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Agenda

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Freedoms of the air? Liberalising aviation for the long haul

As moves towards more liberalised global air travel tentatively progress, Alex Plant, Head of Economic Policy and International Aviation, UK Civil Aviation Authority, assesses the benefits of European and US reforms to the long-standing 'bilateral' system, and considers the prospects of a fully competitive international market

It may come as a surprise to the uninitiated to discover that the airline industry—in many ways perhaps the most naturally mobile and global of all industries—is subject to a restrictive regulatory regime. The commercial freedom of airlines is fettered by government-imposed rules which often include a requirement that airlines be owned and controlled by nationals of the airline's country of origin.

While 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 normal rules on health and safety, unfair competition, etc), the situation is reversed for international air services. An airline can only fly an international route if it has been granted the rights ('freedoms') under an inter-governmental agreement.

All of this is a legacy of the Chicago Convention, an international agreement signed in 1944 and still in operation, designed to govern the emerging aviation industry (see box below). The agreement defined a set of 'freedoms of the air' (something of a misnomer as in fact they act as restraints) to describe the various operations an airline may undertake.

The odd and increasingly anachronistic market structure created by the 'freedoms of the air' has been a millstone round the neck of the airline industry for too long.

The bilateral system

Nationality restrictions and the impact on aviation

Following the Chicago Convention, a complex web of bilateral air services agreements emerged, with countries granting, conditioning or withholding these freedoms to airlines through government-to-government negotiations. This, aligned with a desire from governments to protect the interests of their 'flag-carrier' airlines (often state-owned), created a mercantilist mindset—'I'll only allow your airline to fly to destinations in my country/operate more services/fly to points beyond, etc if I get rights of equal value for my airline from you.'

'Freedoms of the air': the Chicago Convention, 1944

These first five are set out in the Chicago Convention, but there are some further freedoms commonly described in air services agreements

- ***1st freedom*—the right to fly over country B without commercial or technical stops**
- ***2nd freedom*—the right to land in country B for technical purposes (eg, refuelling)**
- ***3rd freedom*—the right to set down traffic from country A in country B**
- ***4th freedom*—the right to pick up traffic in country B destined for country A**
- ***5th freedom*—the right to fly from country A then pick up traffic in country B destined for country C (or put down traffic in country B originating in country C en route to country A)**
- ***6th freedom*—taking passengers between countries B and C via state A**
- ***7th freedom*—a service operated between countries B and C but operated by an airline of country A**
- ***8th freedom*—('cabotage') the right to pick up and set down traffic within the borders of country B by an airline of country A**

Note: Definitions refer to a situation where the airline is registered in country A.

In the decades immediately following the Second World War, with few people flying, the negative effects of this restrictive bilateral system were probably quite minimal. However, as demand has grown (with more foreign holidays being taken and business air travel growing in importance as a facilitator of international trade in an increasingly globalised market place) then so has the level of detriment caused by these tight controls on air services.

Under the traditional bilateral system, airlines can only expand their services at the whim of governments. That may often be challenging. If an airline from country A wants to increase its services to country B, the government of country B may only agree to the increase if it is not considered to be detrimental to the interests of its own airline(s). Given that the airline(s) from country B is unlikely to welcome stronger competition from the airline from country A on the routes it operates, it is likely that such a request may often be denied, or at least require difficult negotiation.

The UK–India market used to provide an illustration of this. Despite strong demand for travel between the two countries, and pleas from UK airlines to increase the frequency limits, the UK–India bilateral remained very restrictive throughout the 1980s and 1990s. The Indian government seemed to be influenced by a perceived negative impact for Air India of agreeing to the requests for easing the limits. However, the situation has changed in recent years, with great strides being made to open up the market domestically and internationally, spurred by a recognition of the benefits of liberalisation to India's broader economic interests.

As a result, supply has often lagged demand, with consequent downsides for other sectors. In air services negotiations, governments have traditionally ignored the wider benefits to tourism and trade that would flow from expanded services.

The restrictive bilateral system is in need of overhaul; market liberalisation should provide a better framework under which the industry can operate.

Competition is often also restricted in absolute terms. Entry into some international markets remains practically impossible (typically, governments may only designate one airline from each country involved to operate services). And even airlines that have been designated as able to operate may still find it difficult to grow capacity because they are prevented from increasing frequencies on existing routes, or adding new destinations to their route schedules.

Consumers tend to be the losers from all of this, and under the very restrictive environment for international air travel that operated until comparatively recently, there was scant competition on price, quality or convenience—and a limited choice of airlines.

