

Option	Benefits	Drawbacks	Ideal when…?	Safety implications
Unilateral	*Fully autonomous*	*No reciprocity.*	*No reciprocity sought e.g. domestic liberalisation beneficial in isolation*	*International airlines could access domestic market whilst being regulated elsewhere.*
Bilateral	*Can pick like-minded partners*	*supranational rules, e.g. EU ownership and control rules. Limited bargaining power .*	*Dealing with pro-liberalising states*	*Safety requirements for liberalisation bilaterally determined and controlled.*
Multilateral OAA	*Powerful negotiating position*	*May need the agreement of all members of the supranational body. Risk that deal may be incompatible with national interests.*	*In the case of the UK and the EU, all deals where reciprocal concessions on ownership and control are sought.*	*Safety standards negotiated at a regional level, e.g. European or US level. Need for consistent and objective standards.*
Global	*Universal application*	*Needs unanimity.*	*Securing general agreement / warm words on frameworks for future liberalisation*	*Need agreement on the setting and policing of minimum safety standards.*

5.71 In Europe, the existence of European-wide rules on ownership and control mean that individual EU Member States have their hands tied when discussing ownership and control liberalisation with their non-European partners. Liberalising deals struck on ownership and control will therefore almost inevitably be unbalanced if negotiated bilaterally. Nevertheless, progress has been made under these conditions where the co-signatory views it as being in their interests (for example, New Zealand). In all cases where reciprocity is sought, the only body capable of delivering a satisfactory agreement is the European Commission, due to their legal competence over European ownership and control regulations. Where the Commission has secured a full negotiating mandate on behalf of the Community (for example, in the case of EU/US), it can overturn the "49 per cent rule" through agreeing a new ASA, without need for a separate process of legislative change. Moves in some other regions, though still at an early stage, suggest that liberalisation may increasingly be at region-to-region level, with negotiating groupings "coalescing" around shared ownership and control rules. This approach may be more effective in opening up aviation than bilateral engagement has been, though it may be many years before Europe finds itself engaging with another Regional body on the issue of aviation.

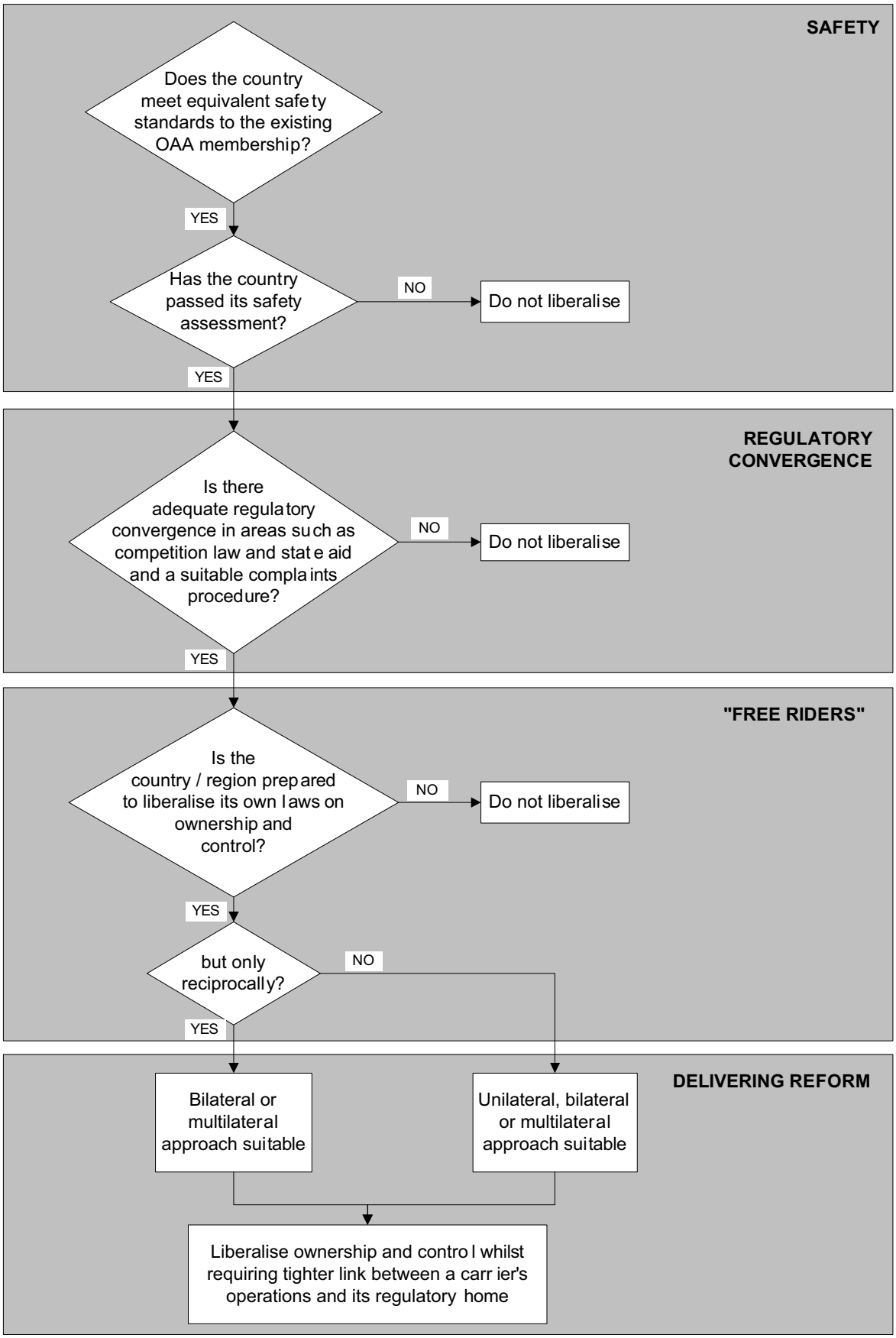
5.72 The EU/US discussions create the prospect of further ownership and control liberalisation for US and EU airlines. The emergence of an expanded "club" of countries with open ownership and control legislation underpinned by agreements on regulatory convergence is the ideal, although statutory ownership and control requirements from the US promise to block this outcome in the near future. However, some liberalisation is possible. Whether this club is able to grow will depend on how engagement with third countries is expected to take place subsequent to the deal. If the parties revert to bilateral engagement on the issue of ownership and control when dealing with third countries outside of the EU/US club, then it is likely that progress will continue to be incremental and incomplete (if negotiated on a "fully exclusive" basis, for example). However, a future agreement that made allowance for subsequent non-circumvention agreements to be signed by either party with a third country/region, might trigger quicker progress in this area, as other countries could be relatively swiftly absorbed within the group.

