WORLDWIDE AIR TRANSPORT CONFERENCE: CHALLENGES AND OPPORTUNITIES OF LIBERALIZATION

Montreal, 24 to 29 March 2003

Agenda Item 2: Examination of key regulatory issues in liberalization
2.1: Air carrier ownership and control

LIBERALIZING AIR CARRIER OWNERSHIP AND CONTROL

(Presented by the Secretariat)

SUMMARY

This paper examines issues and policy options in liberalizing air carrier ownership and control, and proposes a new alternative criterion (beyond national ownership) for airline use of market access. It also discusses and proposes possible approaches to facilitating liberalization in this area.

Action by the Conference is in paragraph 8.1.

REFERENCES

Doc 9587, *Policy and Guidance Material on the Economic Regulation of International Air Transport*

1. INTRODUCTION

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, codesharing, 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.

1.4 Transnational investments in air carriers have also occurred against a backdrop of widespread multinational ownership in other service industries. 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. This paper addresses the issue of further reform of the ownership and control criteria.

2. PREVIOUS ICAO WORK

2.1 ICAO has addressed this issue extensively to meet changing needs. As early as in 1983, the 24th Session of the Assembly adopted Resolution A24-12 (now incorporated in A33-19) which introduced the concept of “community of interest” in respect of airline designation involving developing countries. At the 1994 World-wide Air Transport Conference (ATConf/4), two broadened criteria were endorsed (one widening the substantial ownership and effective control criteria to one or more States parties to an agreement; and the other extending the “community of interest” concept to all States, i.e. to any one or more other States belonging to a pre-defined group). On the recommendation of ATConf/4, the Organization developed a further criterion based on the “principal place of business plus a strong link” concept (Recommendation ATRP/9-4) which was subsequently approved by the Council as guidance for optional use by States (see Doc 9587). The “community of interest” and “principal place of business” provisions each appear today in a limited number of air services agreements.

2.2 At the 33rd Session of the ICAO Assembly in 2001, attention was drawn to the growing complexity in regulation as a result of the various approaches being used by States for airline designation and authorization, and to the need for ICAO to harmonize them, perhaps on the basis of the “principle place of business” concept. The Assembly noted that investment in airlines, trans-border or not, might be an overriding concern in the near future, and agreed that this matter should be taken up in the context of the Fifth Air Transport Conference (ATConf/5).

2.3 As part of its preparatory work for ATConf/5, the Secretariat conducted in 2002 a survey of States’ policies and practices on air carrier ownership and control (State letter SC 5/2-01/50 dated 16 May 2001). The survey revealed that while the interest of national airlines still weighs heavily in many States’ consideration for air carrier ownership and control rules, a broader perspective of national interest including economic development and trade has become an overriding factor. Many States were receptive to the use of certain broadened criteria. The survey confirmed the usefulness of ICAO’s guidance in this area

and the need for ICAO to undertake further work. The findings suggested that the key to advancing liberalization lies with regulatory arrangements that would address the needs and concerns of both designating and receiving States.

3. DISCUSSION

3.1 Under the present regulatory regime for scheduled international air services, a State must secure not only the necessary market access rights but also the operating permissions from all the partner States its designated airline(s) would serve. The traditional nationality-based criterion for airline designation and authorization had been widely accepted during the time when most national carriers were owned by the designating State or its nationals. However, the situation has changed significantly as a result of liberalization and privatization. The ownership of national air carriers has become increasingly diverse, many are no longer state-owned, and some are approaching the point where homeland nationals hold a bare majority of shares as many States have adjusted their policies to relax restrictions on foreign investment in national carriers, particularly when privatizing them.

3.2 Furthermore, some bilateral air services agreements as well as regional arrangements have introduced certain broadened criteria on air carrier ownership and control. Nonetheless, the majority of agreements, including liberal or "open skies" agreements, have continued to apply the traditional criterion although there is no agreed definitions of the two elements of the concept and it is subject to varying interpretation and application. Exceptions or deviations to the criterion have long existed, and past experience of liberalization in this area (e.g. in the European Union where community ownership and control has superceded national ownership and control) has shown that it can take place without conflicting with the obligations of the parties under the Chicago Convention or undermining the nature of international air transport.

3.3 There is an anomaly in the continuing use of the traditional criterion. It is broadly accepted that each State should be allowed to pursue air transport liberalization at its own choice and its own pace, but the traditional provision, by virtue of the right of refusal held by other States, effectively prevents a State which chooses to liberalize more rapidly from doing so in respect of airline designation for the use of market access. Moreover, the primary aim of States using this criterion has been to limit the economic benefits of bilateral air services agreements to the contracting parties and/or their nationals. However, this restriction also limits the sources of investment for air carriers which, given the nature of the airline industry and the increasingly competitive environment, may have an adverse effect on their participation opportunities.

