Oxera

Agenda

Advancing economics in business

Flying in the face of regulation: lessons in liberalisation for airlines

The proliferation of regulation underpinning many industries such as international aviation has come under increasing scrutiny in recent times. Do excessively stringent regulations contribute to low rates of return while simultaneously restricting the flow of benefits to consumers? What lessons can be learnt for this debate from cross-sectoral experience?

There is a paradox at the heart of international aviation. While it has played an invaluable role in the increasing globalisation of the world economy, the sector itself is subject to complex rules, first established in the Chicago Convention of 1944, which prevent it from benefiting fully from these globalisation forces.

Recent attempts to liberalise the industry have faced significant obstacles. For example, the hopes of a new 'Open Skies' deal between the EU and USA—which would have seen many historical restrictions removed—have been dashed following US domestic concerns. This has led to the European Council of Ministers recently declaring 'its deep disappointment and regret at this decision'.[1]

At around the same time that the liberalisation agenda suffered this setback, the UK's Civil Aviation Authority published a discussion document setting out the advantages of pursuing a liberalisation agenda, and how this agenda could be reconciled with concerns that may arise, particularly as regards safety.[2]

In the context of this debate, the International Air Transport Association (IATA) commissioned Oxera to undertake a study of the economic lessons that can be drawn from the liberalisation of other sectors, to inform the current debate in the airline sector. The Oxera study examined developments in the energy, banking, telecoms and media sectors from a range of geographical jurisdictions. The impacts of liberalisation (both product and capital market) were examined according to a number of parameters including:

– **from a consumer perspective**—the impacts on price, quantity, quality and diversity of offering;
– **from a company perspective**—the impacts on capacity utilisation, costs and profitability.

This article considers a number of key themes that emerge from the consideration of the combined sector experience.

Where is the aviation sector at present?

From the 1970s to the 1990s there was considerable liberalisation in the sector, focusing primarily on lifting product market restrictions. For example, the domestic US airline industry was liberalised in 1978, and a similar set of reforms introduced in the EU in 1992. In addition, Open Skies agreements have become increasingly important to international aviation routes, lifting restrictions relating to airlines, frequencies and destinations with respect to flights between the countries concerned.

However, while progress on product market liberalisation has been significant, it is a long way from complete. Indeed, IATA estimates suggest that only 17% of international traffic operates in a liberalised environment.

Progress on the capital market liberalisation front has been slower than that of product market liberalisation. In terms of domestic US flights, non-domestic investors are prevented from owning more than 25% of the equity share capital of domestic airlines. For EU companies, non-EU shareholdings are restricted to less than 50%. Finally, Open Skies agreements do not remove the nationality ownership rules that are embedded within the Chicago Convention. These rules effectively give country X the right to reject country Y's air carrier if that carrier is not substantially owned and effectively controlled by nationals of country Y.

Capital market liberalisation is a key issue for the airline sector. What lessons can the experience of other sectors provide?

This article is based on a forthcoming IATA/Oxera study on liberalisation in aviation. See http://www.iata.org/NR/rdonlyres/128E2B53-2865-4AAB-B940-7C89C944DDC6/0/Liberalisation_summary.pdf.

Capital market liberalisation: what are the processes?

Capital market liberalisation refers to the lifting of restrictions on who is entitled to own and/or control companies (ie, the lifting of restrictions in the market for corporate control). In contrast to product market liberalisation, which has a more direct influence on price, competition and innovation, the impact of capital market liberalisation on consumers is indirect. The key processes relate to operating and financing costs, corporate governance and management practices.

- ***Economies of scale/scope*. Consolidation within an industry can reduce average costs by exploiting economies of scale. Mergers of related activities can generate economies of scope. Capital market liberalisation can also be a policy to promote efficiency in a fragmented market. In these industries, it leads to consolidation, with the goal of exploiting economies of scope and scale.**
- ***Access to capital*. Restrictions on foreign ownership limit an industry's financing options. The result can be higher financing costs and, in some cases, lack of external financing. Liberalisation can therefore reduce financing costs and promote investment.**
- ***Share of managerial best practice*. International ownership can help improve performance by facilitating the transfer of management best practice techniques.**

Lessons from other sectors

Capital market liberalisation appears to have had a positive impact on efficiency and financing costs in a number of sectors. However, the process of internationalisation often takes several years to unfold and consolidation in the sector can lead to a position of market power.

Economies of scale and scope

The liberalisation of cross-border banking in the EU following the Single Market Programme provides a useful example of the impact of capital market liberalisation on efficiency. The Single Market Programme was introduced in 1993, creating a single passport for banking services and harmonising key supervisory standards. As a result, regulatory barriers preventing foreign banks from buying domestic banks were significantly reduced. Alongside the Single Market Programme (and sometimes in anticipation of it), there has been a domestic process of deregulation.

