

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**
2.2: Market access

LIBERALIZATION DEVELOPMENTS RELATED TO MARKET ACCESS

(Presented by the Secretariat)

SUMMARY

This paper provides information on regulatory and industry developments related primarily to market access over the past decade, and draws attention to some of the regulatory issues raised by these developments.

Action by the Conference is in paragraph 5.1.

REFERENCES

Doc 9587, *Policy and Guidance Material on the Economic Regulation of International Air Transport*
Circular 269, *Implications of Airline Codesharing*
Circular 291, *The World of Civil Aviation 2001-2004*

1. INTRODUCTION

1.1 Since the last Worldwide Air Transport Conference (AT Conf/4) in 1994, there have been significant developments in the air transport regulatory scene and in the airline industry. Much progress has been made in the liberalization of international air transport regulation with an increasing number of States being parties to arrangements towards full market access. At the same time, the airline industry has witnessed major structural transformation, *inter alia*, through alliances, mergers and acquisitions in order to cope with an increasingly competitive environment. This paper provides a brief overview of regulatory and industry trends and developments (except the commercialization aspect which is covered by WP/21) that have taken place since 1994, primarily in the context of market access, as well as an update of information contained in WP/8. It also draws attention to some of the regulatory issues raised by these developments. More detailed

information covering the year 2001 can be found in the Chapter 2 of *The World of Civil Aviation* (Circular 291).

2. REGULATORY DEVELOPMENTS

2.1 **International Air Services Transit Agreement.** Although most international air services operate under bilateral or regional regimes, the International Air Services Transit Agreement (IASTA), which provides for the multilateral exchange of rights of overflight and non-traffic stop for scheduled air services among its Contracting States, has made an important contribution to the development of international air transport. The Agreement is a cornerstone of multilateralism in air transport. The number of Contracting States which are parties to the IASTA increased from 99 in 1994 to 119 as of February 2003, but more than one-third of ICAO Contracting States, including several with large land masses, remain outside the Agreement. Assembly Resolution A33-19 Appendix A “Urges Contracting States which have not yet become parties to the International Air Services Transit Agreement (IASTA) to give urgent consideration to so doing”. Therefore, the Conference may wish to reaffirm the importance of the IASTA for liberalization and for multilateralizing the air transport system and for States to give effort to the Assembly Resolution.

2.2 **Bilateral liberalization.** Bilateral air services agreements are still the prevailing approach used by States in expanding international air transport services. During the period from 1995 to 2002, over 650 bilateral air service agreements (including amendments or memoranda of understanding) were reportedly concluded. Over 70 per cent of these agreements and amendments contained some form of liberalized arrangements such as unrestricted traffic rights (covering Third, Fourth and in some cases Fifth Freedom rights), multiple designation with or without route limitations, free determination of capacity, a double disapproval or country-of-origin tariff regime, and broadened criteria of air carrier ownership and control. As the airline business evolves, some of the more recent bilateral air service agreements have included provisions dealing with new types of commercial activities, some of which have market access implications, such as computer reservation systems (CRSs), airline codesharing, leasing of aircraft and intermodal transport.

2.3 One notable development is the considerable increase in the number of “open skies” agreements, which provide for full market access without restrictions on designations, route rights, capacity, frequencies, codesharing and tariffs. The first such agreement was concluded in 1992 between Netherlands and the United States. Since then, about 87 “open skies” agreements were concluded, involving approximately 70 countries, with the United States being one of the partners in 59 cases. These agreements involve not only developed countries but also an increasing number of developing countries (about 60 per cent). In addition to the basic market access elements, about 50 agreements also grant “Seventh Freedom” rights for all-cargo services (four agreements also granting this right for passenger services). Twenty-one of the “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.

2.4 **Regional and plurilateral liberalization.** Some agreements negotiated in recent years have sought to liberalize air transport services on a regional or sub-regional basis or amongst a group of like-minded States. The regional and/or plurilateral liberalization arrangements have the basic objective of providing greater market access and improving services amongst the Member States concerned. Small groups of States of comparable size and development would find it easier to agree on market access than larger, diverse groups of States. The small groups would also provide a more manageable environment to test liberalized air transport policies.

