

EUROPEAN EXPERIENCE OF AIR TRANSPORT LIBERALIZATION

(Presented by Albania, Armenia, **Austria**, Azerbaijan, **Belgium**, Bosnia and Herzegovina, Bulgaria, Croatia, Cyprus, Czech Republic, **Denmark**, Estonia, **Finland**, **France**, **Germany**, **Greece**, Hungary, Iceland, **Ireland**, **Italy**, Latvia, Lithuania, **Luxembourg**, Malta, Moldova, Monaco, **Netherlands**, Norway, Poland, **Portugal**, Romania, Serbia and Montenegro, Slovakia, Slovenia, **Spain**, **Sweden**, Switzerland, The former Yugoslav Republic of Macedonia, Turkey, Ukraine, **United Kingdom**)¹

1. SOME INTRODUCTORY COMMENTS

1.1 The Member States of ECAC and the European Community, together with the European Commission, are pleased to present the attached information paper to the Conference setting out their experience of air transport liberalization.

1.2 One of the key issues before the Conference is the identification of means to achieve further liberalization in the air transport sector at a regional, international and global level.

1.3 In Europe, liberalization was not entered into lightly. Arriving at workable and acceptable liberalization measures took many years and much negotiation. Air transport is an industry of strategic importance and all governments are keen to ensure both that levels of air service are preserved and that their national industry is as healthy as possible. Key concerns that arose in the course of liberalization in Europe included:

- a) that national flag carriers would find it impossible to adapt to a more open trading environment, putting jobs and air services under threat;
- b) that essential but uneconomic services could be lost as carriers turned their focus to profitable routes;
- c) that new entrants would focus on major trunk routes, leaving regional services underdeveloped; and
- d) that tough competition would place pressure on airlines to cut corners in matters of safety and security, while removing control over traffic rights will make it more difficult for the authorities to enforce standards.

1.4 Many of these concerns may now be shared by other ICAO Members presently contemplating liberalization measures.

¹ The 15 Member States of the European Union appear in bold

1.5 The attached paper explains the effects of Europe's regional liberalization and demonstrates that means can be found of overcoming potential problems. It shows that liberalization has been a positive experience for both consumers and airlines.

1.6 Mechanisms were found that allowed flag carriers to restructure, in some instances with the help of their governments, and the majority have survived and prospered in the liberalized environment.

1.7 Some airlines have indeed cut jobs in order to improve their efficiency, but the rapid growth of new airlines in the liberalized market has led to an increase in overall employment in the air transport industry measured over a decade of liberalization.

1.8 New carriers have certainly placed much attention on the major trunk routes between Europe's major cities, but growth has not been confined to these routes - many new regional services have been opened on a commercial basis over the past ten years.

1.9 Moreover, means have been created of preserving essential, but uneconomic routes, by using public service obligations and open tendering - a process that allows thin routes to survive, but on the basis of fair competition and at the lowest cost possible to the taxpayer.

1.10 European states have continuously deepened their cooperation on matters of safety and security, both through ECAC and through the EC. There is no evidence that safety or security standards have suffered as a result of the liberalization process.

1.11 There have been some difficulties. In particular, some of the national flag carriers have found it very hard to compete, on one hand, against larger competitors and, on the other, against new entrants who have started their operations with a clean sheet. But a number of them have proved that it is possible for an airline to find its niche in a liberalized environment without regulatory protection and to be a successful business.

1.12 In summary, the European experience of liberalization has been positive and means have been found of addressing many of the concerns that were raised at the beginning of the process.

1.13 The process itself is of course, not complete and may be said to be in mid course. It should also be understood that the process that Europe has chosen is one that has been adapted and will continue to be adapted to the needs of European air transport. It differs significantly from the process of deregulation in the United States.

1.14 The Member States of ECAC and the EC, together with the European Commission, offer the attached paper in order to provide other ICAO Members with more detail about the liberalization process and its effects. They look forward to working with ICAO states to explore potential for applying this experience more widely at regional and global level.

2. **BACKGROUND**

2.1 This paper summarizes Europe's experience of air transport liberalization, focussing in particular on the single market established within the EU. Unlike airline deregulation in the United States, liberalization within the EU brought together a number of distinct national markets, previously interlinked by a web of bilateral air services agreements, into a single market. The decision to create a European single market in aviation formed part of the move to a single internal market across a whole range of economic activity, as embodied in the Single European Act. The reforms were introduced against a background of actual or impending recession, high cost levels amongst many of the major national airlines combined with pre-existing dominance in their home markets, and growing congestion at a number of the most important EU airports. This covering paper provides an overview of the regulatory changes by which liberalization was achieved and its broad effects. A series of annexes exemplify various aspects of Europe's experience in more detail. It is hoped that these papers will provide a useful contribution to the debate that will take place at the ICAO conference on air transport liberalization in March 2003.