In the mid-1990s, the European banking sector presented significant opportunities to exploit economies of scale and scope. The Single Market Programme started a process of restructuring that is still going on today: smaller banks merged to achieve economies of scale, and commercial and investment banks merged to exploit the synergies between the two activities (even if 'true' cross-border expansion and mergers in EU banking remained relatively limited). Moreover, the increased takeover threat may have increased pressure on management to perform.

The result was a significant improvement in the efficiency of the banking sector. Between 1994 and 1999, efficiency scores (a measure of how close a bank's structure is to best practice) in retail banking increased from around 75% to 85% in France, and from 70% to 80% in Germany (see Figure 1).[3]

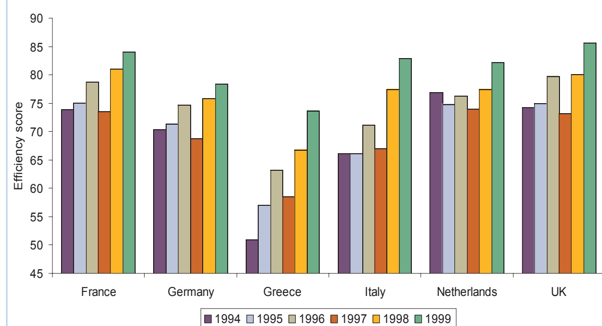
Access to capital

Access to a wider pool of capital can lead to a decrease in the cost of capital. As an illustration, in 1991 restrictions on foreign ownership of telecoms firms were introduced in Canada, effectively limiting their financing to domestic capital. The effect of these restrictions on the incumbent local exchange carrier (ILEC) differed from that on the competitive local exchange carriers (CLECs). CLECs, being less profitable, less able to finance themselves on retained earnings and more reliant on external sources of capital, were more vulnerable to limitations in their sources of financing. In 2001, the estimated cost of capital for a CLEC was 20%, while it was only 6.3% for an ILEC.[4]

Capital market restrictions have knock-on effects on investments. In Canada, investments per capita declined from almost 150% of the OECD average in the period 1988–90 to only 80% in 1994-96.[5]

Access to foreign capital can also prove crucial for the survival of ailing firms. When the New Zealand television channel, TV3, went into receivership in 1991, foreign ownership restrictions in the New Zealand media sector were removed in an attempt to revive the company.

Figure 1 Efficiency scores of retail banks in selected Member States



Source: Weil, L. (2003), op. cit.

CanWest, a Canadian TV broadcaster, bought a 20% stake in TV3, and also secured exclusive management rights to control and operate the channel.[6] Under the ownership and control of CanWest, the performance improved and TV3 became financially viable.

Share of managerial best practice

The transfer of international best practice in management and technological development and deployment is facilitated through greater diversity in ownership patterns. According to Sidak (1997), one of the benefits that foreign direct investment brought to the US telecoms industry was in the form of 'positive externalities in technology and management'.[7] It has been argued that such investment generated beneficial spillover effects for US telecoms firms in the form of new technology diffusion and improved management practices.

This argument appears to be supported by the results of research undertaken by Trewin (2000).[8] In this analysis, time series data (from 1982 to 1992) was obtained for 37 countries on the total costs incurred in the provision of telecoms services, and econometric analysis was undertaken to determine the relationship between costs and the level of foreign investment. To capture the differential impact of spillover benefits, the sample was divided into high- and low-income countries. As might be expected, the impact of increased foreign investment on cost reduction in low-income countries was much greater than for high-income countries. It was found that, for every 1% increase in the maximum allowed foreign ownership, costs for low-income countries tended to be 1.74% lower, while for high-income countries the figure was 0.33%. These results appear to indicate that the benefits arising from foreign investment in low-income countries are greater due to the broader scope for improvement in managerial and technical expertise.

The limits of capital market liberalisation

The slow process of internationalisation

The removal of constraints on foreign ownership is unlikely to lead to a sudden wave of cross-border investments. The process usually occurs over a long period. In EU banking, cross-border merger activity has picked up only recently, several years after the launch of the Single Market Programme. For almost a decade, the consolidation process was largely a domestic one. This suggests a two-step consolidation: first, a domestic wave of mergers to create 'national champions'; and then a cross-border process to exploit the opportunities created by the single market.[9]

Foreign investments appear to be exposed to greater risks than domestic ones. A number of studies on the US banking market have found that foreign-owned banks are less profitable than their American peers.[10] Possible explanations for this include selection bias implicit in the enterprises for sale (foreign banks acquiring poorly performing US banks and being unable to improve performance),[11] and specific risks related to the operation of cross-border enterprises.[12] Foreign firms entering the Indian media market have been found to struggle to capture a significant audience due to the presence of cultural differences and varying viewing habits. To tackle these cultural elements, foreign firms have created alliances with local players.[13]

Market power

Concentration can create market power to the detriment of consumers. There is therefore a potential trade-off between the benefits of increased efficiency and the risks linked to market power.

