



The Challenges and Opportunities of Liberalization:

The Philippine Perspective

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I

Why do States Participate in international aviation?

- sovereignty ensures government has major role
- Nearly all states have flag carriers
- Aspirations are embodied in local and international law

DOES A LARGE COUNTRY OR ECONOMY NEED AN INTERNATIONAL FLAG CARRIER?

In the U.S

Self-evident truth: Close links between the national flag carrier and the State exist.

- US's Policy Objectives
- Change Challenge and Competition The National Commission to Ensure a Strong Competitive Airline Industry, A Report to the President and Congress:

"This nation's civil aviation system is a vital national resource."

xxx

The air transportation system has become essential to economic progress for the citizens and businesses of this nation."

(US International Air Transportation Policy Statement (1995))

- *"Provide carriers with unrestricted opportunities to develop types of service and systems based on their own assessment of market demand." (emphasis added)*
(US Statute, No. 49 U.S.C. 40101 (a) (15))
- *"Strengthening the competitive position of air carriers to at least ensure equality with foreign air carriers, including the attainment of the opportunity for air carriers to maintain and increase their profitability in foreign air transportation".*

In Australia

- **Australian Policy Objectives**

(International Air Services Commission Act 1992)

"The maintenance of Australian carriers capable of competing effectively with airlines of foreign countries." (emphasis added)

(Policy Statement by MP Deputy Prime Minister and Minister for Transport and Regional Services 2000)

"The Government will: xxx improve access by Australian airlines to international aviation markets."

- **Large economies maintain state owned carriers**

- Russia
- China
- France
- India

DOES A SMALL COUNTRY NEED AN INTERNATIONAL FLAG CARRIER?

In the Philippines

Philippine Constitutional Directives:

Art II Sec. 19

"The State shall develop a self-reliant and independent national economy effectively controlled by Filipinos."

Art XII Sec. 1 par. 2

"...The State shall protect Filipino enterprises against unfair competition and trade practices."

Art XII Sec. 10 par. 2

"....The Congress shall enact measures that will encourage the formation and operation of enterprises whose capital is wholly owned by Filipinos.

In the grant of rights, privileges and concession covering the national economy and patrimony the State shall give preference to qualified Filipinos.

The State shall regulate and exercise authority over foreign investments within its national jurisdiction and in accordance with its national goals and priorities."

Art XII Sec 11

Public utility subject to nationality requirements

Law and Policy

Republic Act No. 2232 (1959) "An Act to Reactivate the International Air Transport Services of the Philippine Air Lines, Inc. and to appropriate the Necessary Funds therefore" provides, to wit:

"Section 1. Declaration of Policy. – Because of the peculiar geographical location of the Philippines, it is vital to her security and defense and to the enhancement of her commerce that she should maintain her own international air operations. xxx"

Executive Order 219 (1995) entitled Establishing the Domestic and International Civil Aviation Liberalization Policy (E.O. 219)

"At least two international carriers shall be designated official carriers for the Philippines"

CHICAGO CONVENTION

Preamble

"(T)he future development of international civil aviation can greatly help to create and preserve friendship and understanding among the nations and peoples of the world. . .

X X X

that international air transport services may be established on the basis of equality of opportunity and operated soundly and economically;"

Art. 1 of the Chicago Convention

"Sovereignty

The contracting States recognize that every State has complete and exclusive sovereignty over the airspace above its territory."

Art. 6 of the Chicago Convention

"Scheduled Air Services

No scheduled international air service maybe operated over or into the territory of a contracting State, except with the special permission or other authorization of that State, and in accordance with the terms of such permission or authorization."

National flag carrier is a necessity for States to exercise traffic rights and avail the other benefits in Air Services Agreements (ASA)

Article 44 which lists among the economic aims and objectives of ICAO to be:

"(a) Insure the safe and orderly growth of international civil aviation throughout the world;

X X X

(e) Prevent economic waste caused by unreasonable competition;

(f) Insure that the rights of contracting States are fully respected and that every contracting State has a fair opportunity to operate international airlines;"

DECLARATION OF GLOBAL PRINCIPLES FOR THE LIBERALIZATION OF INTERNATIONAL AIR TRANSPORT

"1. Overall Principles:

