

WORLDWIDE AIR TRANSPORT CONFERENCE: CHALLENGES AND OPPORTUNITIES OF LIBERALIZATION

Montreal, 24 to 29 March 2003

- Agenda Item 1: Preview**
1.1: Background to and experience of liberalization

CASE STUDIES ON LIBERALIZATION

(Presented by the Secretariat)

SUMMARY

This paper provides several case studies on liberalization experiences and proposes the further development and dissemination by ICAO of case studies to assist States in the liberalization process.

Action by the Conference is in paragraph 4.1.

1. INTRODUCTION

1.1 In its single Recommendation the 1994 Worldwide Air Transport Conference, in paragraph j) recognized “that liberalized arrangements at the sub-regional or regional level provide valuable experience as regards the content, process and structure of regulatory change, and this experience should be disseminated to States for their information”. Moreover, in Assembly Resolution A33-19, Consolidated Statement of Continuing ICAO Policies in the Air Transport Field, paragraph 6 of Appendix A “requests the Council to continue the comparative and analytical study of the policies and practices of Contracting States and airlines concerning commercial rights and the provisions of air services agreements and to inform all Contracting States of any new developments in international cooperation, including liberalized arrangements, with respect to commercial rights”.

1.2 Implementation of these elements of the Recommendation and Resolution has so far been provided primarily through exchange of information at the programme of workshops and seminars on air transport regulatory policy. In addition, information on liberalization developments is included in the annual ICAO publication World of Civil Aviation (see circular 291). In view of the request by the Council that this Conference focus on “how to liberalize”, the Conference may wish to consider a case study approach. This paper proposes such an approach in order to develop a broad data base of liberalization experiences for the information of States, with ICAO as the clearing house for such information.

2. A CASE STUDY APPROACH

2.1 Attached to this paper are several case studies prepared by the Secretariat, which describe in summary form liberalization experiences in the State(s) concerned. The aim is to provide some useful information which seeks to identify the effects of liberalization policies pursued by State(s). Such policies will differ according to certain factors, including basic economic conditions and stage of economic development. Although there is no single formula applicable or relevant to all situations, case studies may suggest that there are some underlining similarities in the outcomes realized in liberalized marketplaces, regardless of the diversity of policies which involve different paths and paces of liberalization.

2.2 It should be borne in mind that the analysis in these case studies is not strictly quantitative but more in the nature of qualitative and descriptive. Nor is the method used here a means to determine the precise benefits or drawbacks of a particular approach since not all input is available nor all factors known to make such an examination. Assessment of overall net impacts (including costs and benefits) of liberalization on consumers and producers is beyond the scope of this approach and is best left to be done by individual States (in this regard, ICAO is developing guidance material on economic contribution of civil aviation for cost-benefit analysis by States). Nevertheless, fact-finding exercises through the examination of each case could serve to identify some significant changes which have occurred and which could be attributed in part to liberalization. It should also be noted that the attached case studies, chosen to provide a broad geographic and marketplace coverage, as well as cases at different phases of liberalization, were developed by relying on a database on liberalization which the ICAO Secretariat has been developing internally. The views expressed in the attached case studies are those of the Secretariat and do not constitute an assessment by ICAO. With the aim of producing a more comprehensive and useful database, it would be helpful if States also provide ICAO with information on their experiences with the liberalization process in general as well as with specific approaches.

2.3 Each case study attached hereto is structured around three components: Background; Liberalization of regulatory framework; and Effects and developments. The Background gives a brief description of pre-liberalized regulatory schemes and market situations. The Liberalization of regulatory framework summarizes the chronology and scope of liberalization that State(s) implemented. The Effects and developments section is an overview of the main changes in key elements (such as traffic and competition), as are available to ICAO, since the liberalization was instituted, as well as airlines' responses to the liberalized circumstances.

2.4 For purposes of this paper, the studies are limited to approximately one page each. Further case studies prepared by the Secretariat will follow the basic format set out in the previous sub-paragraph. In accordance with the mandate set out in Assembly Resolution A33-19 and as a practical tool to assist States in developing their liberalization approaches and policy options, the Secretariat will make available through appropriate means, any further case studies it produces, together with case studies or information on liberalization experiences submitted by States or organizations.

3. CONCLUSIONS

3.1 From the foregoing discussion, the following conclusions may be drawn:

- a) A case study approach to liberalization experiences, while of necessity limited in scope, provides a suitable vehicle for the analysis and dissemination of information on such experiences of States at national, sub-regional, regional or plurilateral level. Case studies

on liberalization may assist States to further develop their liberalization approaches and policy options.

- b) ICAO should continue to develop and disseminate by appropriate means case studies and information on liberalization experiences. States should be urged to submit such information to ICAO for general dissemination.