So the airline industry, which in normal market conditions could freely respond to changing demand patterns, has instead been locked into a stodgy, uncompetitive, and highly regulated market structure—a scenario that is still prevalent in many international markets today.

The inefficiency of this market structure has not only hampered growth in other sectors of the economy, which could otherwise have used air travel more efficiently, it has probably also contributed to a poor return on shareholder investment within the airline sector.

An oft-quoted joke pertaining to this is: ‘How do you make a million dollars in the airline business? Start with ten million.’ But the figures themselves are less funny. It is estimated that the international airline industry has never yielded a positive return on capital invested over the business cycle in the post-Second World War period, and this may be explained in part by the regulatory environment in which international airlines have found themselves.

What seems clear is that the restrictive bilateral system is in need of overhaul, and that market liberalisation should provide a better framework under which the industry can operate.

The argument about regulatory structures and the benefits of liberalisation should be seen in the context of the broader issues facing the aviation sector, most notably the impact that aviation has on the environment, an externality that is currently not fully addressed by the sector.

Whatever optimal level of activity would result from a truly sustainable model for aviation, it would still be better for the market to be governed by competitive disciplines and open access than by economic restrictions imposed by governments.

In recent decades there have, however, been some major reforms towards a more liberalised market.

Liberalising steps: US and EU reforms

US domestic deregulation

The first major move towards deregulation of the airline industry came in the shape of US domestic deregulation in 1978. Prior to then, US domestic services had been

subject to heavy market access restrictions, but from 1978 the market was opened up. This was not without controversy at the time, with opponents claiming that deregulation would lead to consumers losing out, routes being sacrificed and airlines going to the wall. Although the replacement of a very stable but limited market with a much more dynamic and competitive one did herald the demise of some long-established companies, it also helped to produce a much wider range of choice for consumers, including lower fares, pioneered by the expansion of low-cost carriers such as Southwest Airlines.

'Community of interest'

The first major step forward in liberalising international aviation perhaps came from the reforms that culminated in the 1992 'Third Package', which created a single market for aviation within the EU. From this point, the typical bilateral restrictions on frequencies, nationality of airlines and designation that had governed intra-EU aviation were swept away and replaced with a totally liberal environment for those airlines that were part of the EU 'club'—or, put another way, within the 'community of interest'. It is this radical change that enabled airlines such as easyJet and Ryanair to take advantage of newly created opportunities and operate services throughout the EU from wherever they see fit, as long as they remain majority-owned and controlled by EU interests.

The effects of EU liberalisation are well known, and dramatic, and in many ways mirrored the experience of deregulation in the US domestic market. Fares are now lower, and there is greater choice of airlines (and airports); many more routes are available, and services from regional airports have expanded hugely, particularly in the UK. Competition has forced efficiencies on established carriers and there are more passengers, and more aviation-related employment, than ever before. However, the full benefits of a more competitive marketplace are still hampered by the fact that the bilateral system hinders efficient market rationalisation. In particular, the bilateral system limits merger opportunities because traditional bilateral agreements only grant freedoms to airlines owned and controlled by the nationals of the other party to the agreement.[1]

So if, for example, a Portuguese and a German airline were to merge and become majority Portuguese-owned, the merged entity could face the risk of losing its hard-won rights to operate from Germany to country B on the basis that the airline is no longer German and the bilateral agreement between Germany and country B includes a nationality clause. Fear of this outcome may have contributed to the particular structure of the Air France–KLM merger, which seeks to preserve the 'Dutchness' of the KLM element.

The community of interest model has also been tested in other parts of the world, with the Caribbean states (CARICOM) and Latin American groupings also liberalising their internal markets.

Open Skies

1992 was a seminal year in aviation, as it also heralded the first 'Open Skies' agreement, between the USA and the Netherlands. 'Open Skies' refers to a new type of air service agreement, pioneered by the USA, which was the first major attempt to liberalise international aviation. Typically, Open Skies agreements remove all limits on designation of airlines, frequencies, destinations and pricings. As such, they represent a valuable advance on the restrictive bilaterals they replace. However, they stop short of full market opening, in that cabotage (the right to operate domestic services) remains the sole preserve of airlines from the relevant country, and that nationality-based ownership and control rules are also retained—thereby precluding international mergers.

Where next? An EU–US open aviation area?

