



REGULATORY AND INDUSTRY OVERVIEW

(Presented by ICAO Secretariat)

1. INTRODUCTION

1.1 Since the mid-1990s, 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, and new business models in order to cope with an increasingly competitive environment. This paper provides a brief global overview of regulatory and industry trends and developments that have taken place in recent years.

2. REGULATORY DEVELOPMENTS

2.1 **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 2005, about 900 bilateral air services 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 traffic 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 services 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.

2.2 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 the Netherlands and the United States. Since then, 121 “open skies” agreements were concluded, involving 87 States, with the United States being one of the partners in 74 cases. These agreements involve not only developed countries but also an increasing number of developing countries (about 65 per cent). In addition to the basic market access elements, 75 agreements also grant “Seventh Freedom” traffic rights for all-cargo services (eight agreements also granting this right for passenger services).

Twenty six 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 traffic rights, Seventh Freedom traffic rights for all-cargo, third country codesharing, charter services, and ground handling, some of which are applied only to United States carriers.

2.3 **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.

2.4 Before the fourth World-wide Air Transport Conference (ATConf/4) in 1994, there were just two such regional arrangements, namely the single aviation market within the European Union (EU, then European Community) in 1987¹ and the Decision on Integration of Air Transport amongst five Andean Pact States in 1991 (Andean “open skies” policy). Since 1995, eight more regional arrangements have emerged with a worldwide dispersion:

- a) the Caribbean Community (CARICOM) Air Service Agreement amongst 15 States in the Caribbean (1996, entry into force in 1998 for nine States);
- b) the Fortaleza Agreement amongst six MERCOSUR States in South America (1997);
- c) the Banjul Accord amongst six States in Western Africa (1997, a separate more liberal multilateral agreement was signed among seven States in 2004);
- d) the CLMV Agreement by Cambodia, Lao People’s Democratic Republic, Myanmar and Viet Nam (1998, a formal multilateral agreement was signed in 2003);
- e) the Intra-Arab Freedoms of the Air Programme amongst 16 States of the Arab Civil Aviation Commission (ACAC) in the Middle East and Northern Africa (1999);
- f) an agreement amongst the six States of the Economic and Monetary Community of Central Africa (CEMAC) (1999);
- g) the Air Transport Liberalisation Programme amongst 20 States of the Common Market for Eastern and Southern Africa (COMESA) (1999); and
- h) the Yamoussoukro II Ministerial Decision amongst 52 African Union States (1999, entry into force in 2000).

2.5 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 the IMT Growth Triangle region by Indonesia, Malaysia and Thailand (1999), and the BIMP East ASEAN Growth Area region by Brunei, Indonesia, Malaysia and Philippines (1999).

¹ The first liberalization package was applied in 1987 within 12 member States, followed by the second package in 1990. The third package was implemented in January 1993 with a single market completed in April 1997. The number of member States increased to 15 in 1995 by adding three then EFTA States and to 25 in 2004 by adding another ten member States in Central, Eastern and Southern Europe. The EU’s liberalization package has also been applied to three EFTA States belonging to the European Economic Area (EEA) since 1995 as well as Switzerland (through bilateral agreements) since 2002.

2.6 At the plurilateral level, the Multilateral Agreement on the Liberalization of International Air Transportation (MALIAT) known as the “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, Samoa and Tonga subsequently joined the agreement (Peru withdrew in 2005). In 2004, Brunei, Singapore and Thailand signed two Multilateral Agreements — one on the Full Liberalization of All Cargo Services and the other on the Liberalization of Passenger Air Services — both of which are open to other member States of the Association of South East Asian Nations (ASEAN).

2.7 Several arrangements are also in the signature and/or ratification process, for example, a Common Air Transport Programme amongst eight States of the Economic and Monetary Union of West Africa (WAEMU, 2002); a Pacific Islands Air Services Agreement (PIASA) amongst 16 States of the Pacific Islands Forum (2003); a road map to liberalize air cargo and passenger services as well as to build a common ASEAN aviation market (2005); and an Air Transport Agreement for a Common Aviation Area, which is open to 25 member States and three associate members of the Association of Caribbean States (ACS, 2004).

2.8 **Block Negotiation by European Union.** There was a development affecting a common EU policy with third countries. In November 2002, the Court of Justice of the European Communities (ECJ) 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.