2.5 Before AT Conf/4, there were just two such regional arrangements, namely the European Union (EU) — single market completed by 1997 with 15 Member States and three States belonging to the European Economic Area (EEA), joined by Switzerland in 2002, and to be further expanded to include another ten Central and Eastern European States in 2004— and the Andean Pact involving five States in South America. Since 1995, eight more arrangements have emerged with a worldwide dispersion. They include:

- a) the Caribbean Community (CARICOM) Air Service Agreement amongst 14 States in the Caribbean (1996);
- b) the Fortaleza Agreement amongst six States in South America (1997);
- c) the CLMV Agreement by Cambodia, Lao People’s Democratic Republic, Myanmar and Viet Nam (1998);
- d) an agreement amongst 16 States of the Arab Civil Aviation Commission (ACAC) in the Middle East and Northern Africa (1998);
- e) the Banjul Accord amongst six States in Western Africa (1997);
- f) an agreement amongst the six States of the Economic and Monetary Community of Central Africa (CEMAC) (1999);
- g) an agreement amongst the 20 States of the Common Market for Eastern and Southern Africa (COMESA) (1999); and
- h) the Yamoussoukro II Ministerial decision amongst 52 African States (1999).

Of these ten agreements, seven provide for instant or phased-in liberalization leading to full market access. In addition, there are two area-specific agreements covering IMT-Growth Triangle region by Indonesia, Malaysia and Thailand (1999), and BIMP-East ASEAN Growth Area region by Brunei, Indonesia, Malaysia and Philippines (1999). Furthermore, the Multilateral Agreement on the Liberalization of International Air Transportation known as “Kona” open-skies agreement was signed in 2001 by five like-minded members of the Asia-Pacific Economic Cooperation (APEC) (i.e. Brunei, Chile, New Zealand, Singapore and the United States). It is open for adherence by other members of APEC as well as non-member States. Peru and Samoa joined the agreement in 2002 and some other States are reported to be interested.

2.6 Several potential arrangements are also in the pipeline, for example, a draft agreement between the EU and 13 Central and Eastern European States for the creation of a European Common Aviation Area (ECAA); a proposal by the Association of European Airlines (AEA) for a Transatlantic Common Aviation Area (TCAA) for liberalization between the EEA and the United States, which has been promoted by the European Commission¹; Pacific Islands Air Services Agreement (PIASA) amongst 14 States of the

¹ Within the EU, there was a development affecting a common EU policy with third countries. In November 2002, the European Court of Justice ruled on a case brought in 1998 by the European Commission against eight Member States which have concluded or amended bilateral air services agreements (seven of them “open skies” agreements) with the United States. The judgement affirmed the ability of the Member States to enter into bilateral agreements with third countries to the extent that these do not affect Community rules on air transport, but found that some of the provisions in these bilateral agreements infringed the Community’s exclusive external competence as regards air fares and CRSs. The Court also found that the clause regarding ownership and control of airlines infringed Community law on freedom of establishment. Following the Court’ judgement, the Commission requested the Council to urgently issue a mandate for the Commission to open negotiations for a Community-wide air services agreement with the United States as well as the similar agreements with Japan and the Russian Federation.

Pacific Islands Forum; and a common regional commercial air policy for the Association of Caribbean States (ACS).

3. INDUSTRY DEVELOPMENTS

3.1 **Airline alliances and codesharing.** A relatively recent and rapidly evolving global phenomenon is the formation by airlines of alliances, i.e. voluntary unions of airlines held together by various commercial cooperative arrangements. There are now over 600 such alliance agreements in the world, which contain a variety of elements such as codesharing, blocked space, cooperation in marketing, pricing, inventory control and frequent flyer programmes, coordination in scheduling, sharing of offices and airport facilities, joint ventures and franchising. Intermodal alliances with railways have also grown in Europe and North America. The steady expansion of transnational alliances for strategic purposes and to achieve market access and synergies are a consequence of air carriers' response to, *inter alia*, perceived regulatory constraints (for example, bilateral restrictions on market access, ownership and control), a need to reduce their costs through economies of scope and scale; and a more globalized and increasingly competitive environment.

3.2 While numerous agreements concern co-operation on a limited scale (for example, codesharing on certain routes), the number of wide ranging strategic alliances has been on the rise. Most notable was the emergence of several competing "global alliance" groupings. Each group is composed of some major airline members having different geographical coverage with fairly extensive networks. Through the alliances, these carriers have combined their route networks which extend to most parts of the world, and carried together over 50 per cent of the worldwide scheduled passenger traffic. Four existing global alliance groupings are:

- a) "Star Alliance" founded in 1997 by Air Canada, Lufthansa, SAS, Thai Airways International and United Airlines (currently 15 members and to be joined by additional two carriers);
- b) "oneworld" founded in 1998 by American Airlines, British Airways, Canadian Airlines, Cathay Pacific and Qantas (currently eight members);
- c) "SkyTeam" founded in 2000 by AeroMexico, Air France, Delta Air Lines and Korean Air (currently six members); and
- d) the alliance group dubbed "Wings" led by KLM and Northwest Airlines (with strong ties with Continental Airlines).

