

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**
2.3: Fair competition and safeguards

SUSTAINABILITY AND PARTICIPATION

(Presented by the Secretariat)

SUMMARY

This paper addresses, in the context of fair competition and safeguards, the issue of sustainability of air carriers and assurance of services, including the provision of State aids/subsidies. In this context, the paper also discusses regulatory measures to ensure the effective and sustained participation of developing countries in international air transport. It proposes some conclusions for action by States, and a regulatory arrangement on participation and preferential measures.

Action by the Conference is in paragraph 7.1.

REFERENCES

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

1. INTRODUCTION

1.1 The term “sustainability” in the air transport context generally refers to the capability of an airline to maintain its corporate existence in the marketplace, and includes the effective continuation of air services to/from its home territory. This is often not only related to and influenced by market conditions such as market size, location and propensity to travel, but also by the policy of the States concerned, *inter alia*, on economic development, labour, tourism, social needs and national security. Consequently, sustainability of air carriers, including assurance of services, has been one of the primary reasons many States have provided their national air carriers over the years with a wide variety of aids and subsidies (which are often used interchangeably and refer to government assistance to the airline industry). Furthermore, such States usually consider also that a viable air transport sector brings employment opportunities, technology transfer and foreign exchange benefits. It has been recognized, however, that State assistance has the potential to affect

trade in air services and to distort competition, although some assistance may be justified from the social and economic standpoint.

1.2 State assistance has also in effect been common at the bilateral level, because the bilateral air transport framework itself has conventionally provided a non-monetary form of implicit assistance to national air carriers in their own markets by limiting the scope of competition. Liberal air services agreements concluded in recent years have substantially reduced or eliminated such implicit assistance by a State in some markets. The liberalization movement based primarily on reciprocity, however, gives rise to the participation concern about how to ensure an effective and sustained involvement by a State in the international air transport system, given the asymmetric competitiveness among airlines and their market opportunities. Article 44 of the Chicago Convention states, as an objective of the Organization, to “insure that the rights of contracting States are fully respected and that every contracting State has a fair opportunity to operate international airlines.” There is thus an expectation of participation in international air transport, although participation does not require equity in results achieved but is rather ensured by the maximization of opportunities to be involved.

1.3 The paper discusses the two inter-related issues described above, i.e. a) sustainability of air carriers including assurance of services through the provision of State aids and subsidies, and b) regulatory arrangements designed to ensure an effective and sustained participation by a State in the competitive marketplace, notably preferential and participation measures in air services agreements.

2. PREVIOUS ICAO WORK

2.1 The 1994 World-wide Air Transport Conference (ATConf/4) recognized that State aids/subsidies *per se* were not necessarily unfair but some of them had the potential of distorting competition. While recommending that States take transparent and effective measures to ensure that their State aids/subsidies to certain air carriers do not adversely impact on other competing air carriers, the Conference noted that the distinction between what was a legitimate investment in an air carrier and what amounted to a State aid/subsidy was not an easy one to make. ATConf/4 recommended separately that ICAO proceed with studies and develop recommendations on preferential measures in the economic regulation of international air transport to ensure the effective participation of developing countries in air transport.

2.2 In 1996, the Council decided that a Secretariat study on preferential measures, undertaken pursuant to the ATConf/4 recommendation, should be disseminated to States for their consideration and use as far as possible. The potential preferential measures, covering market access, ownership and control criteria, slot allocation and “doing business” matters, are set out in ICAO’s *Policy and Guidance Material on the Economic Regulation of International Air Transport* (Doc 9587). The 32nd Session of the Assembly in 1998 urged States to give special consideration in their air transport relationships to the interests and needs of the developing countries and, where circumstances permit, to grant appropriate preferential measures.

3. RECENT DEVELOPMENTS

3.1 Sustainability

3.1.1 In many States, the aviation sector has been characterized by State ownership and control of national airlines, though a trend towards partial or full privatization has been continuing since the mid-1980s. Complete or partial State ownership has frequently involved the provision of capital, loans, or guarantees by the State or by public institutions for national airlines having financial difficulties and seeking

additional resources. In addition, many States have provided assistance to their national airlines through more indirect methods such as: preferential tax status; discounts or exemptions on charges for airport services (including landing fees); discounts on the price of, or preferential arrangements for, the supply of fuel; grant of exclusive rights to duty-free sales outlets or ground-handling contracts at airports; “buy national” policy (exclusive military and government contracts); and other fiscal privileges. Some bankruptcy codes also contain generous provisions (for example, exemption from interest and pension fund payment), which act as an indirect form of State assistance for financially-troubled airlines.