3.4 An issue for consideration is whether there is a need to maintain an economic connection between the airline and its designating State (including, but not limited to "principal place of business and/or place of incorporation"), particularly in a situation where air carrier ownership and control is liberalized on a regional or multilateral basis. There has been some discussion on whether the economic connection should be dispensed with altogether, leaving regulatory control of safety and security as the only link between the designating State and the airline. IATA has gone further in strongly advocating that any airline might be designated under an air services agreement, provided that the party accepting the designation is satisfied that the Air Operator Certificate (AOC) of that airline is granted by an authority that is acceptable to it.

3.5 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 through 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 operation. 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.

3.6 The current bilateral mechanism also creates two distinctive yet interlocking issues for States: 1) for those who wish to liberalize, how to remove the potential risk that their designated airlines might be rejected by the bilateral partners; and 2) for those who want to retain the national ownership and control requirement for their own carriers, whether to accept foreign designated airlines with liberalized ownership and control, and if so, how to ensure that they could still identify the link between the airline and the designating State to prevent "flags of convenience" and for safety and security matters. In the case of 1), it appears that a State would be reluctant to liberalize if it may risk losing its traffic rights because of its designated airline's foreign ownership. As for 2), the approach of the State to accepting designations can help or hinder the liberalization efforts of the designating States. A major challenge is how to have States that do not wish to liberalize at present not inhibit others from doing so.

3.7 The objective of regulatory liberalization in this area should be to create an operating environment in which air carriers could operate efficiently and economically without compromising safety and security. Liberalization experience, at the national and regional levels, seems to suggest that unless the constraint originating from the bilateral regime is overcome, there will be limited progress in advancing the cause. Therefore, efforts should focus firstly on developing an alternative regulatory arrangement which would remove the constraint and address the concerns associated with such removal, and secondly on means to implement this reform.

4. ALTERNATIVE REGULATORY ARRANGEMENT

4.1 Based on the above discussion and drawing on the work already done by ICAO as well as by other organizations (e.g. the European Civil Aviation Conference (ECAC), the Organisation for Economic Co-operation and Development (OECD), the International Air Transport Association (IATA), and the "Kona" open skies agreement among six member States of the Asia Pacific Economic Cooperation (APEC)) , a possible alternative regulatory arrangement for airline designation and authorization could be devised by building on Recommendation ATRP/9-4 (i.e. the "principal place of business plus a strong link" approach which has already been endorsed by the Council). The arrangement would be that parties to a bilateral agreement would agree to accept the designation of an airline for the use of the agreed market access if the airline has its "principal place of business" in, and there is "effective regulatory control" by, the designating party. The arrangement would be accompanied by specific criteria for the two concepts (see paragraph 4.6 below).

4.2 The proposed arrangement would seek to broaden the economic criteria for airline designation and authorization while preserving the necessary link between the carrier and the designating State, and strengthening regulatory controls including on aviation safety and security.

4.3 The arrangement would enable a State to designate air carriers as it sees qualified (including those with majority national ownership) to use and benefit from its entitled market access rights under a bilateral agreement. At the same time, it would reinforce the obligation on the part of the designating party to maintain effective regulatory control (including safety and security oversight) over the airline it designates. Such control is envisioned primarily through licensing which can include both economic and operational elements. The arrangement would not require the State to change its existing laws, policies or regulations pertaining to national ownership and control of its own national air carrier(s), but would allow such change if and when the State wishes to do so.

4.4 For a State which receives the designation, it would retain the discretionary right of refusal as a measure of control to address legitimate concerns if and when required. The continued availability of this right, coupled with strengthened regulatory controls including those required of the designating party, would provide the means a receiving party needs to address potential concerns such as safety, security or other economic aspects including potential emergence of "flags of convenience".

4.5 The proposed arrangement should help to create a more favourable operating environment in which airlines can conduct their business according to the market conditions and their commercial needs as in other industries. It could benefit all such States whose air carriers need access to international capital, notably including those from the developing countries, thereby enhancing their participation in the air transport system. The arrangement would facilitate privatization of State-owned airlines where foreign investment is sought. It would not lead to drastic changes to the existing bilateral framework since it could be introduced through the normal bilateral negotiation and consultation process, taking into account reciprocity. Its application could facilitate broader liberalization in such areas as market access, but would not lead to a "laissez-faire" situation as all regulatory tools remain available and it would be up to each State to determine how and to what extent it wishes to pursue liberalization.

4.6 The following draft model clause, developed with the assistance of the Air Transport Regulation Panel (ATRP), is proposed for consideration by the Conference for Contracting States to use at their discretion in air services agreements. This provision has been inserted in the Template Air Services Agreement in ATConf/5-WP17.

"Article X: Designation and Authorization

1. Each Party shall have the right to designate in writing to the other Party [an airline] [one or more airlines] [as many airlines as it wishes] to operate the agreed services [in accordance with this Agreement] and to withdraw or alter such designation.