- b. promotes the effective and sustainable participation in and benefit from international air transport by all States, respecting national sovereignty and equality of opportunity;*
- c. takes into consideration the differing levels of economic development amongst States through maintenance of the principle of "community of interest" and the fostering of preferential measures for developing countries."*
- i. promotes efficiency and minimizes market distortions;*
- j. safeguards fair competition adequately and effectively;*

4. Liberalization

X X X

- 4.4. Each State will determine its own path and own pace of change in international air transport regulation, in a flexible way and using bilateral, sub-regional, regional., plurilateral or global avenues according to circumstances.*
- 4.5 States should to the extent feasible liberalize international air transport market access, air carrier access to international capital and air carrier freedom to conduct commercial activities.*

II

How does a country like the Philippines ensure its continued participation in international aviation?

Common Goals vs. Variety of Approaches

Sovereignty is expressed by a wide spectrum of regulatory viewpoints

The Challenge: Reconciling Liberalization with Norms and Concepts

Liberalization is a Process

- Big Bang is not possible
- Location, size and economic development not a barrier
- Open Class Competition

Strategies and Methodologies in the Philippines

Partnership between Government and the Private Sector

Focus on Demand

GDP is the key

China's Spectacular Economic Growth

For a country like China the air traffic demand is self-evident. A snapshot of some statistics readily shows this:

- The World Travel and Tourism Council (WTTC) estimates China's inbound domestic and outbound traffic will generate US \$ 184 billion in economic activity in 2004.
- China's Domestic air market is 100 million
- China's INBOUND tourism is around 17 million arrivals per year. A growth rate of 48% percent.
- China's OUTBOUND traffic is around 30 million per year. A growth rate of 43%

The strategic question is:

How do you create the demand?

- make the country an attractive destination.
- Peace and order
- Overcome negative travel advisories

Tourism Policy and Program

Tourism as an engine of growth and a key driver of the economy (i.e. foreign exchange, investment, employment, etc.)

Tourism in the Philippines

- 98% of tourist visiting the Philippines travel by air
- Tourism sector dived due to terrorism and negative travel advisories
- Divergence of approach between national flag carrier and foreign carriers
- PAL leads FIRST, FOREMOST and ALWAYS in promoting the Philippines as a destination

Tourism Hubs

Happy Tourists, Happy Investors

Overseas Filipino Workers and Immigrants: The Filipino Diaspora

Philippines is the planet's top source of migrant workers.

As of last count, there are some 8 million Filipinos working abroad, scattered across the four winds, and growing.

OFWs is a natural market for the NFC.

New International Gateways and Low Cost Carriers

- Existing international gateways such as Clark, Laoag, Cebu, Davao are underutilized to the detriment of tourists and OFWs

- Clark

The development of Clark Special Economic Zone (CSEZ) into a world class airport, investment and tourism destination in Central Luzon as a Magnet for job and economic activity.

- Executive Order 219 directs the opening of new gateways –

"1.6. Developmental and Cooperative Air Services. The CAB may grant authority to operate air services principally for the development of routes, destinations and gateways but not to exceed one (1) year.

Further, authority shall be granted in the operation of air services connecting non-premier city airports of other countries to new international gateways of the country as provided for under economic cooperation agreements with the Philippines."

- *Embracing LCCs as tools to stimulate demand and utilize air rights and airports*

*Government has been responsive and creative to encourage utilization of air rights.
(e.g. Air Asia, Tiger now flies to Clark daily)*

Air Access Liberalization

Definition of Open Sky

- “Ex re sed Non Ex Nomine”

One must look to the real state of things without attaching decisive importance to the legal denomination which the party may give their actions.

- Open: means without restrictions
- OPEN SKIES IN AVIATION: Restrictions Exist (i.e. Cabotage, 7th Freedom, Nationality Clause)
- US OPEN SKIES: (6) Restrictions
- Freedoms of the Air: Imprisonments of the Air

Open Sky is not a Panacea

- Leap to open sky not advisable
- Benefits not guaranteed
- Open skies is inconsistent with some local laws which mandate Economic Regulation

Survey of U.S. Open Skies Agreement*

31% or 58 countries have entered into open skies agreements out of a potential 190 bilateral partners

- Fully 36% or 21 countries have no air services to/from the U.S.A at all. Their open skies agreements with the U.S. are purely symbolic.