3.1.2 It is estimated that the amount of direct State aid in monetary forms peaked in the mid-1990s when several major European carriers received over \$10 billion in aid, and dropped back by 2000. However, the latter tendency has since been reversed, because a number of States have recently taken action in response to the financial difficulties of their airlines. Rescue packages provided for a number of carriers in most regions (for example, Air Afrique, Air Jamaica, Air New Zealand, Malaysia Airlines, and Swissair) illustrate such change in attitude towards State aid. The situation was exacerbated by the events of 11 September 2001 in the United States. Following those events, over 60 States, foremost amongst them the United States, provided varying forms of emergency assistance to their airlines. While most States stepped forward to guarantee third-party war risk insurance for a limited duration, others provided a more comprehensive aid package for their airlines directly in the form of monetary disbursements to compensate for the losses incurred due to the immediate closure of airports and airspace. Other State aid in an indirect manner included loan guarantees, restructuring of loans at low interest rates and taxation concessions. Such support in a variety of forms has underlined the perception of the air transport industry as a strategic sector, and for many States, their national carriers as strategic investments.

3.1.3 In addition to support for airlines’ corporate bodies, States often provide direct or indirect subsidies to commercially unsustainable routes. This ensures that remote areas continue receiving a basic level of air service, particularly in cases where there are no reasonable alternatives to air transport but the air service is not otherwise commercially viable. While most such assistance has been given to domestic air services (for example, the Remote Air Service Subsidy scheme in Australia and the Essential Air Services program in the United States), international routes linking remote areas are also regarded as justifying direct subsidies as liberalization takes place. For example, in Europe, a Council Regulation of the European Union (No. 2408/92) allows a Member State to impose a public service obligation upon an air carrier in respect of scheduled air services to an airport serving a peripheral or development region in its territory, or on a thin route to any regional airport in its territory. If no air carrier has commenced its service or is about to start its service on a route concerned, then a Member State may limit access to that route to only one air carrier for a maximum of three years and the right to operate such services shall be offered by public tender. In the Caribbean, some regional services by foreign airlines are financially supported by some island-developing States whose economies are heavily dependent on tourism and access to major markets.

3.2 Participation

3.2.1 While the liberalization of air services agreements has diminished the degree of implicit assistance to national airlines (for example, protection from competition by limiting market access and pricing), a number of liberal bilateral and regional arrangements recently concluded contain provisions regarding the application of preferential and participation measures to less-competitive airlines, in order to facilitate the liberalization process and to promote a level playing field. Preferential measures are non-reciprocal regulatory arrangements which States in a regulatory relationship agree are needed by a developing country for its effective and sustained participation in international air transport. On the other hand, participation measures, which are available to all States, are used to build confidence in progressively moving to a less restrictive regime and to ensure that the results of increasing competition, while not equal, do not become too unequal.

3.2.2 Although documented information on the negotiation and grant of preferential measures is limited, such measures have been known to be granted, but in the context of reciprocity and often with the commitment of developing countries to a more liberal regime after the specified transition period rather than on a purely non-reciprocal basis. For example, about one-third of bilateral “open skies” agreements concluded by the United States have a transition annex that places limits on or provides for the phase-in of, *inter alia*, frequencies, Fifth Freedom rights, “Seventh” Freedom rights for all-cargo, third-country codesharing, charter services, and ground handling, some of which are applied only to United States carriers. With respect to regional agreements, in 1998, Cambodia, the Lao People’s Democratic Republic, Myanmar and Viet Nam signed the Agreement on the Establishment of Sub-Regional Air Transport Cooperation (CLMV Agreement), which aims at progressively liberalizing the air transport market among the four countries towards full-market access while specifically seeking preferential treatment for their air carriers by any other State.

4. DISCUSSION

4.1 The ability of an airline to sustain its operations and continue participating in international air transport is not only dependent upon its relative input cost base and productive efficiency, realized under different market circumstances, but also is often supported by various direct, indirect or implicit State assistance described in the previous section. In considering the issues of sustainability and participation of air carriers, therefore, it is necessary to examine the feasibility and desirability of assistance provided by a State to airlines for these purposes.