A 2002 European Court of Justice ruling effectively stated that the nationality clauses in traditional bilaterals are illegal since they violate the 'establishment clause' of the Treaty of Rome, which prohibits anything that restricts an investor of one Member State from establishing a business in another Member State. Consequently these clauses now need to be renegotiated to comply with the ruling. As the most important trade partner, it was natural that the USA should be the first focus, and there was a strong argument that negotiations should take place at the EU level, rather than through bilateral negotiations between individual Member States and the USA. The European Commission therefore received a mandate from Member States to negotiate with the USA on an all-encompassing EU–US air services agreement.

The EU vision for this new agreement went beyond a simple adoption of the US Open Skies template with the offending nationality clause replaced with a 'Community carrier' clause. Instead, the aim was to negotiate towards an 'Open Aviation Area' with the USA—essentially a single market between the EU and USA. This is a more radical and liberal concept than Open Skies as all restrictions on market access would be removed (including restrictions on cabotage); there would be no limits on ownership and control of airlines between the two blocs, and the only regulatory restrictions would be those related to aviation safety, security and competition law.

This bold vision was always going to be hard to achieve given the political climate in the USA, particularly in

relation to cabotage rights and ownership and control. The subsequent negotiations—which began in 2003 and continued, with a hiatus, through to December 2005—have shown the difficulties of achieving such radical reform quickly.

Cabotage (8th freedom) has proven to be a taboo subject for the USA—largely because of fears from US unions that this would lead to job losses—and reform of ownership and control has also been very difficult. As I write, the US administration has just closed a consultation on reforming the traditionally tightly interpreted control provisions while leaving the statutory limits on ownership of US airlines unaffected.

Later this year, the USA will issue its conclusions on this reform proposal, which will be a major element in the EU's consideration of whether a first-stage agreement (with both sides committing to further phases of liberalisation) can be signed with the USA.

The benefits of reform

Clearly there are benefits to opening up international aviation markets for consumers and airlines alike, and the US Open Skies model represents an improvement over more restrictive types of bilateral agreement. The fact that the UK–US bilateral, for example, still limits flights between Heathrow and the USA to only four designated airlines and at limited frequencies is anomalous, hampers competition and denies opportunities for innovation.

However, an Open Aviation Area, allowing, as it would, for more radical restructuring of the industry and truly opening up the possibility of global airline competition, could provide greater economic benefits than Open Skies alone. The Brattle Group estimated that benefits worth around $5 billion could flow from an Open Aviation Area,[2] with gains on both sides of the Atlantic, and this was quantified on conservative assumptions. Even though capacity at Heathrow would remain scarce, the removal of the absolute barriers to entry would provide new opportunities. Airlines already holding slots at Heathrow could choose to switch some of these for use on US routes. Assuming that secondary trading of slots were formalised, it would be easier for airlines to purchase a slot in order to launch US services.

Arguing the case

One of the key elements that distinguishes the Open Aviation Area from Open Skies is the approach to ownership and control of airlines. Opponents to relaxation of ownership and control fear that it could lead to:

- a loss of jobs (either in total or in certain geographical locations);
- impoverished terms and conditions for employees;
- a diminution in safety standards;
- increased security risks.

However, judging by the experience of EU liberalisation, a more likely outcome is that:

- more jobs will be created, and probably in similar locations as airlines seek to meet underlying demand which is unlikely to change radically in the short term;
- employees may move to different packages of remuneration, but will not necessarily be worse off;
- more efficient firms will gain market share in an expanding market;
- safety can be well-regulated regardless of the nationality of the owners of an airline;
- security risks can be managed through mechanisms other than blanket bans on ownership and control of companies; and
- firms entering into transatlantic mergers may create new opportunities for efficiencies, market entry and effective competition with other airlines.

Conclusions

The odd and increasingly anachronistic market structure created by the 'freedoms of the air' has been a millstone round the neck of the airline industry for too long. In recent decades, much progress has been made to normalise aviation, and put it onto a footing more similar to other industries. However, much remains to be done.

The realisation of the Open Aviation Area concept could truly revolutionise the industry, and is a prize well worth pursuing, which is why the EU–US negotiations are so important. If a deal can be reached that genuinely moves beyond the Open Skies template towards something more radical, it could be the first step in a process that should ultimately lead to a global change in the way that the airline sector is structured.

If the two largest aviation blocs in the world can agree to truly liberalise then it is likely that this will become the template for the rest of the world. Ownership and control liberalisation is central to this, and so the coming months, and the outcome of the US administration's considerations of reform of its control rules, may prove to be pivotal for international aviation.

Alex Plant

[1] Some countries also have national laws limiting ownership and control of airlines that could still be in place even if the bilateral air service agreements were liberalised—the USA is one example.
[2] The Brattle Group (2002), 'The Economic Impact of an EU–US Open Aviation Area', December.

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

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