Bahrain, Benin, Brunei Darussalam, Burkina Faso, Cape Verde, Luxembourg, Malta, Morocco, Namibia, Netherlands Antilles, Norway, Oman, Qatar, Rwanda, Senegal, Slovakia, Sri Lanka, Tanzania, United Arab Emirates, Uganda and Uzbekistan

- Fully 31% or 18 countries have unilateral operations only, i.e., only U.S. carriers fly to their country, or only the home country airlines fly to the U.S.

Austria, Aruba, Czech Republic, Denmark, Dominican Republic, Finland, Gambia, Ghana, Guatemala, Iceland, Jordan, Malaysia, Nicaragua, Nigeria, Pakistan, Poland, Romania and Sweden.

- 33% or 19 countries have meaningful competitive air services to/from the U.S.A involving the airlines of both sides.

*Survey does not yet include 12 additional countries namely: Samoa, Jamaica, Tonga, Albania, Madagascar, Gabon, Indonesia, Uruguay, India, Paraguay, Maldives, Ethiopia



AAPA: Mainland China destinations

AAPA members serve a total of 27 mainland Chinese cities

1. Shanghai
2. Beijing
3. Xiamen
4. Guangzhou
5. Qingdao
6. Hangzhou
7. Kunming
8. Dalian
9. Chengdu
10. Tianjin

Flights/Week

- 280
- 168
- 47
- 44
- 39
- 36
- 24
- 23
- 22
- 17



800 flights per week

Source: AAPA

Hainan which has an open sky regime in place has not become a hub nor does it even occupy a slot in the top (10) city destination in China.

Philippine – US ASAs

Granting of unlimited frequencies, unlimited 3rd and 4th freedom rights and unlimited 5th freedom rights to nearly all third country destinations has not automatically created demand.

- Manila is not a passenger hub but remains a feeder
- Flights to the Philippine have not increased noticeably
- Visa restrictions to the US has dampen travel demand

PROGRESSIVE LIBERALIZATION IS PERFECTLY RESPECTABLE APPROACH

Asian carriers have prospered using this regime in well negotiated air treaties.

Progressive liberalization with the end goal of promoting fair competition across all market segments is a respectable and credible alternative approach to the open skies model for liberalization. It has been adopted almost universally for intra-Asia air services relationships, even by countries like Singapore and Korea which have signed open skies agreements with the US. (*"Don't Open the Skies"* by David Turnbull, Deputy Chairman & Chief Executive of Cathay Pacific – article published in the *Asian Wall Street Journal*, June 7-9, 2002)

Fierce competition exists under such a regime.

Most international routes to and from the Philippines are fiercely contested by a number of foreign and local airlines, including the following key markets:

1. RP-USA (contested by at least 10 carriers)
2. RP-Middle East (at least 12 carriers)
3. RP-Europe (at least 11 carriers)
4. RP-China (at least six carriers)
5. RP-Hong Kong (at least four carriers)
6. RP-Korea (at least five carriers)
7. RP-Singapore (at least five carriers)
8. RP-Thailand (at least five carriers)
9. RP-Indonesia (at least seven carriers)
10. RP-Japan (at least 10 carriers).

6th Freedom Rights Expand Traffic Rights Beyond Bilaterals

Foreign Carriers underutilize their entitlements under their ASAs with the Philippines

- 40 to 50 airlines already enjoy rights to fly to new international gateways like Clark, Cebu and Davao. Yet only a handful operate these flights. Thus, giving air rights will not generate additional traffic.

WEEKLY SEAT CAPACITY ENTITLEMENT AND USAGE By Region

Region	Capacity Rights per Region	Capacity Rights on the Route	Airline Operations Philippines	Foreign	Total Seats Offered	Total Unused Rights
Americas *	21,600	43,200	19,691	8,177	17,999	25,201
Europe	13,200	26,400	831	3,523	4,050	77,912
Asia/Pacific	68,560	161,190	38,482	52,796	91,278	53,390
Middle East	22,268	42,996	3,639	12,875	16,028	26,968
GRAND TOTAL Weekly Capacity	125,628	281,786	62,643	77,371	129,355	152,431
Annual Capacity	6,532,656	14,652,872	3,257,436	4,023,292	6,726,460	7,926,412

*RP-US market has unlimited frequencies and unlimited 3rd, 4th, 5th freedom rights

CHINA APPROACH:

Despite huge demand China uses a combination of progressive liberalization and declared a partial open sky for one province

Approach not readily replicated since China conditions are different

- Huge market demand already exists
- “China Inc. approach: Reform is from the top
- Chinese carriers are government owned and controlled entities (“GOCCs”).
- Shanghai, Beijing, Guangzhou are firmly established hubs
- The Chinese government has extraordinary levers of control to protect the economy against ruinous competition.

