IATA

SECURING THE FUTURE OF INTERNATIONAL AIR TRANSPORT

Introduction

1. The airline industry faces its worst crisis ever. Worldwide losses in 2001-2 amounted to about USD 30 billion. This is more than total industry profits since 1945 and equal to 32% of shareholder equity in 2000.

2. Numerous airlines, particularly in certain regions, face bankruptcy. Some have already gone out of business. This situation raises fundamental questions about the financial sustainability of full-service airlines and of the traditional business model.

3. The time has come to address these questions.

4. This paper examines some of the causes of the current crisis, the steps taken by full-service carriers to improve their efficiency and suggests steps governments can take to help airlines adjust to changing markets.

5. The answer lies not in subsidies or in re-regulation, but in completing the liberalization process for all components of the air transport business.

Seeds of the Crisis

5. The problems of full-service carriers have been building for several years. They were brought to a head by the events of September 11, which had serious consequences for an industry that has always operated on the slimmest of margins.

6. Two developments in particular in recent years have had a gradual but fundamental impact on modern economies and on the airline industry. These were the liberalization of world markets and rise in Internet use.

7. The liberalization of world markets has brought increased competition and excess capacity for many goods and services, resulting in falling prices for many goods and, to a lesser extent, services. Consumers have come to expect a steady fall in prices and their behavior has changed accordingly. Consequently a growing number of businesses have less pricing power and find it harder to pass on higher costs.

8. The rapid expansion in Internet use has also influenced pricing practices. For air travel, it has created a new and dynamic relationship between airlines, consumers and intermediaries, not least by shifting market power to consumers who are able to conduct repetitive searches for the lowest fare.

9. Today, more than ever before, full-service airlines can only survive by making continuous and drastic cost reductions and by tailoring their product offerings in response to customer needs. As shown below, they have been effective in cutting those costs under their direct influence. But this has proved insufficient as many costs remain outside their control and their ability to restructure is restricted.

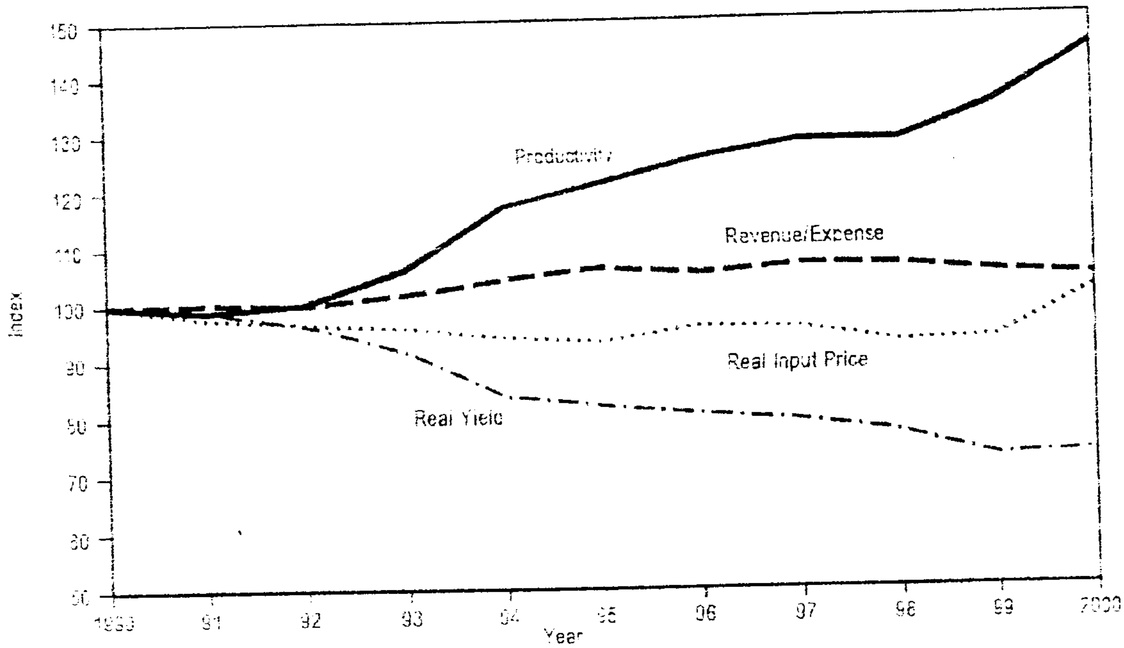
Airlines are trying hard to adapt

10. Nevertheless, the record of the airline industry in meeting customer demand for lower prices has been impressive. Productivity, using a combined ICAO index (see Table 1), rose by 45% during the 1990s and average yields in constant money terms fell by about a third. Real input prices remained relatively unchanged but rose sharply in 1999. Despite

this, the net operating result[1] never exceeded 2.9 per cent and ranged as low as -3.9 per cent in 2001.