The partnership of each global alliance group, however, remains unstable. For instance, the inability of British Airways and American Airlines to obtain regulatory clearances prevented them from forming a transatlantic alliance between the two core oneworld members. A proposed codesharing agreement amongst Continental Airlines, Delta Air Lines and Northwest Airlines is expected to ultimately bridge SkyTeam and Wings groups. A proposed trans-Tasman alliance involves Qantas (oneworld member)'s equity investment in Air New Zealand (Star Alliance). The Swissair-led European alliance group "Qualiflyer" was dismantled in 2001 following the demise of Swissair and Sabena.

3.3 The shifting development and marketing power of global alliances, together with their competitive consequences, including their dominance at some hubs, have caused concerns to small and medium-sized airlines regarding their survival and have prompted efforts by these airlines to either develop a particular segment of a market or to compete as low-cost point-to-point airlines. Some small airlines also moved to form regional alliances with neighbouring carriers (for example, Carib Sky Alliance and China Sky Aviation Enterprises), and to enter into franchise agreements with major airlines (for example, British Airways' franchise agreements include three African carriers, i.e. Comair of South Africa, Regional Air of

Kenya and Zambian Air Services). Overall, airline alliances are widespread but still evolving, with partnership relations becoming more intertwined and complex.

3.4 Airline alliances and codesharing have regulatory implications because of their potential effect on market access, competition and consumer interest. In 1997, ICAO released a major study of the *Implications of Airline Codesharing* (Circular 269) and has since produced recommendatory guidance on the consumer protection aspects of codesharing (see Doc 9587). In practice, there has been no systematic regulatory treatment of these arrangements but rather on an *ad hoc* basis, often dictated by general aero-political considerations of the States concerned. Nevertheless, it has now become a general practice that international codesharing is treated within the context of bilateral air services agreements and that underlying traffic rights are required for codesharing services. Some major alliances have also been examined closely by relevant national and regional regulatory bodies (notably, the United States Department of Transportation, the European Commission and the Australian Competition and Consumer Commission); and, in some cases, certain regulatory measures were introduced to ameliorate the anti-competitive aspects of the arrangements.

3.5 **Mergers and acquisitions.** Airlines in many parts of the world continued the pursuit of the perceived advantages of enhanced market strength through mergers, acquisitions or operational integration under a single holding company. The common thread of this trend is the continuing development of growth strategies designed to hold and expand the existing market shares, gain access to new markets, achieve unit cost reduction, shield themselves against fierce competition, and increase the scale of operations in order to attain a critical market position. Most mergers or acquisitions have been achieved within the same country, as were the cases of Air Canada's acquisition of Canadian Airlines in 2000; American Airlines's bankruptcy buyout of Trans World Airlines in 2001; Alianza Summa jointly established by Avianca, Aces and SAM Columbia in 2002; Japan Airlines System jointly established by Japan Airlines and Japan Air System in 2002; and ongoing government-led consolidation exercise in the Chinese airline industry. Against the industry consolidation, however, quite a few States expressed their concerns, and scrutinized proposed mergers with great caution. For example, United Airlines - US Airways merger plan was blocked by the United States Department of Justice in 2001.

3.6 The opportunity for cross-border mergers and acquisitions has increased as many States adopted a new policy or amended existing rules on foreign investment or control in national carriers (for example, Australia, Brazil, China, India, and Malaysia), and relaxed the air carrier ownership and control conditions in the air services agreements. Most attempts to initiate cross-border mergers or acquisitions, however, were abandoned owing to the aero-political, economical and regulatory complexity (for example, Alitalia - KLM and British Airways - KLM merger plans in 2000). Even in the successful cases, the control and management of foreign carriers was not financially risk-free (for example, Iberia and its parent company SEPI's majority control of Aerolineas Argentinas, and Air New Zealand's acquisition of Ansett, both of which fell through in 2001). Because of the difficulties in implementing cross-border mergers and acquisitions with success, most foreign investments in the airline industry have been made in a limited scale, instead of taking a majority stake or pursuing a full-scale merger, and often as part of a strategy to forge or strengthen alliances and expand market access. Nevertheless, foreign investments have sometimes been short-lived (for example, Swissair's minority shareholdings in AOM-Air Liberté, LTU, Sabena and South African Airways). As of December 2002, about 60 carriers had shareholdings in foreign airlines while over 200 airlines had equity owned by foreign investors in various degrees.

4. CONCLUSIONS

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

- a) The International Air Services Transit Agreement (IASTA) is important for liberalization and the operation of international air services. States should therefore

pursue, and ICAO continue to promote, universal adherence to and implementation of the IASTA; and

- b) ICAO should continue to monitor closely regulatory and industry developments with a view to providing States with latest information on potential future aviation issues.

5. **ACTION BY THE CONFERENCE**

5.1 The Conference is invited to:

- a) note the recent regulatory and industry developments in paragraphs 2 and 3; and
- b) review and adopt the conclusions in paragraph 4.1.

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