Cohabitation of Unilateral, Bilateral and Multilateral Methods

ICAO Declaration of Global Principles endorses all forms of agreements.

Bilateral, multilateral and plurilateral agreements are essentially neutral.

Bilateralism should not be equated with protectionism.

- Bilateral ASAs can be as restrictive or protective on market access, capacity and pricing or as open or liberal with the bilateral partner. (e.g. Trigger mechanism at 70% load factor)

Asian carriers have prospered using a network of bilateral agreements.

Privatization of the National Flag Carrier Has Been a Major Liberalization Step

Art. II Sec. 20

- *"Sec. 20. The State recognizes the indispensable role of the private sector, encourages private enterprise, and provides incentives to needed investments."*

Privatization is a fundamental pre-requisite for further liberalization and consolidation

- Incentive to be profitable
- Motivated to cut costs

State ownership and control inhibits and discourages cross border merger.

- GOCC disinclined to merge
- Private company will reject merger with GOCC

Privatization facilitates the relaxation of the nationality requirement.

- Search for and access to capital is beyond local borders

Privatization strengthens the airline industry because it removes distortions.

- Without access to public funds the playing field is level.
- The possibility of failure is real.

Privatization of the national flag carrier or the airline industry is risky.

➤ PAL's 65 year history as Asia's first airline show the difficulties.

➤ Overview of PAL ownership -

- March 15, 1941 - PAL was incorporated as a private company
- September 1941 - Government invested in PAL paving the way for its nationalization
- March 1954 - Government ordered the immediate cancellation of international services as an economy measure
- June 1959 - Congress passes R.A. No. 2232 entitled "An Act to Reactivate the International Air Transport Services of the Philippine Airlines, Inc. and to appropriate the necessary funds therefor."
- January 1965 - The government relinquished its control of PAL and bidded out half of its shares
- March 1972 - Benigno P. Toda, Jr., Board Chairman of PAL acquired majority control
- November 1977 - Government takeover of PAL
- March 1992 - Privatization of PAL

Overcoming Post Privatization Challenges

- Post Privatization Birth Pangs (e.g. culture change, union militancy and labor strikes, bureaucratic processes, etc.)
 - Volatile external factors (e.g. war, SARS, fuel price, etc.)
 - Renationalization risks in order to serve as a loss leader for tourism
- Privatization has transformed PAL into a competitive organization with private sector values and attitudes which can bring forward the agenda of liberalization
- Commercial business instead of arm of government
 - No bail out; no subsidy (e.g. security, insurance)
 - Simple organizational structure
 - Corporate Governance
 - Right sized

PAL's status in the Asian Region as a privately owned carrier is a key measure of the Philippines' commitment to liberalization.

- 6 out the 7 ASEAN countries are government and controlled corporation (GOCCs)
- 11 out of 17 airlines in the Association of Asia Pacific Airlines (AAPA) or 65 percent of the membership are still GOCCs.

Liberalization of Ownership and Control (Relaxation of Nationality Requirement)

- Nationality rules are protective devices for individual carriers and for the industry at large.

"The ownership rules have allowed a number of states, which thirty to thirty-five years ago did not have an air transport industry, to develop successful and financially strong airlines. The highly profitable Singapore Airlines, protagonists today of 'open skies', only survived their infancy in the early 1970s because of the protection they were afforded by the bilateral system. A more recent successful example has been Air Mauritius. Even today, the ownership rules may facilitate the emergence of new and potentially viable flag carriers." The Airline Business in the 21st Century by Rigas Doganis

- Nationality rules protect the industry from global domination by a handful of mega carriers which would negate the ICAO goals of participation in international aviation.