2. On receipt of such a designation, and of application from the designated airline, in the form and manner prescribed for operating authorization [and technical permission,] each Party shall grant the appropriate operating authorization with minimum procedural delay, provided that:

a) the designated airline has its principal place of business [and permanent residence] in the territory of the designating Party;*

*b) the Party designating the airline has and maintains effective regulatory control** of the airline;*

c) the Party designating the airline is in compliance with the provisions set forth in Article X (Safety) and Article Y (Aviation Security); and

d) the designated airline is qualified to meet other conditions prescribed under the laws and regulations normally applied to the operation of international air transport services by the Party receiving the designation.

3. On receipt of the operating authorization of paragraph 2, a designated airline may at any time begin to operate the agreed services for which it is so designated, provided that the airline complies with the applicable provisions of this Agreement.

Notes:

*(i) *evidence of principal place of business includes such factors as: the airline is established and incorporated in the territory of the designating Party in accordance with relevant national laws and regulations, has a substantial amount of its operations and capital investment in physical facilities in the territory of the designating Party, pays income tax, registers and bases its aircraft there, and employs a significant number of nationals in managerial, technical and operational positions.*

***evidence of effective regulatory control includes but is not limited to: the airline holds a valid operating licence or permit issued by the licensing authority such as an Air Operator Certificate (AOC), meets the criteria of the designating Party for the operation of international air services, such as proof of financial health, ability to meet public interest requirement, obligations for assurance of service; and the designating Party has and maintains safety and security oversight programmes in compliance with ICAO standards."*

(ii) The conditions set forth in paragraph 2 of this Article should also be used in the article on revocation of authorization.

4.7 The proposed arrangement might have potential implications for States party to the International Air Services Transit Agreement (IASTA) in that some airlines may cease to qualify under the ownership and control provision of that agreement. However, the impact may be very limited because: 1) the airline could still be substantially owned and effectively controlled by the designating State under the proposed arrangement, or by one of the States party to the IASTA, which currently has 118 parties; 2) the airline may be able to operate under relevant bilateral agreements in which the first two freedoms of the air have already been granted; and 3) in the case where the airline cannot qualify under the first two situations, the States concerned may be requested to exercise the discretionary right in a liberal manner to permit such operation when the airline meets other overriding requirements such as safety and security.

5. POSSIBLE APPROACHES TO FACILITATING LIBERALIZATION

5.1 Liberalization in this area can be facilitated in a number of ways. Firstly, States can apply the broadened criteria, including the above alternative arrangement, for their carriers; the more States that do so, the greater the potential for their acceptance in air services agreements.

5.2 However, given that the majority of States have used, and continue to use, the traditional criterion in their bilateral agreements, and the long and complex process for changing the thousands of existing agreements, there is merit in exploring more practical solutions which would enable States to deal with the ownership and control requirement with flexibility without changing the existing regime but, at the same time, provide the certainty required by the States from the regulatory perspective and by the carriers to make strategic and investment decisions.

5.3 Many States have legitimate reasons to require national ownership and control for their own carriers. However, such a State could give sympathetic consideration to the needs and wish of other States to liberalize in this area in three possible ways, by:

a) allowing its bilateral partners to use the broadened criteria for those partners' designated carriers while retaining the traditional criterion for its own designated carriers (such as that practised in the bilateral agreements involving the Hong Kong Special Administrative Region of China as a party);

b) exercising the discretionary right under the bilateral agreement to accept the designated carrier of its bilateral partner which does not meet the traditional ownership and control criterion if that carrier meets other overriding requirements such as safety and security; and

c) making public its position on the conditions under which it would accept foreign designations, preferably as a general applicable policy, given that air services are network-based which can only be operated after authorization from all destination States are obtained. A case-by-case policy would not help bring about the certainty needed by the airlines.

5.4 For those States that wish to take positive measures to liberalize ownership and control rules, one possible approach might be to make voluntarily a public "pledge" or commitment to treat the ownership and control requirement liberally in accepting foreign designated airlines under the bilateral agreements. This may be done independently by individual States, or multilaterally by like-minded States in a coordinated manner.

5.5 While independent action by such States remains a valid option, a coordinated multilateral arrangement may offer a better means to achieve the aim on a broader, more secure basis. Liberalizing ownership and control rules for a State may become more attractive if there is a critical mass of its bilateral partners committing to not rejecting the designation of its airlines. This critical mass is unlikely to develop quickly in the absence of coordinated action, as individual renegotiations of air services agreements will take a considerable amount of time. A core group of important markets interested in and publicly making that commitment may therefore create momentum for liberalization pending the wider usage of the alternative criterion in paragraph 4.6 above. This Conference is an opportunity for such States to make such declarations.

