

## 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 International Transport Workers' Federation)

##### SUMMARY

Liberalizing the airline ownership and control criterion is certainly not an easy objective to achieve, as the ATConf/5-WP/7 by the Secretariat makes clear. The ITF argues that the benefits of such liberalization are questionable, and that the economic problems that could arise are insufficiently addressed in the proposal. Liberalization further risks weakening the connection between aircraft operations and their safety and economic supervision by formalizing a variety of differing designation and authorization standards. The ITF draws on real examples to conclude that the proposed Article on designation and authorization is flawed. Practical concerns about the effectiveness of the proposal are matched by reservations about the measures' impact on sovereignty and the ability to defend the national interest. The ITF welcomes some elements within the proposed framework but recommends alternative means of progressing these.

Action by the Conference is in paragraph 2.

#### 1. INTRODUCTION

1.1 At the heart of the ITF's concerns regarding the proposals contained in ATConf/5-WP/7 are three issues: a) avoidance of "flags of convenience" through maintenance of the link between the nationality of ownership of the carrier and nationality of the safety and security supervisory authority; b) the impact of liberalization on the ability of governments to pursue their national interests on the basis of sovereignty and

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<sup>1</sup> French and Spanish versions will be provided by the International Transport Workers' Federation (ITF).

reciprocity and c) the practical economic consequences of this measure at a time of continuing global instability in the aviation industry. This Working Paper looks at each of these issues in turn.

## 2. **MAINTAINING THE LINK BETWEEN SAFETY AND SECURITY REGULATORY SUPERVISION AND NATIONALITY OF OWNERSHIP**

2.1 ATConf/5-WP/7 acknowledges that broadening the ownership and control criterion raises legitimate concerns about the possible development of aviation “flags of convenience”. The ITF, as a multi-modal transport organization has intimate experience of the consequence of flagging-out in the maritime sector. Ships and fleets can be “flagged” out to countries (including land-locked nations with no historical maritime tradition) that offer lower-cost safety and labour standards and inadequate safety supervisory and inspection structures. Flagging out is generally driven by the wish to save costs or to escape effective regulatory control by the State in which the vessel or fleet is beneficially owned. The result is higher accident rates, proportionately more safety and security breaches, and lack of effective implementation of existing international safety, welfare and operational requirements amongst flagged out vessels. Flagging out also brings difficulties in identifying the competent legal authority in situations as diverse as personal injury claims or pollution or environmental damage, as evidenced, for example, following the recent Prestige sinking in Northwest Spain. This vessel was Greek beneficially owned, registered through a Liberian shell company and flying the flag of the Bahamas.

2.2 At the root of the problem of maritime flags of convenience is the weakness of the definition of “genuine link” contained in the United Nations Convention on the Law of the Sea (UNCLOS). The ITF fears that the new wording of “principal place of business” to be applied in the aviation sector will be a step in the direction of the loose regulation that so bedevils the maritime industry. For this reason, the ITF formally recorded its dissent to the change within the ICAO/European Civil Aviation Conference (ECAC) working group that elaborated the new wording.

2.3 The concept of “principal place of business” given in ATConf/5-WP/7 (even with the guidance contained in notes 1 and 2 of paragraph 4.6) is ambiguous. For example, a carrier with a significant “foreign” crew base and ground station in another State, would (subject to local incorporation) meet the criteria within ATConf/5-WP/7 to be able to effectively transfer regulatory control of such a subsidiary to a State which is neither the country in which the carrier is beneficially owned, nor has its headquarters. The proposed definition of “principal place of business” must be tied to the place of beneficial ownership unless we are to see a situation in which stand-alone subsidiaries of global airlines are able to “cherry-pick” whether to be subject to local or home-based regulation and supervision.

2.4 Advocates of liberalization will quickly point out, however, that there is a dual requirement in the criterion: evidence of principal place of business has to be matched by evidence of effective regulatory control by the designating State. This, it is argued, ensures that safety and security oversight responsibility is maintained by the designating State. However, regulatory requirements and standards of effective control differ between jurisdictions, with potentially different impacts on cost for carriers. As ICAO’s own safety oversight assessment programme is revealing, even the application of agreed standards does vary quite widely. Notwithstanding the process of safety regulatory harmonization involving the Joint Aviation Authorities of Europe, the Federal Aviation Administration of the USA and the authorities of other States, there are still wide variations in cost-sensitive regulations between States. For example, prominent differences in flight and duty times, minimum crew complements, and certification and personnel licensing requirements between States risk encouraging carriers to seek the most cost or operationally beneficial regulatory regime, opening the door to “social dumping” and “safety dumping”.