If Europe and American can shed the rules and completely liberalize the airspace, the rest of the world will be forced to follow. The two regions together account for well over half the world's air traffic. Global takeover will then be possible, leading to consolidation and economies of scale. From this, a handful of mega-airlines could come to rule the skies", (Open Skies and Flights of Fancy, The Economist, 4 October 2003, p. 65-67.)

- The Chicago Convention does not contain any rule restricting the ownership and control of Airlines. Art. 17 and 18 deal with the nationality of the aircraft.

In the 1994 ICAO Worldwide Air Transport Conference -There is no single agreed definition of what is meant by substantial ownership and effective control.

- Nationality clauses have become the heart of bilateral agreements and the battleground for initiatives at modernizing regulatory arrangements for air transport.

"In the first decade of the third millennium, it is the ownership and investment rules that are the most likely to be liberalized. x x x This is because while there are strong economic forces pushing the airline industry towards concentration and the creation of competing global alliances, to maximize the potential benefits of scale and of global network. Moreover, relaxing the ownership rules would also make it unnecessary any longer to safeguard domestic or Seventh Freedom rights. x x x" (Doganis, R. The Airline Business in the 21st Century, p. 147)

- Philippines has Adopted Flexibility

- Philippines has liberalized the threshold percentage in the ASAs in select circumstances
- Philippine-Palau ASA relaxed the nationality requirements for two years requiring only 30% Palau ownership
- Philippine investment climate seeks and welcomes foreign investment up to 100% of equity.
 - Existing foreign Equity in Public Utilities in Anticipated to Break the traditional 60/40 rule
 - Philippine sentiment is in step with ASEAN and ICAO

- Philippines is ready with accelerated liberalization in airline sector with safeguards

- Embrace relaxation of nationality rules for investment purposes with the safeguard guarantee that NFC will continue its operation

Takeover and Integration of Swiss into the Lufthansa Group.

The Integration Agreement ensures: 1) fair development of the Zurich hub, 2) the size of the long haul fleet, 3) SWISS quality brand, 4) the continued existence of SWISS as an operating airline based in Switzerland, 5) A guarantee to preserve the SWISS air traffic infrastructure for the long term where an independent foundation will be established under Swiss law for a period of ten years to ensure board representation in Lufthansa and the SWISS Board.

Foreign investment in PAL should also respect its economic importance to the nation:

- The domestic and international Route Network
- The multiplier effect on the local economy
- The source of technology
- Servicing the OFW
- Servicing Tourism
- Strong carriers support the Hub
 - Promote RP destinations on a sustainable basis regardless of the state of world aviation.
 - Strong local carriers are an integral component of major hubs, e.g. Singapore, Hongkong, Tokyo, Seoul, London, Frankfurt etc. Airlines of other countries use RP traffic as feeder traffic for their long-haul routes.

IMPERFECT COMPETITION IN AN IMPERFECT MARKET

Liberalized market requirements

- Possibility of failure is real
- All subject to same commercial pressures

Imperfect competition

- State aid (i.e. in the U.S. Billions of Dollars; in the E.U., Commission says it is not absolutely prohibited)

A few foreign airlines have sounded the alarm over state aid distortions.

Qantas Airways' chief executive, Geoff Dixon, complained that the airline business is "*inherently undisciplined and unfair because many carriers around the world are being propped up by governments*". (*Orient Aviation Magazine*, February 2005)

Said Dixon: "*This is a pretty bad industry. The whole industry is capital intensive, labour intensive, out of control and effectively bankrupt. The competition is mainly subsidized and many of them [subsidized airlines] don't have competition authorities.*"

Dixon also stated that "*I think we can [compete on our own], but not if there is competition that is unfair. US carriers, many operating under bankruptcy protection, are on state aid.*"

The article went on to say: "*Dixon said two-thirds of the 40 international airlines operating to and from Australia each week are government-owned or subsidized. US airlines received US\$ 15 billion in grants and loans after 9/11, as well as substantial government support in relation to many security measures for which Qantas is not supported. The spectacular expansion of Middle Eastern operators such as Emirates and Etihad is also a big concern.*"

"British Airways (then) Chief Executive Rod Eddington complained *"to Loyola de Palacio, European transport commissioner, that action should be taken to halt the latest tranche of state aid to Alitalia, the struggling majority state-owned Italian flag carrier. X x x*