Liberalisation in the banking sector, both in the USA and Europe, has led to a substantial reduction in the number of firms in the sector. In the USA, the Interstate Banking and Branch Efficiency Act (1994) (IBBEA) allowed interstate branching for the first time for both foreign and domestic banks, hence allowing mergers to take place between banks in different states. To a significant extent, the restrictions preventing cross-*state* mergers might be expected to have much the same impact as restrictions that preclude cross-*country* mergers. The IBBEA was followed by an increase in share of total assets of the top 100 banks from 46% in 1993 to 62% in 1997.[14]

Although market power is a risk for consumers, a well-functioning competition law (anti-trust) regime should be able to mitigate this risk in the airline sector in exactly the same way as it does in other sectors of the economy.

Conclusion

Following substantial deregulation in product markets, restrictions on ownership—particularly foreign ownership—remain the most substantial barrier to full liberalisation of the airline industry. What would be the consequences of removing these barriers?

The experience from other cases of capital market liberalisation suggests that the main benefits may come on one hand from increased efficiency from economies of scale and scope following consolidation, and on the other hand from lower financing costs.

It is now up to trade negotiators on all sides to identify how such potential benefits may be achieved in the sector.

[1] Council of the European Union (2006), press release of 2272nd Council Meeting, December 11–12th.
[2] Civil Aviation Authority (2006), 'Ownership and Control Liberalisation: a Discussion Paper', October.
[3] Weil, L. (2003), 'On the Relationship between Competition and Efficiency in the EU Banking Sectors' mimeo, November.
[4] Standing Committee on Industry, Science and Technology (2003), 'Opening Canadian Communications to the World', April.
[5] Wall Communications (2000), 'Policy Study of the Canadian Telecommunications Foreign Ownership Regime', January, p. 76.
[6] Seven Network (1999), 'Supplementary Submission to the Productivity Commission Inquiry into the Broadcasting Services Act 1992', August.
[7] Sidak, J.G. (1997), *Foreign Investment in American Telecommunications*, University of Chicago Press, p. 69.
[8] Trewin, R. (2000), 'The Impact on Output of Impediments to Trade and Investment in Telecommunication Services', in C. Findlay, and T. Warren (eds), *Impediments to Trade in Services: Measurement and Policy Implications*, London: Routledge.
[9] Molyneaux, P. (2003), 'FDI Race in EU Banking', in P. Ghauri and L. Oxelheim (eds), *European Union and the Race for Foreign Direct Investment in Europe*, International Business and Management Series, Elsevier; and Nolle, D.E. (1995), 'Foreign Bank Operations in the United States: Cause for Concern?' in Gray, H.P. (ed), *International Finance in the New World Order*.
[10] See, for example, Seth, R. (1992), 'Profitability of Foreign Banks in the United States', Federal Reserve Bank of New York Research Paper No. 9225.
[11] Seth, R. (1992), op. cit., and Peek, J., Rosengren, E.S. and Kasirye, F. (1998), 'The Poor Performance of Foreign Bank Subsidiaries: Were the Problems Acquired or Created?', academic research paper, Boston College and Federal Reserve Bank of Boston.
[12] Leveen, S. and Praveen, J. (1992), 'A Multivariate Analysis of the Effects of Foreign Ownership on the Performance of United States Banks'; and Leveen, S. and Praveen, J. (1994), 'A Desegregated Approach to the Analysis of the Effects of Bank Foreign Ownership on Bank Performance'.
[13] Pathania-Jain, G. (2001), 'Global Parents, Local Partners: A Value-chain Analysis of Collaborative Strategies of Media Firms in India', *The Journal of Media Economics*, **14**:3.
[14] Jeon, Y. and Miller, S.M. (2001), 'Deregulation and Structural Change in the U.S. Commercial Banking Industry', September.

If you have any questions regarding the issues raised in this article, please contact the editor, Derek Holt: tel +44 (0) 1865 253 000 or email d_holt@oxera.com

Other articles in the February issue of *Agenda* include:

- **establishing predation? *France Telecom* and Article 82 reform**
- **the Airport Charges Directive: is more regulation in the interests of passengers?**
- **up for grabs: Endesa, E.ON, economic nationalism and EU law** ***Michael Grenfell, Norton Rose***

For details of how to subscribe to *Agenda*, please email agenda@oxera.com, or visit our website

www.oxera.com

© Oxera, 2007. All rights reserved. Except for the quotation of short passages for the purposes of criticism or review, no part may be used or reproduced without permission.