



WORKING PAPER

WORLDWIDE AIR TRANSPORT CONFERENCE (ATCONF)

SIXTH MEETING

Montréal, 18 to 22 March 2013

**Agenda Item 2: Examination of key issues and related regulatory framework
2.2: Air carrier ownership and control**

LIBERALIZATION OF AIR CARRIER OWNERSHIP AND CONTROL

(Presented by the Secretariat)

EXECUTIVE SUMMARY

This working paper examines issues and possible options in liberalizing air carrier ownership and control rules in relation to airline designation under bilateral air service agreements, including a proposal for a multilateral approach.

Action: The Conference is invited to:

- a) review the information and assessments presented in this paper;
- b) endorse the conclusions presented in paragraphs 4; and
- c) adopt the recommendations presented in paragraph 5.

References: ATConf/6 reference material is available at www.icao.int/meetings/atconf6.

1. INTRODUCTION

1.1 Under their bilateral air services agreements, States have traditionally retained the right to withhold, revoke, or impose conditions on the operating permission of a foreign air carrier that is not “substantially owned and effectively controlled” by the designating State or its nationals. This “nationality clause” criterion has been used, since the 1940s, in the overriding majority of air service agreements, and continues to be included in many newly negotiated bilateral accords.

1.2 The rationale for the nationality clause is that it provides a convenient link between the carrier and the designating State by which parties to the agreement can: a) implement a “balance of benefits” policy for the airlines involved; b) prevent a non-party State through its carrier from gaining, indirectly, an unreciprocated (“free rider”) benefit; and c) identify the country that is responsible for safety and security oversight. National defence considerations are also a factor in some cases. The nationality clause made obvious sense in the days when most airlines were State-owned.

1.3 Over the past two decades, liberalization, privatization and globalization have significantly changed the airline industry. Transnational investments in air carriers have occurred against a backdrop of widespread multinational ownership in other service industries. The original bases for use

of the nationality clause have been seen as increasingly at odds with the changed global business environment in which the industry must operate. Past analysis in ICAO and considerable State practice in recent years have confirmed that safety and security can be safeguarded without reliance upon the traditional nationality clause. Additional background information is presented in Appendix A.

1.4 To facilitate liberalization, ICAO has addressed this issue extensively and developed guidance for States. Although there has been some encouraging progress in State practice in terms of relaxing the application of the rules or accepting airlines with foreign ownership, legal restrictions on ownership and control of airlines in States' laws and bilateral agreements have largely not changed. Ten years after the 2005 Fifth Worldwide Air Transport Conference (ATConf/5), continuation of such legal restrictions is often characterized as abnormal and harmful. The need to enable air carriers to adapt to the dynamic global environment and to enable States to participate more effectively in international air transport calls for a change in approach. This paper examines the options for addressing this complex issue, focussing mainly on the airline designation and authorization clauses in air service agreements.

2. MAJOR DEVELOPMENTS AND ICAO'S WORK

2.1 Facing heightened competition on the one hand and the constraints of the regulatory system on the other, airlines have found various ways by which to expand networks across national borders, including alliances, mergers and acquisitions, many of which involved foreign investment or equity exchange. Recent years have seen an extraordinary acceleration of this trend. In Europe, Latin America, and Asia, airlines with foreign or transnational ownership and control, as well as "families" of related carriers in different countries but under a single management, are now a common and growing phenomenon. Although there have been some accommodation in the legal framework for these developments, the mergers and acquisitions yielding these new airline enterprises have, in most cases, occurred without full legal protection from the potential inherent in nationality clauses to block or condition air services by the new entities. In many cases, airline managements have felt compelled to adopt complex "holding company" structures or create different classes of stock ownership in order to maintain a legal defence against the invocation of nationality clauses.

2.2 Along with industry changes, some States have adopted more flexible treatment of the airline ownership and control requirement. As demonstrated by State practice over the past decade, an increasing number of countries are now more willing to accept air services operated by airlines that have substantial foreign ownership or are multi- or trans-national in character. The case that 114 States have now accepted the "Community carrier" principle of the European Union (EU) through "horizontal agreements" is one, but not the only, prominent demonstration of this important change. Other examples include the use of alternative criteria for airline designation and authorization in bilateral agreements and acceptance of cross-border mergers and acquisitions although mostly within a regional grouping of States.

2.3 In 2009, seven States, through the platform of the International Air Transport Association (IATA) "Agenda for Freedom" initiative, took coordinated action by signing a "Statement of Policy Principles" in which the States undertook, as a political commitment, to liberalize key aspects of international air transport regulatory practice, including airline ownership and control by waiving the nationality clause "on the basis of reciprocity". This statement, endorsed by the European Commission, has since been signed by four additional States, and remains open for endorsement by any interested State. At the 37th Session of the ICAO Assembly, IATA expressed the view that ICAO should now resolve to move this initiative forward.