4.2 The objectives of State assistance are varied, but as regards the international arena, have often been aimed at maintaining the participation of national air carriers in the air transport markets concerned and at ensuring continuity of air services to/from their territories. Developing countries, in particular, are concerned about over-dependence on foreign carriers to provide international air services, especially in bad times when the services may be adversely affected. Some States are also likely to regard the survival of their own air carriers as a definite means of providing an effective assurance of services. Regardless of the objectives and forms, it is widely recognized that State assistance may have the potential of market distortion, leading to anti-competitive behaviours such as capacity dumping and predatory pricing. To minimize such adverse effects on competition in the marketplace, particularly in the case of direct financial aids/subsidies, several States (and groups of States) have developed rules on State aids/subsidies, which provide criteria to meet very specific objectives only where better alternatives are unavailable.

4.3 The major practical complication is the difficulty in quantifying the full scale of State assistance owing to the existence of various indirect or implicit assistance measures. Only direct aids/subsidies in monetary forms can be quantified to some extent, although different accounting methods and reporting practices make it difficult to produce a comparative assessment of them. Furthermore, actions by States over perceived levels of assistance that may be considered to distort competition have the potential to lead to retaliatory actions by other States in view of differing attitudes towards such assistance.

4.4 In a situation of transition to liberalization or in an already-liberalized market, there may be exceptional circumstances where State assistance can produce economic and/or social benefits even though such assistance may affect market competition. So far as the *ad hoc* aids/subsidies are concerned, financial restructuring may serve to facilitate the transforming process of less efficient airlines as was the experience in the European Union. The decisions on restructuring finances are usually made against a background of social and political pressures to save national airlines and to ensure that the transition to more efficient operations is achieved at the lowest cost to those most affected, in particular to labour and creditors. It should be noted, however, that without well-defined conditions (including goals, adequate time frame and long-term plans) and stringent regulatory mechanisms for enforcement, information disclosure and monitoring,

restructuring finances would simply protect less productive airlines without fostering internal efficiency. Restructuring finance of airlines, therefore, needs to be accompanied by clear criteria and methodology if it is to achieve its intended purpose.

4.5 Some forms of subsidies in support of minimum levels of air services to remote areas may also be justified from the social interest perspective, provided that they are allocated transparently and effectively. In such circumstances, they can ensure the provision of a service satisfying fixed standards of continuity, regularity, capacity and pricing, which standards the air carrier may not assume if it were solely considering its commercial interest. A traditional method to meet such social needs has been to rely on implicit ways such as cross-subsidization across the network through the strict regulation of market entry and tariffs, but the regulatory cross-subsidization system is neither transparent nor likely to stimulate efficiency. A more effective and transparent alternative may be to provide direct financial subsidies for non-remunerative local services with institutional arrangements such as competitive tendering/bidding systems that clearly define selection criteria applicable to the ways in which subsidies are awarded. Since the tendering/bidding systems grant subsidies and operating rights to the most efficient carriers, they may serve to keep the costs of subsidies low, as demonstrated by the domestic experiences in several States. At issue is to what extent this mechanism used in domestic contexts could be applied to international services.

4.6 With respect to participation aspects of State assistance through air services agreements, preferential and participation measures may be seen as justifying non-monetary forms of assistance provided by a State to designated carriers other than its own, especially during the transitional period towards a more liberalized regime. Their application may help to instil the required level of confidence among various States to pursue diligently the processes of liberalization. In a situation of transition to liberalization, ensuring the participation of developing countries in international air transport may form an integral part of the “how to liberalize” process. In marked contrast with the traditional bilateral restrictions based on reciprocity, these measures are designed to provide less competitive carriers with an unreciprocated right or preparation time to enable them to develop a service that cannot be contested fully by competitors in a certain period; so that States with less competitive carriers can commit to stepping forward to progressive liberalization. For example, preferential measures can provide a "head start" for less-competitive airlines wishing to have greater opportunities (for example, by granting more traffic points), and allow a developing country to introduce liberalization progressively (for example, to open up its market at a later stage). While these measures could prove useful in many cases, it would be difficult to formulate an article of general applicability on these measures for inclusion in the air services agreements themselves and in the ICAO Template Air Services Agreement (TASA). Instead, an annex containing appropriate specific measures may be used along the lines of a “Transition Annex”.