3. **THE ECONOMIC REGULATORY FRAMEWORK**

3.1 Prior to the process which led to the establishment within the EU of the single market in 1993, the air transport market across the whole of Europe was a collection of national markets. Domestic air services within each country were governed by national rules which varied enormously in the degree to which competition was permitted or promoted. International air transport in Europe was governed by the bilateral air services agreements between each pair of countries. Although some of these agreements were relatively liberal, all contained traditional ownership and control restrictions and many restricted market access and capacity, frequently allowing only one airline from each country to operate services, often on a limited number of specified routes. International fares were generally agreed between airlines under the auspices of IATA and both international and domestic fares were usually subject to government regulation.

3.2 With the development of two international agreements in 1987 which permitted partial capacity and tariff liberalization, ECAC took the first steps in Europe towards liberalizing the air transport market. However, it was within the EU that the real progress towards full liberalization was made, aided by the EU's institutional framework and its general impetus towards economic integration. A process of progressive liberalization swept away the pre-existing institutional barriers to entry and competition and created a genuinely single market within the EU. This has since been extended to cover Iceland, Norway and Liechtenstein through the creation of the European Economic Area, while Switzerland is also now associated with the market through a bilateral agreement. In advance of their full accession to the EU, negotiations are under way with eleven more ECAC States on the early creation of a yet wider European Common Aviation Area based on EU rules. The description that follows focuses on the experience of liberalization as it has occurred thus far within the EU.

3.3 **The "Third Package"**

3.3.1 As its name suggests, the Third Package of liberalization measures which took effect on 1 January 1993 represented the culmination of a gradual process of dismantling the bilateral restrictions which had begun with the First Package in December 1987. Most significantly, the Third Package gave practical effect for the first time in the air transport sector to the right of establishment provisions of the Treaty of Rome by introducing common licensing criteria for air carriers across the whole of the EU. It replaced national ownership and control restrictions with the concept of a "Community air carrier", under which EU airlines must be majority owned and effectively controlled by EU Member States and/or nationals of EU Member States. Any airline meeting these (and specified financial and safety) requirements must be licensed by the EU Member State in which it has its registered office and principal place of business. Once an airline has been granted an Operating Licence by any EU Member State it is afforded the rights laid down in the Market Access Regulation, which

allows airlines to exercise traffic rights on virtually any route within the EU. The Air Fares Regulation also establishes the right in principle for airlines to set their own fares freely.

3.3.2 Having said that, in order to accommodate EU Member States who felt that their national markets would need time to adjust to the notion of a completely open environment, the Regulation did not seek to abolish national markets in a single step. It essentially provided for a transitional period during which a number of provisions circumscribed the general right of access in certain respects, mostly relating to domestic services. The most significant restriction which continued to apply after 1 January 1993 was that relating to cabotage services - domestic services operated in one EU Member State by a carrier licensed in another Member State. EU Member States were not obliged until 1 April 1997 to open their domestic markets to free competition from all EU-licensed carriers, although airlines were entitled to operate consecutive cabotage services as extensions to services to or from their own state provided that no more than 50% of the capacity was made available on the cabotage sector. Provision was also made for Member States to impose public service obligations on routes to regional airports in their territory which were considered vital for economic development so as to ensure that air services would be provided (see part of Annex 3, but in particular, Annex 4).

3.4 **Competition Rules**

3.4.1 The removal of restrictions on market entry, capacity, frequency and pricing resulted in greater emphasis being placed on the use of normal competition law to safeguard against anti-competitive behaviour and abuse of market power. In fact, rules had already been adopted in 1987 that gave the European Commission the power to apply the competition rules of the EU Treaty (Articles 81 and 82) to air transport services within the EU and to adopt certain group exemptions. Article 81 prohibits agreements between firms which prevent, restrict or distort competition unless those agreements can be shown to promote technical or economic progress and that consumers enjoy a fair share of the resultant benefits. Article 82 prohibits the abuse of a dominant position. The Commission also has exclusive competency to assess the competition issues raised by a transaction that falls within the scope of the EU Merger Regulation. The Commission does not yet have equivalent investigation and enforcement powers for air transport between the EU and third countries.

3.4.2 Specific block exemptions concerning certain categories of agreement in the air transport sector were adopted and, while some have since been removed, those relating to consultations on passenger tariffs on intra-EU scheduled air services and slot allocation at EU airports remain in force. The effect of these block exemptions has been that operators have not needed to apply to the Commission for an individual exemption each time they are involved in these practices.