2.5 For the time being, such selectivity of safety and security jurisdictional authority has been largely prevented by the existing ownership and control criterion, though we can cite the example of one airline in Latin America re-registering their entire fleet in a neighbouring country to escape the consequences of the US Federal Aviation Administration's safety oversight categorization of their home State. In another working paper (ATConf/5-WP/73) we describe a number of attempts by carriers to escape employment or fiscal regulation by being selective over nationality. These real examples point to the growing complexity and difficulty in maintaining effective regulatory control, which would be further exacerbated if there is no natural link between the jurisdiction of regulation and the location of the carriers' assets.

2.6 The undoubted willingness of operators to be selective about regulatory jurisdiction when given the option raises concerns regarding the recognized limitation on the capacity and resources available to national aviation safety regulatory authorities to effectively oversee global carriers operating in large numbers of countries. Even within the European Union, where a common regulatory framework allows carriers with an Air Operator Certificate issued by one Member State to operate freely within any other, problems are emerging. Where, for instance, does effective oversight lie with a carrier registered in Iceland on the basis of a "virtual" headquarters, operating flights from the United Kingdom to third countries and using personnel employed by a manning agency in the Channel Islands? Such arrangements are a growing phenomenon.

2.7 Of course, specific safety and security clauses within bilateral and multilateral air service agreements are to be welcomed, and these are provided for in the proposed Article contained in Para 4.6. Nevertheless, a patchwork of requirements in the multitude of such agreements cannot be an effective substitute for the global harmonization airworthiness and operational requirements and the development of minimum global personnel standards. Only with a global framework of requirements (rather than broad standards), backed by consistent enforcement, will it be possible to protect against the natural tendency of transnational enterprises to pick and chose the most business-efficient regulatory jurisdictions. Until such a time as a detailed global framework is in place, broadening the ownership and control criterion risk opening the airline sector to social dumping, safety dumping, security dumping and reduced oversight.

### **3. PRESERVING RECIPROCITY AND SOVEREIGNTY OVER THE AVIATION INFRASTRUCTURE**

3.1 Underpinning the nationality provisions in air service agreements has been the recognition of the strategic importance of the economic, development, and social functions of aviation. Nationality requirements (and the powers of designation and authorization) have been a tool by which States have been able to ensure that air service provision meets the interests of all their stakeholders, including shareholders, passengers, employees, and dependent industries and communities.

3.2 This is not just a case of ensuring a "balance of [economic] benefit", as ATConf/5-WP/7 puts it, but of guaranteeing the right of participation of each State in international air services. This is fundamentally an issue of national economic sovereignty and autonomy and in some States is also tied to questions of defence security and national emergency resources.

3.3 Air carriers, of course, operate in a commercial environment, provide commercial services and are subject to market disciplines. However, air transport services differ from many other commercial activities in terms of the impact of interruption, disruption or loss of service on the wider economic, social or developmental health of nations. It is for this reason that they are regulated differently to non-essential commercial activities.

3.4 The reaction of governments following the recent critical downturn in the economic fortunes of carriers has highlighted the importance that many States place on the existence of a stable aviation infrastructure. State intervention and support has taken a variety of forms depending upon circumstances and reflects an understanding that air transport is more than just another commercial activity, and that there is a public interest dimension.

3.5 The obvious danger of permitting foreign ownership of designated carriers is that this would weaken the influence of the designating State over this public interest dimension of its air transport services. Following ownership liberalization States might, in the short-term, continue to influence the priorities of carriers through their control of traffic rights, but in an increasingly “open skies” environment such leverage is likely to decline, especially if there is, as we anticipate, a parallel process of concentration into global multinationals. The likeliest losers in such a situation are developing nations or those with a modest existing air carrier infrastructure and dependant passengers who become subject to greater monopoly concentration and less choice in the provision of their required air services.

3.6 The proposals in ATConf/5-WP/7 emphasize that States would retain an existing critical protection through their discretionary right of refusal to accept designations proposed by other parties, and also highlights that States may continue to apply traditional national ownership and control rules when designating their own carriers, even if they permit a broader definition for the carriers designated by the other Parties to their air service agreements.

3.7 This is an important and welcome restatement of sovereign rights, whose practical effect would, however, be seriously diluted by the sort of “pledges” or declarations advocated in paragraph 5 of ATConf/5-WP/7. The ITF can anticipate circumstances where some flexibility may be desirable, for example, in relation to carriers operating within economically integrated regions, but we would urge States to think carefully before making sweeping commitments or statements of policy conducive to foreign designations.