4. **ACTION BY THE CONFERENCE**

4.1 The Conference is invited to:

- a) note the case studies attached to this paper; and
- b) review and adopt the conclusions in paragraph 3.1.

CASE 1

CENTRAL AMERICAN STATES' OPEN SKIES AGREEMENTS WITH THE UNITED STATES

Background. For most Central American States, their bilateral relationship with the United States is a central issue in their aviation policy, since the US is a major market for these States. However, there exists a major disparity between the two sides in their market size, carriers' competitiveness and travel propensity. Before liberalizing their air services agreements with the United States, therefore, it was considered necessary to integrate the small airlines of the sub-region, in order to increase their competitiveness through the exploitation of economies of scale and scope.

The consolidation exercise was approached cautiously because of varying national circumstances: Aviateca (Guatemala) and AeroNica (Nicaragua) were 100 per cent State-owned and in the process of privatization, while LACSA (Costa Rica), TACA International (El Salvador) and SAHSA (Honduras) were private. During 1989 - 1992, TACA International acquired minority equity shares in the other four carriers. Based on these shareholdings together with a series of separate commercial agreements, the Grupo TACA was launched in mid-1990s¹. COPA (Panama) also became a marketing partner of the group. All the carriers in the group have kept their separate identities, but all the commercial and operational activities (such as purchases, maintenance, insurance, marketing and sales) were pooled. In 1996, the Grupo TACA concluded a reciprocal codesharing agreement with American Airlines, the largest US carrier operating on Central American routes, which would be implemented after governmental approval.

Liberalization of regulatory framework. The creation of the Grupo TACA has given the Central American States involved a measure of confidence and comfort in opening up their markets. The liberalization of bilateral air services agreements with the United States was also necessary to ensure the approval of the Grupo TACA's codesharing agreement with American Airlines by the US Department of Transportation (DOT). In 1997, Panama, Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua separately concluded "open skies" agreements with the United States. The agreements were virtually identical and provided for full market access without restrictions on designations, route rights, capacity, frequencies, codesharing and tariffs. Four of the six agreements also granted Seventh Freedom rights for all-cargo services, and further agreement granted Seventh Freedom rights for charter all-cargo services.

Effects and developments. The group approach has enabled smaller States and their carriers to consolidate their efforts so that they can continue to participate in the competitive marketplace as a strong regional representative with collective bargaining power. The Grupo TACA has also played an important role in promoting Central America as an integrated multinational tourism destination. According to the US DOT data, Grupo TACA (including COPA) carried 1.62 million passengers between Central America and the United States in 2000, compared to 1.39 million in 1994 and 1.34 million in 1997. This strong increase was achieved mainly by expanding the network through the codesharing operation with American Airlines, which was officially approved by the US DOT in 1998.

Such demand growth has also been stimulated by a significant increase in competition under the "open skies" agreements. Continental Airlines, Delta Air Lines and United Airlines each made substantial gains in Central American markets, resulting in gradual decline of market shares for Grupo TACA and its allied American Airlines. In particular, the strength of Continental Airlines was raised by the alliance agreement with COPA, in which Continental acquired 49 per cent stake in 1998. The US DOT granted antitrust immunity to the Continental-COPA alliance in 2001. By way of contrast, the application of antitrust immunity by American Airlines and Grupo TACA provoked opposition from competing carriers because of its potential market dominance, and resulted in its voluntary withdrawal in 2002.

¹ Now the Grupo TACA is comprised of Aviateca, LACSA, NICA (ex-AeroNica), TACA de Honduras (ex-SAHSA) and TACA International, as well as TACA Peru. Its international network is complemented by TACA Regional Airlines, which consists of Aeroperlas (Panama), Inter (Guatemala), Islena (Honduras), La Costena (Nicaragua) and SANSA (Costa Rica).

CASE 2 INDIA'S OPEN SKIES POLICY ON AIR CARGO

Background. During the 1980s, the Indian economy grew by over 5 per cent as an annual basis, but suffered from chronic shortages of international air cargo capacity. As the export industry demanded on-time delivery of raw material and manufactured goods, and as the time-sensitive materials were to be delivered more frequently by air, capacity constraint was regarded as the key obstacle that would hinder the industry from enhancing export and foreign currency exchange earnings. Impetus to the reform of air cargo sector was added in 1986, when the Indian government allowed air taxi operators to provide on-demand services primarily to boost tourism on major routes. In the early 1990s, the Government announced an industry-wide “economic disengagement” policy, which aimed at moving from a planned closed economy towards a much less regulated market system.