2.9 Following the Court’s judgement, in June 2003, the Council of the EU conferred on the Commission a mandate to negotiate air services agreements on behalf of all member States with the United States for creation of an Open Aviation Area (OAA) between the two territories, as well as a so called “horizontal” mandate to negotiate with third countries on the replacement of certain specific provisions in the existing bilateral air services agreements declared contrary to Community law by a judgement of the Court. In April 2004, the Council and the European Parliament adopted a regulation on the negotiations and implementation of air services agreements between member States and third countries. In December 2004, the Council further granted negotiation mandates to the Commission for a Euro-Mediterranean aviation agreement with Morocco and a European Common Aviation Area (ECAA) agreement with the countries of the Western Balkans. In addition, the Commission has been asking the Council to grant negotiating mandates for OAAs with Russian Federation and China and other important third countries such as Australia, Chile, India, New Zealand and Ukraine.

2.10 Under negotiation mandates conferred by the Council, the Commission has been actively conducting negotiations on air services agreements with third countries. After two-year long negotiations, a first-step OAA agreement with the United States was tentatively agreed to in November 2005. A Euro-Mediterranean agreement was initialled in December 2005, while an ECAA agreement involving total 35 States was agreed to in December 2005 and was opened for signature in June 2006. “Horizontal” agreements have so far been initialled with 23 States, and some of them were formally signed (Chile, Ukraine, Georgia, Singapore, New Zealand and several Balkan countries).

2.11 **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 stops 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 123 as of May 2006, but about one third of ICAO Contracting States, including several with large land masses, remain outside the Agreement. Assembly Resolution A35-18, Appendix A, “Urges Contracting States that have not yet become parties to the International Air Services Transit Agreement (IASTA) to give urgent consideration to so doing”. The fifth Worldwide Air Transport Conference (ATConf/5) recognized IASTA’s contribution to the sound and economic development of air transport to the States which are parties to it and reaffirmed its importance for liberalization and for multilaterally developing the air transport system.

2.12 **Trade in services.** At the multilateral level, the World Trade Organization (WTO-OMC) came into being on 1 January 1995, and along with it, the entering into force of the General Agreement on Trade in Services (GATS). The GATS Annex on Air Transport Services applies trade rules and principles such as most-favoured-nation (MFN) treatment, national treatment and transparency to three specific so-called “soft” rights, namely, aircraft repair and maintenance, selling and marketing of air transport, and CRS services. It excludes from the application of the GATS “services directly related to the exercise of traffic rights”.

2.13 Pursuant to an earlier ministerial decision, the WTO-OMC launched in 2000 the first review of the operation of this Annex with a view to considering a possible extension of its coverage in this sector. During the review, there was some support to extend the Annex to include some additional “soft” rights (for example, ground handling) as well as some aspects of “hard rights” (for example, air cargo, non-scheduled and multi-modal transport), but there was no global consensus on whether or how this would be pursued. In 2003, the WTO-OMC decided to end a first review process of the Annex as well as any further discussions on its expansion. The result of this review was that the Annex remains unchanged and continues to cover the existing three “soft” rights. In September 2005, the second review of the Annex was formally commenced in accordance with Paragraph 5 of the Annex, which requires that the review be conducted at least every five years.

2.14 **National liberalization policies.** Several States launched a review process of their overall air transport policies, which was considered necessary in light of the global trend toward increased liberalization. Some of these policies seek to liberalize air transport services, in whole or in part, on a unilateral basis without requiring comparable rights from bilateral partners in return. For instance, Bahrain, Cambodia, Chile, China, Ecuador, Guatemala, Honduras, India, Lebanon, Pakistan, Philippines, Sri Lanka, Tunisia and the United Arab Emirates (member sheikhdoms including Abu Dhabi and Dubai) each adopted an “open skies” policy on a unilateral basis for foreign airlines’ international air services at specific airports and/or for limited durations.

2.15 Others aim at liberalizing domestic air transport markets and also at permitting more airlines to fly international routes. Since 2000, the liberalization of the domestic air services have been further progressed in Brazil, China, India, Japan, Indonesia, Saudi Arabia (announced in April 2006) and Thailand. Bangladesh, India, Mozambique and Nigeria each allowed privately-owned airlines to operate in certain international markets. Canada adopted a new multiple designation policy for international scheduled air services in 2002, which removed restrictions on the number of Canadian carriers designated to serve foreign markets whenever multiple designation was possible. The United Kingdom announced in 2005 the liberalization of foreign airlines’ Fifth Freedom air services to/from the regional airports not covered by existing bilateral air services agreements.