3.5 **State Aid**

3.5.1 Early in the liberalization process the Commission adopted a strict policy to apply the EU Treaty's provisions on state aid to the airline industry and, in particular, attached a clear "one time, last time" condition to any state aid that it approved. The Commission has left little doubt in its communications that a second injection by Governments not in accordance with the "market economy investor principle" will only be considered in the most exceptional of circumstances and in light of unforeseeable events external to the company. (For more information, see Annex 7).

3.6 **Slot allocation, Ground-handling and Computer Reservation Systems**

3.6.1 A number of other measures have been adopted to accompany the freedoms granted under the Third Package, in particular aimed at enabling airlines to secure fair access to key infrastructure and services. An EU Regulation (95/93) established common rules for the allocation of slots at congested EU airports aimed at facilitating competition in particular through encouraging and giving a degree of priority to new entrants in the

allocation of available slots. The market for ground-handling services at EU airports was progressively opened to greater competition by an EU Directive (96/67) in the expectation that this would lead to reduced operating costs for airlines and improved quality of handling services. A code of conduct for computer reservation systems was also introduced (by EU Regulation 2299/89 as subsequently amended) aimed at ensuring that the distribution of airline products was neutral and non-discriminatory between airlines.

4. THE TECHNICAL FRAMEWORK

4.1 While liberalization was achieved through the establishment of an EU-wide economic regulatory framework, it is important to note that the harmonization of “technical” matters was not seen as a prerequisite to this liberalization. This was because there was already in train a long-standing process of harmonization of safety standards which had commenced some years ahead of the progressive liberalization of economic regulation, and in which ECAC had played an important role. The harmonization of safety standards was gradually taken over by the JAA (Joint Aviation Authorities), an associated body of ECAC, which expanded its original area of work from certification to include also maintenance, flight operations and personnel licensing. This expansion of the JAA’s work has steadily evolved during the 1990s and has resulted in a large number of JARs (Joint Aviation Requirements), some of which have been adopted as EU Regulations. The main instrument has been EU Regulation 3922/91 (on the harmonization of technical requirements and administrative procedures in the field of civil aviation) which incorporated into EU law a number of JARs in the field of airworthiness and maintenance of aircraft and products. The EU Regulation to establish the European Aviation Safety Agency (EASA) has been adopted and the Agency should be set up in the relatively near future.

4.2 In the environmental arena, EU-wide action has focused primarily on aircraft noise rather than gaseous emissions. In particular, based on an agreement reached in ICAO in 1990, aircraft not meeting Chapter 3 noise standards were banned under EU Directive 92/14 from operating at EU airports after 31 March 2002, and a seven-year transitional period was established over which such aircraft were phased out.

5. FACTORS INFLUENCING THE EFFECTS OF LIBERALIZATION

5.1 Before summarizing the main effects of liberalization in the EU it is important to note some of the factors which have served to shape the way in which the liberalized market has developed, for example in comparison to the way in which the US domestic market developed after deregulation. The geography and demography of Europe has inevitably played its part in influencing this development. In the EU the scope for competition via indirect routing has been much more limited than in the US, not least because journey lengths within Europe tend to be much shorter - averaging less than 700 km on the denser routes between EU states - and a higher proportion of passengers end their journey at a hub city. This places greater emphasis, generally speaking, on the need for competition on a route to be head-to-head if it is to be effective. The relatively short distance of many routes also means that intra-EU air services increasingly face strong competition from improved surface modes. In particular the development of high-speed rail links are increasingly likely to attract passengers away from air services (although they can also have the effect of generating additional journeys to offset this).

5.2 The extent of new entry and development of competition on many of the denser routes has, however, been constrained by the lack of capacity at some of the more significant airports in Europe. While existing aviation infrastructure has shown considerable ability to handle increased demand, certain airports such as Heathrow have reached the point where the scope for further expansion within the existing infrastructure is strictly limited. For example, well over half of the 20 densest routes within the EU have a seriously constrained airport at one or both ends. Existing airport capacity is being expanded in some parts of the EU but concerns about adverse environmental impacts often make such expansion difficult.

5.3 There was some expectation that the establishment of the concept of a “Community air carrier”, based on common licensing criteria and with the right of establishment anywhere within the EU, might lead to a process of consolidation among the larger EU airlines. That this has not occurred is no doubt due in large part to the fact that under EU Member States’ bilateral agreements, third countries would in many cases be entitled to reject the designation of a carrier not owned and controlled by nationals of the designating country. Any cross-border acquisition or merger between airlines from more than one EU Member State would therefore place at risk the combined entity’s ability to exploit traffic rights to third countries. These continuing external factors are likely, therefore, to have constrained significantly the extent to which the structure of the European airline industry has been able to adapt in response to liberalization.