#### 4. THE ECONOMIC CONSEQUENCES OF BROADENING THE OWNERSHIP AND CONTROL CRITERION

4.1 ATConf/5-WP/7 concludes, in Para. 6.1 a, that “There are clear benefits of liberalizing air carrier ownership and control.” Paragraph 3.5 of the working paper describes these as wider access to capital markets, reduced reliance on government support, more extensive networks through mergers and acquisitions, improved economic efficiency, and more competitive carriers.

4.2 Investment is certainly an issue for many carriers, and a very real concern for many aviation employees, but ATConf/5-WP/7 does not substantiate a case that liberalizing ownership would make a significant contribution to resolving problems of access to capital. A majority of the world’s carriers are already listed in national stock markets, and the principal problems of the market capitalization of the sector come from poor share and dividend performance. The reason airlines have difficulties raising money is because of their business models, their long-term marginal profitability, and a continuing and damaging inability to manage the business cycle. There is no lack of available capital in the dominant aviation markets of the world; rather there is a lack of investor confidence, which inhibits access to such capital. Promoting stable and ordered growth in the industry in a low-risk (or predictable risk) environment - rather than the new uncertainties resulting from the deregulation proposed in ATConf/5-WP/7 - would be a better means of promoting access to future investment.

4.3 A reduction in reliance on government support is also cited in ATConf/5-WP/7 as a benefit accruing from liberalization of the ownership and control criterion. While we believe that there are, in many cases, specific advantages for governments to retain ownership over their designated carriers, there is nothing in the existing economic regulatory regime to inhibit divestment or privatization where this has been decided. Governments have been able to significantly reduce or eliminate their stakes in national carriers without difficulty under the existing ownership conditions. For example, within the past fifteen years almost all the carriers of Latin America have been privatized without recourse to foreign ownership. Some countries have also increased the legal threshold for foreign capital investment in their carriers. All of these measures are available without any change to the existing ownership and control rules. Industrial and corporate reorganization through outsourcing and subcontracting has also acted to reduce the size of the State's commitments in some cases.

4.4 There is no doubt that the national ownership and control criterion for acts as a barrier to the global consolidation of the airline industry. But is that a bad thing? ATConf/5-WP/7 argues that mergers and acquisitions or alliances could permit airlines to build more extensive networks. The reality is more complex. Where mergers have taken place at a national or regional level, the result has often been a reduction in routes served or frequencies offered. Typically, mergers have been deployed as an economic tool for stripping out capacity in the sector. Far from offering passengers greater choice, recent airline mergers have more often than not resulted in a concentration of monopoly power. The airline alliances have also shown a readiness to transfer business between themselves or to withdraw from routes and markets in ways that do not necessarily result in greater consumer choice. Some States are anxious to pursue policies of international airline consolidation in the belief that this is likely to leave their nations or regions' carriers in a better position to compete globally. Yet there is scant evidence of improved economic efficiency or greater competitiveness amongst recently merged airlines. It seems unwise to open the doors to such international takeovers without specifying means by which the adverse consequences of concentration can be addressed. At a very time when a broad range of economic opinion is beginning to question the benefit of global mergers in view of their poor or negative effects on share values it would be wise to have some effective regulatory tools in place to manage such consequences. We do not believe the text in Para 4.7 provides these.

4.5 Another advantage of national ownership is that it acts as a constraint against both speculative capital and as a barrier to capital flight. Until now, capital flight has been seen as a problem in relation to inward-investment in privatized carriers, and has primarily affected Latin America and Africa. A change in the nationality criteria, however, risks exporting the problem to the economically strongest aviation States. A national carrier with global reach would, without the national ownership and control criterion, be free to replace home-based services with autonomous foreign subsidiaries. A carrier in one region might, for instance, purchase a carrier in a different region and in doing so abandon its own services in that market.

4.6 Underpinning the critically poor health of many international carriers has been their managements' relentless pursuit, above all, for market share. Breaking the link between nationality and designation risks reinforcing this bad habit by promoting growth through acquisitions and takeovers and by permitting a global free movement of aviation capital which could see relocation of activity to the most commercially conducive (e.g. lowest cost) locations. What ATConf/5-WP7 fails to address is how such a process can be managed in a way that ensures the right to participation of all nations, protects the public interest functions of aviation, and prevents social dumping, security dumping and safety dumping.

4.7 ACTION BY THE ATCONF

4.8 The Conference is invited to:

- a) note the contents of this paper;
- b) conclude that the national ownership and control criterion should be retained in the interest of stability, reliability and economic security of air transport provision;
- c) conclude that States should retain effective regulatory tools to ensure that the public interest dimension of air transport services can be met;
- d) invite ICAO to undertake further work to identify measures by which safety dumping and security dumping might be prevented; and
- e) invite ICAO to continue to monitor developments in air carrier ownership and control liberalization and address related issues as required.

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