Table 1

TRENDS IN PERFORMANCE OF WORLD SCHEDULED AIRLINE INDUSTRY



Source: ICAO, "World of Civil Aviation 2001-2004". Montreal2002

11. In fact, productivity has enabled an almost steady decline in average yields for the past half century. Originally these gains were mainly due to improved aircraft technology. As freer markets had an impact, the improvements came to a great extent from commercial and marketing changes.

12. The downturn in financial markets and the impact of geopolitical events have resulted in significant declines or directional shifts in many markets, especially in business travel. Airline pricing practices have also been called into question. At the same time there have been major increases in costs for fuel, airport and air traffic control charges, insurance and security.

13. Confronted with this situation, full-service carriers embarked on even more extensive and accelerated cost reduction measures. Over the last two years, 200,000 skilled airline employees, some 10% of the worldwide workforce, have lost their jobs, with another 200,000 in related businesses. In addition, airlines have canceled aircraft orders, withdrawn capacity and eliminated unprofitable routes. Other cost reduction measures targeted distribution systems, the adoption of e-ticketing and reducing the duplication of services between alliance members.

14. However, the efforts made by full-service airlines to cut costs have not been enough for them to fully adapt to the new environment. Several full-service carriers have gone into creditor protection (including US Airways and United Airlines, the world's second largest airline). Others have gone out of business (Swissair, Sabena, Ansett, TWA, Air Afrique, Canada 3000).

15. This points to a serious structural problem worldwide. Indeed the survival of many airlines and the very concept of air transport networks are now at stake.

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[1] The net result is obtained dividing the operating result plus non-operating items (e.g. interest and subsidies), minus income tax, by operating expenses.

Lessons from "No-frills Carriers"

16. No-frills carriers (NFCs) are often held up as an alternative business model to traditional full-service airlines. They are rightly seen as one of the successes of liberalized aviation markets throughout the world. NFCs have brought strong competition to the market, especially in Europe, North America and Asia/Pacific and forced full-service carriers to rethink some of their commercial practices. Since 11 September, as many as 20 NFC have announced plans to start up.

17. Two features in particular set them apart from full-service carriers. Firstly, NFCs have adopted a much simplified business model. This is based on the use of a single type of aircraft, point-to-point services, short turnaround times and low labor costs. They often use secondary airports to cut costs.

18. Secondly, with few exceptions, NFCs operate within domestic markets or the EU's liberalized internal market. This means that mergers and acquisitions are possible for them. As a result, NFCs have been able follow the dictates of the market, as shown by easyJet's purchase of Go and Ryanair's acquisition of Buzz or by the establishment of Virgin Blue in Australia.

19. Although some NFCs are the fastest growing and the most profitable of all air carriers, there have also been a number of failures, including Debonair, Pro Air, Impulse and Legend Airlines.

20. NFCs provide basic services for a certain portion of the air travel market, supplementing rather than replacing full-service airlines.

21. Full-service carriers offer a more complex and varied range of services adapted to a wide variety of markets and needs. They offer the only way to provide a full selection of services to passengers and shippers. Through interline arrangements, full-service carriers provide non-discriminatory access to world networks and links between large and small communities around the world.

22. The globalization of world trade and travel markets would not have been possible without safe, reliable and economic air services.

23. The benefits of liberalized air transport markets are exemplified by the successes achieved in earlier years by the European charter carriers, global parcel express operators and most recently by the no-frills carriers. All were allowed to develop unique business models without government interference or excessive regulation – and they flourished.

24. In short, full-service carriers need the same degree of commercial freedom that no-frill carriers enjoy in domestic markets. What is more, these carriers should be allowed to achieve economies of scale and scope through building alliances, mergers or acquisitions. Failure to do so will reduce the efficiency of their international services and maintain fragmentation of the industry.