5.6 In exploring how this might be accomplished, the Working Group established by the ATRP on liberalization of air carrier ownership and control recommended that like-minded States may develop an arrangement that amounts to a multilateral guarantee for the airlines to continue to use the market access granted under relevant air services agreements without risk to their designations. Under such an arrangement, States may jointly undertake to interpret the economic designation criterion of their bilateral agreements to encompass airlines with liberalized ownership and control designated either by parties to the arrangement or by any State. All other elements of the relevant bilateral agreements could remain unchanged (such as continued control of market access through negotiated traffic rights, continued provision of safety and security oversight by the designating States). This guarantee might be offered reciprocally or non reciprocally. It may be done through individual statements or a joint statement of common policy, or by a legally binding instrument. These approaches could be applied regionally or globally.

5.7 The Working Group also proposed that ICAO maintain and publish a registry of Contracting States' policies on authorizing foreign designated airlines, including individual and joint policy statements, and that ICAO further refine the options identified by the Group. The Air Transport Committee reviewed proposals and agreed that they should be taken into account by the Secretariat in developing measures to facilitate liberalization of air carrier ownership and control, giving due regard to such important principles as non-discrimination and non-exclusive participation. Consequently, the Secretariat has developed the Recommendation in paragraph 7 below which it believes creates an appropriate balance between facilitating liberalization by States that wish to do so and safeguards for other States.

6. CONCLUSIONS

6.1 From the above discussion, the following conclusions may be drawn:

a) Growing and widespread liberalization, privatization and globalization calls for regulatory modernization in respect of conditions for airline designation and authorization to enable air carriers to adapt to the dynamic environment. There are clear benefits of liberalizing air carrier ownership and control rules. Past experience of liberalization in ownership and control has demonstrated that it can take place without conflicting with the obligations of the parties under the Chicago Convention or undermining the nature of international air transport.

b) In liberalizing the conditions for airline designation and authorization, States should ensure that concerns on safety and security, as well as economic and social impact, be properly addressed and that other potential risks associated with foreign investments (such as flight of capital, uncertainty for assurance of service) are fully taken into account.

c) The proposed article in paragraph 4.6 provides a practical alternative for States to liberalize conditions regarding airline designation and authorization in their air services agreements, which effectively address the needs and concerns of States. Complementing other options developed by ICAO, it would facilitate and contribute to the pursuit by States of the general goal of progressive regulatory liberalization.

d) While it will be up to each State to choose its liberalization approach and direction based on national interest, the use of the proposed arrangement could be a catalyst for broader

liberalization. However, for it to have that effect, it would need to be applied forthwith, and as extensively as possible.

e) Given the flexibility already existing in the bilateral framework, States may, in the short term, take more positive approaches (including coordinated action) to facilitating liberalization by accepting foreign designated airlines that might not meet the traditional ownership and control criterion.

f) ICAO has played, and should continue to play, a leading role in facilitating liberalization in this area, should promote the Organization's guidance, keep developments under review and study further, as necessary, the underlying issues in the broader context of progressive liberalization.

7. RECOMMENDATION

7.1 The Conference is invited to recommend that:

a) States, when dealing with airline designation and authorization in their international air transport relationships, use the alternative criterion set out in paragraph 4.6 as extensively as possible and in accordance with their needs and circumstances.

b) States that wish to liberalize the conditions under which they accept designation of a foreign airline in cases where that airline does not meet the ownership and control provisions of the relevant air services agreements, do so by:

i) issuing individual statements of their policies for accepting designations of foreign airlines;

ii) issuing joint statements of common policy; and/or

iii) developing a binding legal instrument;

while assuring that these policies are developed and applied in accordance with the principles of non-discrimination and non-exclusive participation.

c) States continue to ensure that the State designating the airline provides or ensures the provision of adequate oversight of safety and security for the designated airline, in accordance with standards established by ICAO.

d) States that wish to retain the national ownership and control provision for their own carriers make known their positions and practices regarding the conditions under which they accept foreign designated airlines, and without prejudice to their rights and interest, undertake not to reject the designation solely on the grounds that the foreign designated airline is not majority owned by the designating State and its nationals.

e) States notify ICAO of their policies, including individual or joint statements of common policy, on the conditions under which they accept the designation of an airline pursuant to an air services agreement.

f) ICAO maintain and make public a registry of States' policies, positions or practices on air carrier ownership and control.

g) ICAO assist States or groups of States requesting development and further refinement of the options in paragraph b).

h) ICAO continue to monitor developments in the liberalization of air carrier ownership and control, and address related issues as required.

8. ACTION BY THE CONFERENCE

8.1 The Conference is invited to:

a) recommend the adoption of the proposed model clause on airline designation and authorization in paragraph 4.6;

b) review and adopt the conclusions in paragraph 6; and

c) adopt the recommendation in paragraph 7.

— END —