6. THE EFFECTS OF LIBERALIZATION: KEY INDICATORS

6.1 Notwithstanding the factors identified above, it is generally agreed that the liberalization of air transport markets in the EU has promoted greater competition to the benefit of passengers and shippers. The following is a brief overview of the main changes in key parameters that have occurred since 1992. This is necessarily at a highly aggregated level, but the attached papers detail some of the changes that have occurred in specific sectors of the liberalized internal market.

6.2 Industry Structure

6.2.1 The total number of airlines based in the EU that offer scheduled services has changed little between 1992 and 2000, increasing from 124 to 131 over that time. However, this disguises that there has been extensive entry and exit with only just over half of the airlines present at the start of 1993 still operating scheduled routes under their own code at the end of the period. Of the 144 start-up airlines, less than half (64) were still flying by early 2000. Having said that, these figures arguably overstate the volatility of the market because airlines which become full franchisees of other airlines are treated as withdrawals. Nevertheless, the lowering of barriers to entry appears to have encouraged innovation and entrepreneurship. In particular, liberalization has allowed the establishment of many new airlines which operate totally within the liberalized area. This has spurred the growth in competition, especially on domestic routes.

6.2.2 Apart from Sabena, the other 13 national airlines remain although most are now members of one or other of the principal global alliances. As mentioned above, chief among the factors which prevent closer consolidation are the government-imposed ownership and control restrictions that still form the backbone of most bilateral relations with countries outside the liberalized European area.

6.2.3 Perhaps of greatest importance in the start-up activity has been the emergence of low-fare no-frills airlines which have now taken 10% of the total domestic and intra-EU market and which are rapidly expanding. For the present the no-frills airlines are mainly based in the UK and Ireland where their share is even more significant; in 2001, for example, the no-frills airlines carried 25% of the traffic on routes between the UK and other EU Member States and 22% of the total domestic traffic in the UK (for more information, see Annex 5).

6.3 Output

6.3.1 The period since liberalization has seen a strong growth in the number of scheduled intra-EU routes served, particularly international routes (an increase of nearly 75%). Although some of this increase is attributable to former charter services being converted to the scheduled mode, passengers will have gained from the increased availability of direct services. The number of domestic routes served has also increased but, reflecting the greater maturity of these markets, the growth has been lower (12%).

6.3.2 Output levels of scheduled airlines have increased at a faster rate than the number of routes. Seats and available seat kilometres(ASKs) on domestic routes have grown by 41% and 44% respectively over the period while on international routes the growth in ASKs (138%) has outstripped the growth in seats (105%), indicating an increase in average stage length (which may also, at least in part, reflect the switch from charter to scheduled mode). Scheduled domestic flights grew by 49% between 1992 and 2000 while intra-EU international flights increased by 88%.

6.4 Competition at the Route Level

6.4.1 The number of international scheduled routes with three or more carriers has more than trebled, increasing by over 250%. Although routes do not necessarily coincide with economic markets, they are more likely to do so on short-haul routes and this can therefore be regarded as evidence of a significant increase in competition at the route level although it should be borne in mind that code-sharing agreements and other forms of alliance between operators are now more widespread. As noted above, the switching from charter to scheduled of some low-frequency services may have boosted the number of multi-airline operations, particularly on thin routes, but, even in winter, the number of scheduled multi-operator routes had more than doubled between 1992 and 2000. Domestic routes have historically been dominated by national carriers so that the near doubling of domestic routes with a second carrier (an increase of 88%) is particularly significant.

6.4.2 The share of domestic ASKs performed on routes with more than one carrier has increased from about one third before 1993 to over two thirds in 2000 and, although the share of international ASKs on routes with three or more carriers rose at a slower rate, over half the international ASKs were on multi-airline routes by 2000.