Role for Governments

25. The business model of full-service carriers is not "broken" as some maintain but it does need adjusting. For that, they need the help of governments to complete the liberalization process, apply equal treatment to all air transport service providers and to stop piecemeal regulation.

(a) Governments should complete the liberalization process

26. Few air transport markets in the world are completely deregulated in the sense that airlines are free to shape their commercial policies and business structures as needed. At an international level, even open skies treaties provide only partial liberalization.

27. IATA and its Members look to the Fifth ICAO Worldwide Air Transport Conference in 2003 to show the way for like-minded states to move *beyond open skies*. An important outcome of the Conference would be agreement for like-minded states to eliminate the rules governing foreign ownership and commercial control of airlines, while maintaining safety and security standards.

28. Airlines are still governed by outmoded regulations that require them to be owned and controlled by citizens of the country in which they are established – or face the possible loss of their traffic rights. This prevents them from merging or attracting foreign capital.

29. Acquiring a foreign airline, or starting a new airline with foreign capital, is a near impossible task. What is more, airlines cannot use the restructuring tools available to many other industries. As a result, the industry today remains fragmented, with too many full-service airlines competing for fewer passengers. Carriers must fill excess capacity by pricing on a marginal cost basis.

30. The airline industry as a whole remains very undercapitalized. The consolidated balance sheet for the world's scheduled airlines[2] shows that total debt was 4.2 times stockholder equity in 2000. Interest payments consequently absorb a major portion of any earnings carriers may make at the best of times. The industry's position would be even more critical if interest rates were not at historic lows.

31. The airline industry badly needs consolidation. Airlines need the ability to merge, acquire each other, restructure across borders and they need access international financial markets. The time has come for Governments to remove such restrictions.

(b) Governments should level the playing field

32. When it comes to choosing providers, airlines are between a rock and a hard place.

33. Air transport deregulation will remain a misnomer, even within the United States and the European Union, so long as steps are not taken to alleviate the monopoly position enjoyed by infrastructure providers.

34. Airports and Air Traffic Control providers around the world enjoy *de facto* (and in some places *de jure*) monopolies. Monopoly service providers enjoy the ability to pass on their structural inefficiencies to their captive customers, namely the airlines. Yet regulators and competition watchdogs insist that airlines compete, or be fined.

35. At a time when airlines struggle to survive, airports and Air Traffic Control authorities have been recording margins of 23-28% in 2000 and 2001. In a single week in early 2003, it was announced that Zurich's Airport was to hike its passenger service charge by 47%, Toronto to increase landing charges by 29% and the sole ATC provider in Germany to raise its rates by 20%.

36. Similar fare hikes by full-service airlines would be greeted by calls for a public inquiry and increased competition. Yet Governments and competition authorities remain silent.

37. Airlines are only one link in the air transport value chain. Unless all links in that chain are subject to the same rules, structural dysfunctions will remain. This is the case today and airlines are paying the price for it.

(c) Governments should avoid piecemeal regulation

38. Governments can also play a positive role by reassessing the increasingly piecemeal approach to regulating international air transport operations.

39. Such actions impose a high cost on airlines. But the cumulative cost is not assessed. Especially where taxes and charges are involved, they induce others to take similar measures.

40. It is worth pointing out, at a time when environmental taxes are being discussed in some countries, that the historic reason for the tax exemption for fuel on international flights granted by international treaties was to ensure reciprocity of treatment.

41. The impact of piecemeal measures is especially felt in three areas.

42. Firstly, the impact full-service airlines which must operate across many jurisdictions every day. This requires a certain level of consistency and legal certainty. Different rules are confusing for passengers and costly for airlines. They result in a gradual breakdown in the common rules, ticket and message formats and codes accepted by airlines worldwide.

43. Recent examples include proposals to regulate conditions of carriage, denied boarding, and other consumer protection issues that will do little more than raise costs. Airlines argue that the market place, choice and competition are the best means of meeting customer requirements.

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[2] See Table 2.11 in ICAO, *The World of Civil Aviation, 2001-2004*. Montreal, November 2002.

44. The second area concerns taxes, fees and charges that are easy for governments to levy because of the industry's well-developed charges, billing, and collection system. As evidence of this, the number of entries in the inventory of taxes, fees and charges (TFCs) kept by IATA that can be levied through the tax box on airline tickets rose from 600 in 1989 to almost 1,800 in early 2003.