2.4 Drawing from an ICAO recommendation, the United States (U.S.) took the initiative to explore with interested aviation stakeholders the possible formulation of a legally binding instrument for

liberalizing ownership and control. At the 37th Session of the ICAO Assembly, the U.S. proposed that ICAO consider the development of a multilateral convention to facilitate airline access to international capital, which the ICAO Council later agreed to include in its work programme in relation to the preparation of ATConf/6. A discussion paper (i.e., attachment to A37-WP/190), containing draft text for the proposed convention, can be found on the ATConf/6 website at www.icao.int/meetings/atconf6 (under References).

2.5 ICAO has considerable policy guidance on the subject, consisting of a number of alternative criteria and model clauses for optional use by States which are available in air service agreements, Assembly resolutions, conclusions and recommendations of the air transport conferences (contained in the *Policy and Guidance Material on the Economic Regulation of International Air Transport* (Doc 9587)). The guidance provides States with useful options to liberalize ownership and control rules, whether on a unilateral, bilateral or multilateral basis. The coordinated action taken by several like-minded States cited in paragraph 2.3 above is an example of one option available to States. ICAO also implemented some of the 2005 ATConf/5 recommendations to facilitate liberalization in this area, such as collecting and publishing States' relevant policies, positions and practices. Despite some progress and the continued validity of the ICAO policy guidance, the lack of widespread use of such guidance suggests that other options may need to be explored.

3. DISCUSSION

3.1 The majority of States have continued to use the traditional nationality clause in bilateral agreements, not only leaving it unchanged in existing agreements but also adopting it as part of new air service accords. In part, this may reflect the hesitancy of States to endorse new language in an area long governed by tradition. In addition, there is evidence that States are reluctant to adopt an approach that does not easily distinguish between the nationalities of third-country investors. For example, the law of the EU permits ownership and control of EU air carriers by nationals of third countries only if such countries and the EU have concluded an appropriate, reciprocal agreement. The U.S. has waived the nationality clause in cases where both the relevant airline and the foreign investors are covered by a U.S. negotiated "open skies" agreement, although the U.S. is generally reluctant to legally bind itself to this policy.

3.2 Accordingly, there is merit in exploring more practical solutions which would enable States to deal with the ownership and control requirement with flexibility in light of other policy considerations and without the arduous requirement to amend every air services agreement so as to provide greater certainty to States from the regulatory perspective, and to air carriers making strategic and investment decisions.

3.3 While States can continue to use the various means recommended by ATConf/5, contained in *Report of ATConf/5* (Doc 9819), to advance this goal, ICAO should play a leading role in exploring alternative solutions to modernize the regulatory regime so as to better adapt it to a globalized and liberalized business environment, thus meeting the needs of airlines to operate as a "normal industry".

3.4 In this regard, one action ICAO can take is to explore the development of an international agreement for States to relax ownership and control requirements for airline designation and to facilitate airline access to international capital. A recent survey of States in October 2012 revealed that 77 per cent of the responding States (47 of 61) were supportive of ICAO taking this initiative. The development of such an agreement could draw on past experiences and build on what has been achieved, such as the agreement reached by States under the IATA Agenda for Freedom Summit initiative (paragraph 2.3 refers).

3.5 One option is for the agreement to take the approach of a “waiver of nationality clause”, whereby parties to the agreement, on the basis of reciprocity, commit legally to waive the application of the nationality clause in existing air services agreements in respect of designated airlines and investing nationals of other concerned States. Another option could be for the parties to accept and apply a common criterion for airline designation, such as the “principal place of business and effective regulatory control” criteria developed by ICAO. The design of the agreement should reflect a vision to move forward yet be based on reality, taking account of States’ willingness to adapt to change on an incremental basis and constraints in respect of changing national laws. The agreement should therefore not impinge on any State national legislation and policy in this regard. In light of the disparity in States’ needs and circumstances, the agreement could be for signature by “willing and ready” parties initially and subsequently open for accession by other parties.

3.6 In any case, the development of such an agreement would require substantive and incremental work by ICAO, including further study of the options, and consultation with experts and States and regional groupings. The challenge is for the international aviation community to agree that the time has come for more concrete exploration of such an agreement, and for ICAO to work with States and the industry to define the essential elements that would garner the broadest support and contribute most effectively to the sustainable development of international air transport.