Table 1. Air Transport Liberalization in the EU: Key Indicators

	Pre- Liberalization	Current (a)	Change	Source
Number of EU Scheduled Airlines	124	131	6%	AEA1
Number of EU domestic city-pair routes	813	910	12%	EU2
Number of domestic routes with more than one carrier	106	199	88%	EU2
Weekly Seats on EU domestic routes (in thousands)	2,891	4,084	41%	EU2
Yearly ASKs on EU domestic routes (in billions)	73	105	44%	EU2
Yearly Flights on EU domestic routes (in thousands)	1,486	2,220	49%	EU2
Share of EU domestic ASKs on routes with more than one carrier	34%	68%	+34ppts	EU2
Number of Intra-EU (international) city-pair routes	692	1,202	74%	EU2
Number of Intra-EU routes with more than two carriers	61	217	256%	EU2
Weekly Seats on Intra-EU routes (in thousands)	2,231	4,571	105%	EU2
Yearly ASKs on Intra-EU routes (in billions)	102	243	138%	EU2
Yearly Flights on Intra-EU routes (in thousands)	1,109	2,080	88%	EU2
Share of Intra-EU ASKs on routes with more than two carriers	42%	52%	+10ppts	EU2
No-Frills Airline share of total EU domestic ASKs	0.0%	3.9%	+4ppts	EU3
No-Frills Airline share of total Intra-EU ASKs	0.6%	12.9%	+12ppts	EU3

Change in Business Class Fares on routes within the EEA (nominal)	€242	€350	45%	EU1
Change in Normal Economy Fares on routes within the EEA (nominal)	€213	€243	14%	EU1
Change in Promotional Fares on routes within the EEA (nominal)	€147	€125	-15%	EU1
Change in AEA Average Yield (cents/RPK in US dollars at 2001 ER)	14.48	14.63	1%	AEA2
European Inflation (1992 = 100)	100	119	19%	EU1

- Notes:** (a) “Current” means 2000, except for the no-frills airline share, which refers to summer 2002.
(b) The analysis is based on OAG summer schedules and it therefore excludes non-scheduled services.
(c) No Frills airlines defined as bmibaby, Buzz, Debonair, easyJet, Go, Ryanair, Virgin Express
(d) “ppt” means “percentage point”.
(e) Association of European Airlines (AEA) average yield estimate relates to those member airlines which reported results on domestic and geographical European operations and has been adjusted to reflect a fixed dollar exchange rate.
(f) Inflation estimate based on actual rates for EEA states weighted by GDP from 1992 to 1998 and assumed rates for 1999 and 2000.

Sources:

- AEA Association of European Airlines:
AEA1 – Analysis of airlines shown in OAG in February 2000 and January 1993;
AEA2 – Statistical Appendices to 2002 Yearbook.
- EU European Commission publication: “Updating and development of economic and fares data regarding the European Air Travel Industry”:
EU1 - 2000 Annual Report;
EU2 - analysis of summer 2000 and summer 1992 monitoring data provided by EU;
EU3 - analysis of summer 2002 with summer 1992 monitoring data provided by EU.

6.5 Fares

6.5.1 The aggregate general rate of inflation in EU states between 1992 and 2000 was 19%. Compared to this, on average across routes within the EEA, published Business Class and Normal Economy air fares rose by 45% and 14% respectively whereas promotional (i.e. conditioned) fares decreased by 15%, i.e. in real terms published promotional fares fell by about 30%.

6.5.2 Competition for business passengers, who are the principal purchasers of Business Class and fully-flexible tickets, tends to focus more on service quality than on price. It is difficult to quantify all aspects of service quality although in air transport the number of direct services, the available frequency and seat availability are important factors. Even for the more price-conscious business traveller, published Business Class fares necessarily provide an imprecise indicator of the price paid because of corporate discounts on the one hand and the possibility that business passengers may downtrade to economy class fares, particularly where there is a no-frills option, on the other.

6.5.3 In the US following deregulation full fares increased in price but there was a marked reduction in the proportion of passengers using such fares, as lower-priced alternatives became more easily available. There is no comprehensive data in Europe on the proportion of passengers buying the different types of fares

and how these proportions have changed over time. However, AEA data indicates that average yields in the European area did not change greatly in nominal terms, i.e. have fallen quite sharply in real terms.

7. CONCLUSIONS

7.1 Some of the effects of liberalization are readily apparent, although not knowing what would have happened in the absence of liberalization makes it difficult to assess the impact of the single aviation market in Europe with any precision. But the new regulatory environment certainly has fostered innovation and enterprise, resulting in more routes served and greater competition on many existing routes. The emergence of no-frills carriers, which would have been impossible on many routes ten years ago, has changed the way many people think about air transport, and has necessitated a competitive response from their longer-standing rivals. Consumers have benefited from a wider range of choice, both in locations served and in quality and type of service. The evidence on fares is mixed. Fares at the bottom end of the market have fallen, but it is less clear quite what impact liberalization has had on the prices paid by business travellers. As a general observation, for many - though certainly not all - users there is a wider range of fares and services available than previously. By contrast, liberalization has had only limited impact on the basic structure of the airline sector, almost certainly because this is influenced to such a key extent by the traditional international regulatory framework, which is outside the direct control of any one country or even group of countries.

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