45. The cumulative impact of TFCs, levied on a per capita basis, by different jurisdictions is high. They are remarkable for the variety, the number and the relative proportion of the total amount paid by air travelers.

46. A single airline may, in the various countries it serves, have to deal with a tax on value, an exit fee, a passenger duty, a safety tax, a luxury tax, various airport and facility charges, fees to fund the provision of security, immigration and health inspection services, a national aid tax and a contribution to a rehabilitation fund for the handicapped. A new tax that is fast gaining ground in Africa and Latin America, is a tourist development tax.

47. Individually some levies can be high, such as the UK Air Passenger Duty of UKP 20 for travel outside the EEA. Some may cost airlines more to collect and remit than the face amount, as in the case of the Burkina Faso Domestic Security Tax of USD 0.13. Yet others, which are levied as a charge, can bare little relation to the service, such as the USD 50 passenger service fee levied at Accra Airport.

48. They can also amount to a high proportion of the total cost to the passenger. As an example, a London-New York return trip in March 2003 could be bought for USD 441, of which taxes and charges amount to USD 95 or about 21%.

49. Thirdly, in the aftermath of September 11, a number of poorly coordinated security measures were imposed in different countries. Not least of these are the stringent requirements regarding advance passenger information required by several countries, including the United States, Canada, Mexico, Japan, Australia, New Zealand and the UK. Fines for incorrect reporting of up to USD 5,000 per passenger and USD 75,000 per flight have been mandated in the United States.

50. Airlines are the first to support safe and secure air travel. But many of the measures introduced have had the double effect of increasing costs and discouraging passengers from flying. The global cost of extra security in 2002 has been estimated at USD 3 billion. This is a cost that should be borne as a national security cost by governments. The premiums for war risk insurance paid by the industry increased from USD 1.7 to USD 5 billion.

51. Little by little, the cumulative effects of uncoordinated Government intervention add to the industry's costs and have an impact on the financial sustainability of full-service airlines.

Allow airlines to change

52. The industry's message to governments is clear.

53. International full-service carriers face an uncertain future. Yet they perform a vital role in the economic and social well-being of communities world-wide.

54. Airlines must further cut costs and adapt to the pressing demands of today's air transport market, but their ability to do so is limited by outdated international rules. They are about to reach, or have reached, a glass ceiling in their ability to change. Yet, the only way forward is more change, and fast.

55. This requires a partnership with Governments. Only Governments can change the rules of the game. Governments need to rethink the way they regulate air transport – and not only the airline side of the business. And they must do it together, for this is the most international of businesses and one that requires a harmonized operating environment worldwide. Now is the time to do it. Let airlines change.

Geneva, March 2003.

RESOLUTION OF THE IATA ANNUAL GENERAL MEETING IN 2003

WASHINGTON DECLARATION

FREEDOM TO CHANGE

Introduction

The CEOs of the world's airlines meet in Washington on the occasion of the centenary of the first manned flight. Regrettably, an occasion for celebration has become a time for sober reflection on the future of an industry fighting for its very survival.

Since September 11, 2001, airlines have lost more money than they have made in the last fifty years. They have been hard hit by poor economic conditions, the Iraq war, SARS and by discriminatory taxes and fees beyond their control.

Airlines are doing their part by restructuring and through unprecedented cost reduction. Their partners in the service chain are being asked to improve their efficiency and lower costs. Governments also have a role to play if we are to succeed.

Bold changes are needed to ensure the long-term financial sustainability of an industry that provides mass transportation services to over 1.5 billion passengers per year and over 40% (by value) of all international trade, while serving as an engine of global economic growth.

RESOLUTION

The Presidents of IATA Member airlines call upon Governments to help them ensure a sustainable future by:

a) completing the liberalization process so that air carriers are better able to shape their commercial policies and business structures and to access global capital markets through liberalization of national ownership restrictions;

b) refraining from uncoordinated unilateral measures that hurt consumers by undermining the common rules and standards used by airlines worldwide and by improving cooperation between national competition authorities;

c) regulating airport and Air Traffic Service providers to ensure that these natural monopolies do not abuse their position by passing on their structural inefficiencies to their captive customers – airlines; and

d) ensuring that taxes and fees imposed by governments do not discriminate against the aviation industry.