4. CONCLUSIONS

4.1 In light of the discussions above, the following can be concluded:

- a) since ATConf/5, although diverging views and regulatory approaches remain with regard to air carrier ownership and control, more States are willing to liberalize as evidenced by the granting of substantial ownership in State airlines and acceptance of designations of other States’ airlines with majority foreign ownership and effective control, notwithstanding the nationality clause in their bilateral agreements;
- b) considerable progress has also been made at the regional level, as States in several regions or sub-regions have adopted regional arrangements in liberalizing air carrier ownership and control among respective members, allowing transnational airline mergers to proceed;
- c) despite some progress in liberalization and the continued validity of ICAO policy guidance, States are hesitant to make globally applicable policy statements or commit to allow all airlines from all States to have unlimited foreign ownership. There is a need to explore other more flexible options that can achieve wider acceptance and allow liberalization to move forward, including in an incremental manner, without affecting national legislations; and
- d) ICAO could play a leadership role in developing policy guidance and in facilitating regulatory evolution, including considering the development of a multilateral agreement to meet the needs of States and industry, as recommended by ATRP/11.

5. RECOMMENDATIONS

5.1 The following recommendations are proposed for consideration by the conference:

- a) States should continue to liberalize air carrier ownership and control through various means, including those recommended by ICAO;
- b) ICAO should continue to promote its policy guidance on air carrier ownership and control, and encourage States to use its guidance in regulatory practice. It should also keep its policy guidance current and responsive to changing situations and requirements of States; and
- c) ICAO should initiate the development of an international agreement for States to liberalize air carrier ownership and control based on the proposals discussed in paragraph 3.

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APPENDIX

BACKGROUND INFORMATION

Why “nationality clause”

1.1 In dealing with airline designation and authorization under their bilateral air services agreements, States generally retain the right to withhold, revoke, or impose conditions on the operating permission a foreign air carrier needs in order to operate the agreed services if the carrier is not “substantially owned and effectively controlled” by the designating State or its nationals.

1.2 The national ownership and control criterion, which has been used since the 1940s, provides a convenient link between the carrier and the designating State by which parties to the agreement can: a) implement a “balance of benefit” policy for the airlines involved; b) prevent a non-party State through its carrier from gaining, indirectly, an unreciprocated benefit; and c) identify those who are responsible for safety and security matters. National defence consideration is also a factor in some cases. This criterion is not contained in the Chicago Convention but is rather a national and bilateral regulatory provision. However, the criterion is contained in the International Air Services Transit Agreement (IASTA) which was developed in parallel with the Chicago Convention. The national ownership and control provision, coupled with the view that air carriers had important strategic, economic, and developmental roles, encouraged the growth of national, primarily state-owned air carriers.

1.3 During the last decade, along with the trend of liberalization and globalization as well as regional economic unification, international air carriers have sought to adapt to increasing cost pressures, need for capital and heightened competition in a number of ways, including through cooperative arrangements such as alliances, code sharing, joint ventures and franchise operations, some of which have involved transnational investment (obtaining equity in air carriers from other States). Privatization of formerly state-owned air carriers has sometimes resulted in foreign investment in the privatized carriers. Transnational investments in air carriers have also occurred against a backdrop of widespread multinational ownership in other service industries.

Why need to change

1.4 The original bases for use of the ownership and control criterion are increasingly at odds with this changed global business environment in which the industry must operate. The need to enable air carriers to adapt to the dynamic global environment and to enable States to participate more effectively in international air transport calls for a change in approach and the application of broadened criteria beyond national ownership and control for the use of market access. Air carrier ownership and control is a unique and complex issue, arising mainly from the particular way international air transport is regulated.

Benefits and risks of liberalization

1.5 There are clear benefits in liberalizing air carrier ownership and control. For example, it could provide air carriers with wider access to capital markets, and reduce their reliance on government support. It could permit airlines to build more extensive networks through mergers and acquisitions or alliances. It could also help improve economic efficiency of the airline industry by enabling more competitive carriers and greater variety of services in the market, which in turn could feed into consumer benefits. At the same time, liberalization also carries certain risks which may be causes of concern, such

as: the potential emergence of “flags of convenience” in the absence of effective regulatory measures to prevent them; potential deterioration of safety and security standards with increasing emphasis on commercial outcomes; and possible flight of foreign capital which could lead to less stable operations. There could be impacts on labour, national emergency requirements and assurance of service. Finally, and in the long run there may also be potential implications on airline competition as a consequence of possible industry concentration (i.e. the air transport system being dominated by a few mega-carriers through mergers or acquisitions), a reality that exists in most other service sectors. However, this may be addressed through the parallel development of regulatory measures against anti-competitive practices. In considering liberalization, each State needs to take into account all these benefits and risks when making its choice.

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