He also called the attention of Washington authorities on state subsidies to US airlines where vast sums of aid" had produced "a massive distortion of competition across the Atlantic". X x x He claimed that recent US government actions had granted some \$1.8bn of relief on US airlines' pensions contributions, while at the same time the US government was heavily discounting US airlines' insurance cover. X x x "State aid is bad policy which hurts airlines, consumers and the broader economy alike." " It creates a major distortion in competition between airlines and should not be permitted."
(Financial Times, June 28, 2004)

➤ State owned carriers (i.e. so called "last restructuring" on a serial basis)

"The Singaporean government owns 57% of SIA's stock (some 20% is held by money managers). And... the government aids SIA in many ways. Tax breaks on the carrier's aircraft help SIA maintain one of the youngest fleets of any major airline. The government helpfully paid the multibillion-dollar construction cost of Singapore's impressive Changi Airport, the airline's hub since 1981 and one of the best airports in the world.

➤ Excess capacity

- Nationality rules are not the main cause of the industry's difficulties (Brattle Group)
- Extraneous factors such as war, health epidemic like SARS, fuel price, etc.
- Poor management and governance
 - Failure to cut expensive labor costs
 - Asian Wall Street Journal reported: "How the US Airlines Lost the Battle to Resist Change Following a 25-year Fight." After deregulation, carriers failed to cut. Instead of cutting cost, carriers relied on a bag of tricks focusing on the revenue side of the business. (e.g. FFP, hub systems, international alliances to keep business customers)

➤ Abuse of Bankruptcy laws

- Bankruptcy laws are not inherently unfair unless its protection is abused. (e.g. US Airways entered 2x).
 - Mega carrier under bankruptcy protection is a formidable competitor.
 - United Airlines is setting its sights on new Asian routes as a strategy to exit Chapter 11 Bankruptcy Protection.
 - Aircraft manufacturer and lending institutions have tremendous leverage during the bankruptcy process to help remove excess capacity in the industry
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- No international competition law; divergent national competition law
 - Three fourths of international air transport of passengers is accounted for by carriers from developed countries
 - Global market place, Global market distortion

Each country is free to respond and provide a remedy in accordance with national objectives

The Regulator As A Safeguard of A Level Playing Field in International Aviation

- The global airline industry is inherently uneconomic because of over capacity (Dr. Rigas Doganis, Cranfield University)
- The severity of the financial problems faced by the US airline industry is breath taking. “Every market cycle since deregulation has been profoundly worse than the one that preceded it:
 - Pre-deregulation - \$100 million losses in one year; no airline bankruptcies;
 - 1981-82-\$1.4 billion losses in two years; two major airline bankruptcies; one liquidation;
 - 1990-94-\$13 billion losses in five years; five major airline bankruptcies; two liquidations; and
 - 2000-03- up to \$36 billion losses in three years; three major airline bankruptcies, so far, but more likely.” (Prof. Dr. Paul Stephen Dempsey, Institute of Air and Space Law, McGill University)
 - In 2005, IATA projects an industry loss of US\$5.5 billion and over US\$40 billion for the period 2001-2005
- Carriers cannot be left alone
- Regulators in the saddle seat to weigh up conflicting interest and make critical choices

Common Ground; Shared Destiny

- The history of aviation shows that the developing world and the developed world share an important element: an overriding motivation in aviation policy to ensure the existence of a national flag carrier. Put differently, no country likes to see its national flag carrier go down.
- US
 - Special Legislation to save the industry; effectively a nationalization of the airline industry
- Switzerland
 - Creation of Swiss after the demise of Swissair
- New Zealand
 - Re-nationalization of Air New Zealand
- Malaysia
 - Reversed privatization of Malaysia Airlines
- Paradox of Competition: over reaching ambition with overextended resources
- National Flag Carrier
 - Participation and sustainability is a complex issue
 - Economic analysis is inadequate. Political dimension must be considered

As Mr. Sampson has pointed out in his book entitled *Empires of the Sky: The Politics and Cartels of World Airlines*:

"The laws of free enterprise can never be applied simplistically to the airline [industry] which must always require both competition and regulation. As long as nations feel dependent on airlines as the lifelines of their trade, they will not deregulate the international system; and no airline operating abroad –not even an American airline – can escape from its dependence on the government in the critical bargaining for landing and traffic rights."