5.73 There will be stakeholders who are more sceptical of the benefits for their own interests and lobby vociferously against the normalisation of ownership and control rules. In this debate, the consumer voice is frequently given little weight in assessing the benefits, despite being the main beneficiary of reform. Inevitably, the final decision on whether ownership and control liberalisation should be pursued is likely to be highly political. This paper has shown that many of the reasons cited by opponents of liberalisation in the critical areas of safety or regulatory harmonization can be overcome by putting some relatively straightforward conditions in place (see Figure 1 below).

5.74 The paper does not attempt to tackle the much wider issue of aviation's effect on the environment. However, the CAA is committed to the sustainable development of aviation, and is supportive of efforts to get the environmental framework right, so that aviation meets its full costs, including those related to the environment. The conclusions of this paper, if followed, would encourage a better alignment of capacity to demand, easier access to capital for earlier fleet renewal, and enhance the efficiency of the sector as a whole, something that may in itself bring some secondary benefits in terms of environmental impact.

5.75 In the absence of compelling practical arguments against reform, the debate should move on to the economic benefits of liberalisation, and in a world of liberalised trade in most sectors of the economy, it appears very difficult to justify the continuance of restrictive arrangements for international aviation.

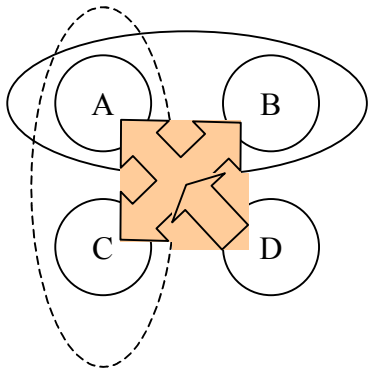
Figure 1 Pathway to liberalisation



INTENTIONALLY LEFT BLANK

Annex 1 Regulatory options and the risk of "free-riders"

Figure 2a Inclusive ownership and control

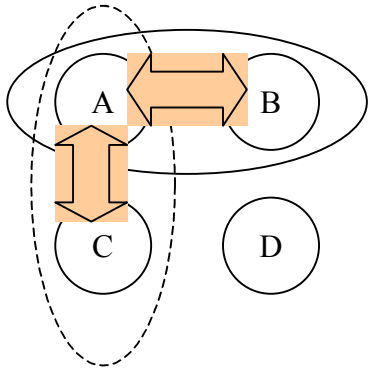


Agreements between countries/regions A & B and/or A & C mean that nationals from A, B, C can all own each other's airlines. Importantly, there are also no restrictions to country/region D owning or controlling airlines from A, B or C despite not being signatory to any of the agreements. In this scenario, airlines from country/region D could be subject to restrictive ownership and control rules whilst having the freedom to take control of airlines from countries/regions A, B and C and take advantage of the traffic rights available to those airlines.