Liberalization of regulatory framework. A policy of “open skies” for air cargo was adopted in 1990, initially for three-year period, and extended in 1992 on a permanent basis (Aeronautical Information Circular AIQ No. 18/1992). Under this new policy, any airlines, both Indian and foreign carriers which meet specified operational and safety requirements, are allowed to operate scheduled and non-scheduled cargo services to/from any airports in India where custom/immigration facilities are available. In addition, regulatory control over cargo rates for major export commodities has been abolished so that carriers are free to set their own rates. The Government also expressed its “favourable” consideration to application by foreign airlines for additional passenger flights operated by mixed passenger/freight aircraft. These new policies were consolidated into a package together with further liberalization on domestic air taxi operations and relaxation of the rules on international tourist charters, and were implemented on a unilateral basis without requiring comparable rights for Indian carriers from bilateral partners in return.

Effects and developments. According to Indian government statistics, the period since the adoption of an open skies policy has seen a strong growth in international air cargo traffic, which increased from about 300 000 tonnes in 1991 to over 420 000 tonnes in 1998. The traffic increase was mainly due to a sizeable growth in scheduled services operated by foreign airlines (about 80 per cent increase for the same period), most of which were permitted to inaugurate under an “open skies” policy. For example, Lufthansa, Air France and KLM doubled their capacities to India, while most foreign airlines adopted a strategy of selective entry in peak periods without long term commitments. Carriage on foreign airlines’ non-scheduled services also doubled for the first three years, but sharply declined to less than the 1991 level by 1998 because of a marked shift to scheduled services and sea cargo. The boom in air cargo was propelled by the progress of the country’s economic liberalization, although infrastructure bottlenecks including a shortage of warehousing facilities have gradually hampered potential cargo business opportunities.

Faced with stiff competition from foreign airlines, Air India, a State-owned national carrier, has seen its market share of international cargo tonnage reduced from 23 per cent in 1991 to 16 per cent in 1992 and has remained around that level since. To recover its market share and augment its capacity, Air India submitted a fleet acquisition programme, for which the Government had expressed support, and new wet-leased freighter operations. Indian Airlines, another State-owned carrier serving domestic and short-haul international routes, tripled its cargo operation from 1991 to 1998. The revenue from cargo reached about 10 per cent of Indian Airlines’ revenue, but its market share for international cargo was still about 3 per cent, compared to 10 per cent in passengers.

CASE 3 TRANS-TASMAN SINGLE AVIATION MARKET

Background. Since the Australia-New Zealand Closer Economic Relations Trade Agreement (known as the CER Agreement) came into effect in 1983, the Australian and New Zealand economies have become increasingly integrated. In 1988, when the CER Trade in Services Protocol was concluded, however, Australia chose to exclude international and domestic air services from its application; the only air services exclusion by New Zealand was international carriers flying cabotage. Consequently, liberalization of air services across the Tasman continued to be dealt with by a bilateral air services agreement and related understandings (for example, the 1989 understanding agreed to multiple designation for freight with no capacity constraint). It should be noted that the integration process has been significantly affected by the progress of domestic deregulation and privation of national carriers. In Australia, the domestic aviation market was deregulated in 1990, and State-owned Qantas was partially privatized in 1993 (full privatization was completed in 1995). In New Zealand, the domestic market was deregulated in 1983, and State-owned Air New Zealand (ANZ) was fully privatized in 1989.

Liberalization of regulatory framework. In 1992, the two States concluded a Memorandum of Understanding (MOU), which lifted capacity restrictions across the Tasman, introduced multiple designation and a double disapproval tariff regime, and set out a phased liberalization towards full trans-Tasman market access and greater beyond rights by 1994. The MOU also contained a commitment to consult on the subsequent full exchange of beyond rights and cabotage rights, but Australia withdrew its commitment in 1994. However, in 1996, the States succeeded in signing the Single Aviation Market (SAM) arrangements, which was incorporated into the CER Protocol. The arrangements allowed a “SAM carrier²” to operate without restrictions trans-Tasman and domestic services in either State (effectively, cabotage). Excluded were unlimited beyond rights, which continued to be governed by the bilateral air services agreements and the 1992 MOU. In 2000, the States concluded an “open skies” agreement, which was officially signed in 2002. This new agreement formalized the provisions of SAM arrangements, eliminated the limitation of beyond rights, and allowed Seventh Freedom rights for all-cargo services.

Effects and developments. In 1994-95, three new entrants started to operate international services on the Tasman route: Kiwi Travel International Airlines, Freedom Air (a wholly-owned subsidiary of ANZ) and Ansett International. The entry of three carriers with lower fare levels was associated with significant traffic expansion especially in the leisure demand segment. According to Australian government statistics, trans-Tasman passenger numbers increased annually by less than 4 per cent between 1993 and 1995, but by 22 per cent from around 1.8 million in 1995 to 2.2 million in 1996. Although growth slowed temporally after Kiwi’s liquidation in 1996, passenger numbers continued to expand and reached 3.3 million in 2000 and 3.6 million in 2001. One factor in this was that Qantas allocated part of its capacity from Asian to trans-Tasman services amid the Asian economic crisis; and another that ANZ radically increased its frequencies with smaller aircraft in cooperation with Ansett.