5. CONCLUSIONS

5.1 From the foregoing discussion the following conclusions may be drawn:

- a) in a situation of transition to liberalization or even in an already-liberalized market, States may wish to continue providing some form of assistance to their airlines in order to ensure sustainability of the air transport industry and to address their legitimate concerns relating to assurance of services. However, States should bear in mind that provision of aids/subsidies which confer benefits on national air carriers but are not available to competitors in the same market may distort trade in international air services and may constitute unfair competitive practices;

- b) because of the lack of an acceptable quantification method and the existence of various non-monetary measures, it is very difficult to estimate accurately the full scale of State assistance and the impact of specific State assistance on competition. Given this difficulty, States should recognize that any actions against foreign airlines which receive aids/subsidies might lead to retaliatory action by the affected State and hamper the ongoing liberalization of international air transport;
- c) there may be some instances where State assistance can produce economic and/or social benefits in terms of restructuring of air carriers and assurance of services. Even in such special cases, however, States should take transparent and effective measures accompanied by clear criteria and methodology to ensure that aids/subsidies do not adversely impact on competition in the marketplace;
- d) States should consider the possibility of identifying and permitting assistance for essential service on specified intra-regional routes of a public service nature in their air transport relationships; and
- e) to ensure the effective and sustained participation of developing countries and to facilitate the liberalization process, States should take into consideration in their air transport relationships the interests and needs of States with less-competitive air carriers and, wherever appropriate, grant preferential and participation measures. Such measures may be incorporated in the “Transition Annex” in their air services agreements.

6. RECOMMENDED REGULATORY ARRANGEMENT

6.1 In moving towards liberalization, the issues of participation as well as sustainability might be addressed, *inter alia*, through existing and future air services agreements by means of a “Transition Annex”. The proposed Annex described below, which is drawn from existing practices and approaches, would be aimed at covering both participation and preferential measures. It would consist of one or more of three types of clauses. If these clauses apply to each Party in the same manner, then they would be considered to be participation measures. If not, then they would be regarded as preferential measures.

6.2 The first clause would be used when a particular Article (or Annex) would not take effect immediately but be implemented in a limited way during the transition period. By way of example, the Parties would agree that, notwithstanding the Annex on Route schedules granting each Party unlimited Fifth Freedom rights, the airline(s) of one Party (the developed State) would not be permitted to exercise those local traffic rights fully between the other Party (the developing State) and a third State until a specified date. The second clause would be similar to the first clause but with phase-in periods. For example, the Parties would agree that, notwithstanding an Article allowing unlimited codesharing, the airlines of each Party would be permitted to expand their third-country codeshare services (frequencies) only in a gradual manner for specified periods. The third clause in the proposed Annex would be used when an Article (or Annex) would not take effect immediately and a different scheme would be applied during the transitional period. For example, the Parties would agree that, notwithstanding a tariff Article with a double-disapproval regime, a country-of-origin regime would govern pricing until a specific date. The following is an indicative list of subjects that could be covered by such an Annex: the number of designated airlines, ownership and control criteria, capacity and frequency, route and traffic rights, codesharing, charter operations, intermodal services, tariffs, slot allocation, and “doing business” matters such as ground handling. Furthermore, any one of the subjects listed could be dealt with by any of the approaches set out in the three clauses.

6.3 The following regulatory arrangement, in the form of a framework for a Transition Annex, is proposed for consideration by the Conference for Contracting States to use at their discretion in bilateral, regional or plurilateral air services agreements. The language in the Annex proposed by the Secretariat is a framework, into which the Parties would need to agree on the terms and wording. Doc 9587 contains material on possible participation and preferential measures. This Annex has been inserted in the TASA (see ATConf/5-WP/17).

TRANSITION ANNEX

The following transitional measures shall expire on (date), or such earlier date as is agreed upon by the Parties:

1. *Notwithstanding the provisions of Article ____ (or Annex ____), the designated airline (or airlines) of Party A (or each Party) may (shall)*
2. *Notwithstanding the provisions of Article ____ (or Annex ____), the designated airline (or airlines) of Party A (or each Party) may (shall) ... as follows:*
 - a) *From (date) through (date), ...; and*
 - b) *From (date) through (date),*
3. *Notwithstanding the provisions of Article ____ (or Annex ____), the following provisions shall govern*

7. ACTION BY THE CONFERENCE

7.1 The Conference is invited to:

- a) review and adopt the conclusions in paragraph 5.1; and
- b) recommend the adoption of the “Transition Annex” in paragraph 6.3.

— END —