- An airline of nationality A could be owned by nationals from D and operate from A to B, C and D, but

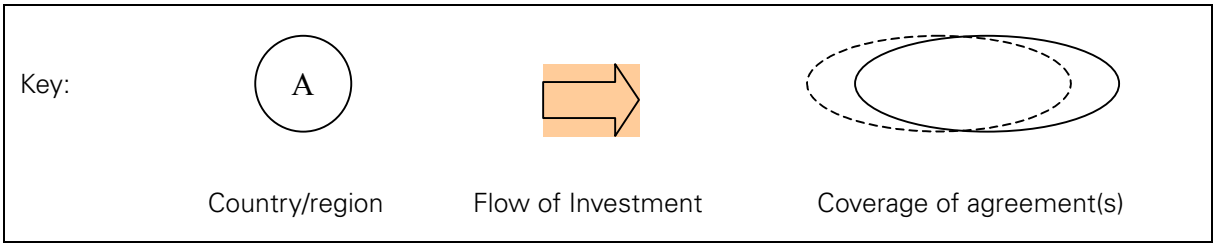
- an airline of nationality A that is owned by nationals from B can only operate between A and B and A and C (A to D being forbidden by the A/D non-liberalised bilateral).

Figure 2b Exclusive agreement



Two separate but similar agreements between countries or regions A & B and A & C restrict ownership purely to nationals from each pair of signature countries/regions. The effect of this is that nationals from countries/regions A & B can own and control each other's airlines. However, nationals from countries/regions B & C would be unable to take a controlling stake in the other's airlines (nor, of course, in airline D).

- Bilateral agreements between D and A, B or C may have to be refined to allow any airline taking advantage of the liberalised ownership and control rules to continue to operate to D (for example an airline of nationality A owned by nationals from B).



INTENTIONALLY LEFT BLANK

Glossary

AOC	Air Operator's Certificate	A term for the certificate of safety compliance issued by an airline's licensing authority.
ASA	Air Service Agreement	Treaty arrangements governing air services between signatory states.
Cabotage		A service operated between two airports within the same country by an airline from another country.
EASA	European Aviation Safety Agency	An agency of the European Union, which has been given specific regulatory and executive tasks in the field of aviation safety. The Agency aims to help establish and maintain a high uniform level of civil aviation safety in Europe.
ECAA	European Common Aviation Area	A single aviation market comprising all members of the EEA and based on two pillars: • Aligning aviation standards and regulations in Europe on safety, security, competition policy, social policy and consumer rights. • Opening up market opportunities by creating a single market for aviation, including open ownership and control rules.
ECAC	European Civil Aviation Conference	The European Civil Aviation Conference is a non-regulatory intergovernmental organisation, with close links to ICAO, established to promote the development of a safe, efficient and sustainable European air transport system.
EEA	European Economic Area	A free-trade area consisting of the members of the EU (Austria, Belgium, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, The Netherlands, Poland, Portugal, Slovakia, Slovenia, Spain, Sweden and the UK) together with Iceland, Liechtenstein, Norway and, to a more limited degree, Switzerland.
FAA	Federal Aviation Administration	The aviation regulator in the US.
GATS	General Agreement on Trade in Services	A treaty of the World Trade Organization (WTO) created to extend the multilateral trading system to services, in the same way the General Agreement on Tariffs and Trade (GATT) provides such a system for merchandise trade.

GATT	General Agreement on Tariffs and Trade	A 1947 agreement to increase international trade by reducing tariffs and other barriers to trade. GATT also provides a framework for periodic multilateral negotiations on trade liberalisation and expansion.
ICAO	International Civil Aviation Organization	A United Nations body formed by the 1944 Chicago Convention set up to act as the forum for the agreement of internationally accepted Standards and Recommended Practices (SARPS). ICAO also undertakes audit of State aviation authorities to determine compliance by States.
WTO	World Trade Organization	An intergovernmental body dealing with the rules of trade among member economies. WTO was established in January 1995 but includes the various agreements from previous negotiations, including GATS.