While two major players, ANZ and Qantas, have not directly exercised cabotage rights in each other’s domestic market, the airline industries of the two States became highly integrated in 2000 as a result of ANZ’s 100 per cent ownership of Ansett and the launch of Qantas New Zealand (formerly Ansett New Zealand) through a franchise agreement. However, the industry structure remains unstable. In 2001, Qantas New Zealand and Ansett stopped operations due to financial difficulties. ANZ, which was almost driven into bankruptcy by the collapse of Ansett, was re-nationalized by the government (which acquired a 82 per cent shareholding in the carrier). In 2002, Qantas and ANZ agreed to enter into a strategic alliance, which would involve Qantas taking a 22.5 per cent shareholding in ANZ, subject to approval from competition authorities in both States.

² An air carrier at least 50 per cent owned and effectively controlled by either Australian or New Zealand nationals or both, with its head office and operational base in Australia or New Zealand.

CASE 4 ANDEAN OPEN SKIES PACT

Background. The “Andean Group” was founded by five South American States in 1969 under the Cartagena Agreement (more often called “Andean Pact”). The original Member States were Bolivia, Chile, Colombia, Ecuador and Peru. Venezuela joined the Group in 1973, while Chile withdrew in 1976. The objectives of the Group were, *inter alia*, to promote balanced and harmonious development among them through wider-ranging economic integration and cooperation. In the aviation field, major airlines operating international scheduled services had been all State-owned (except ones in Columbia) and tightly regulated by their respective governments. Since the late 1980s, moves towards privatization of State-owned national airlines had proliferated in this subregion, and had a significant impetus on the liberalization progress.

Liberalization of regulatory framework. In 1990, the Presidents of five States agreed to move ahead the deadline for forming the Free Trade Area within the subregion, which would come into effect in 1993. As part of this process, in 1991, the Andean Commission adopted Decision 297, “Integration of Air Transport in the Andean subregion”, which established an “open skies” air transport policy on a subregional basis. As regards scheduled passenger and cargo services and non-scheduled cargo operations, exercise of unrestricted Third, Fourth and Fifth Freedom Rights was permitted without limitation on the number of airlines, capacity and frequency³. Airlines’ pricing activity was also liberalized by introducing a country of origin tariff regime. Non-scheduled passenger services were authorized automatically between points without scheduled services. On scheduled services routes, the authorization would be granted provided that the non-scheduled services did not jeopardize the economic stability of existing scheduled services.

Effects and developments. The Andean “open skies” policy created favourable conditions to stimulate economic activity and expand commercial opportunities for the airlines. According to OAG data, scheduled international seat-kilometres available (ASK) within this subregion increased by 325 per cent from 1989 to 2001 (754 million in 1989; 1,970 million in 1995; 2,804 million in 1998; 3,201 million in 2001). This stood in marked contrast to a 12 per cent increase in scheduled domestic ASK within the subregion and also to a world average scheduled international ASK increase of 103 per cent.

Despite a legally-binding commitment to an “open skies” policy, however, the pace of the liberalization actually adopted by each State has varied considerably because of the different economic situations and privatization progress. Columbia (in which all the major airlines including AVIANCA were privately-owned) and Venezuela (which completed partial privatization of VIASA in 1991) were willing to advance the liberalization process, while Peru sought to protect AeroPeru from competition in the run-up to privatization. In 1992, Peru suspended all the commitments to the liberalization programmes. Although AeroPeru was partially privatized in 1993, the suspension continued until 1997 when Peru agreed to gradual incorporation of the country into the Free Trade Area. Bolivia and Ecuador completed the partial privatization of LAB and Ecuatoriana in 1995.

Behind the experience of a strong traffic growth, there has been the demise of several privatized national airlines in the subregion. There has also been strong competitive pressure from United States and European carriers. VIASA and AeroPeru ceased operations in 1997 and 1999, respectively. The vacuum was filled with new private entrants such as Servivensa and Aero Continente. AVIANCA has steadily increased its market share within the subregion, but faced financial problems due to stiff competition on the United States routes. In 2002, Avianca, ACES (Columbia’s second largest carrier) and SAM Columbia (a subsidiary of AVIANCA) integrated their operations under a holding company named Alianza Summa to strengthen its competitiveness and financial basis.

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³ Multiple designation for scheduled passenger and cargo services was added by the Decision 320 in 1992. Decision 297 and 320 were amended for clarification in 1994 by Decision 360 and 361, respectively.