3. INDUSTRY DEVELOPMENTS

3.1 **Airline alliances.** 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. The steady expansion of transnational alliances for strategic purposes and to achieve market access and synergies are a consequence of airlines' 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 cooperation 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 airlines 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. Three existing global alliance groupings are:

- a) "Star Alliance" founded in 1997 (Air Canada, Air New Zealand, All Nippon Airways, Asiana Airlines, Austrian Airlines, bmi British Midland, LOT Polish Airlines, Lufthansa, SAS Scandinavian Airlines, Singapore Airlines, South African Airways, Spanair, Swiss, TAP Portugal, Thai Airways International, United Airlines, US Airways and Varig, to be joined by Shanghai Airlines and Air China);
- b) "oneworld" founded in 1998 (Aer Lingus, American Airlines, British Airways, Cathay Pacific, Finnair, Iberia, Lan Airlines, and Qantas; to be joined by Japan Airlines, Malev and Royal Jordanian);
- c) "SkyTeam" founded in 2000 (Aeroflot, AeroMexico, Air France, Alitalia, Continental Airlines, CSA Czech Airlines, Delta Air Lines, KLM Royal Dutch Airlines, Korean Air, and Northwest Airlines; to be joined by China Southern Airlines)².

3.3 The partnership of each global alliance group, however, remains unstable. For instance, a trans-Tasman alliance was proposed in 2002, which involved Qantas (oneworld member)'s equity investment in Air New Zealand (Star Alliance). In 2004, Mexicana withdrew from Star Alliance and switched its codeshare partner from United Airlines (Star Alliance) to American Airlines (oneworld). In 2004, Cathay Pacific (oneworld) acquired a 10 per cent stake in Air China, which is in the process of joining Star Alliance. In 2006, Aer Lingus confirmed its intention to withdraw from oneworld.

3.4 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 airlines also moved to form regional alliances with neighbouring airlines (for example, Grupo TACA led by

² The fourth global alliance group dubbed "Wings" was absorbed into the SkyTeam group in 2004 when Continental Airlines, KLM, and Northwest Airlines joined in the latter group.

TACA International Airlines since the mid-1990s; a Pan-Arab Alliance “Arabesk” launched by six Arab airlines in 2006), become affiliate or regional members of global alliances (for example, Adria Airways, Blue 1 and Croatia Airlines joined in Star Alliance as regional members in 2004, while Air Europa, Copa, Kenya Airways, Middle East Airlines, Portugalia and Tarom are the candidates for SkyTeam associate airlines), and to enter into franchise agreements with major airlines (for example, Comair of South Africa has been operating as British Airways’ franchise carrier since 1996). Overall, airline alliances are widespread but still evolving, with partnership relations becoming more intertwined and complex.

3.5 Airline alliances and codesharing have regulatory implications because of their potential effect on market access, competition and consumer interest. 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.

3.6 **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.

3.7 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 established by Avianca and Aces in 2002 (dismantled in 2003); Japan Airlines Corporation established by Japan Airlines and Japan Air System in 2002; the creation of three Chinese airline groups headed by Air China, China Eastern Airlines and China Southern Airlines through mergers with other smaller State-owned airlines during 2002-05; the integration of SN Brussels Airlines and Virgin Express under the common ownership in 2005; and the merger of America West Airlines and US Airways in 2005. Against the industry consolidation, quite a few States expressed their concerns, and scrutinized proposed mergers with great caution. For example, the United Airlines – US Airways merger plan was blocked by the United States Department of Justice in 2001.

3.8 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 airlines (for example, Australia, Brazil, China, India, and Malaysia), and relaxed the air carrier ownership and control conditions in the air services agreements. For example, in 2004, Air France and KLM Royal Dutch Airlines created a cross-border European airline group under a single holding company through a share exchange offer by Air France for KLM’s shares. In the same year, Synergy Group in Brazil acquired a 75 per cent stake in Avianca and increased to 100 per cent one year later. In 2005, Lufthansa took over Swiss through AirTrust (in which Lufthansa has a 49 per cent shareholding and will increase to 100 per cent by 2007). Most attempts to initiate cross-border mergers or acquisitions, however, have been 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 airlines was not financially risk free (for example, Iberia and its then parent company SEPI’s majority control of Aerolineas Argentinas, and Air New Zealand’s acquisition of Ansett, both of which fell through in 2001).

3.9 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. Nevertheless, foreign investments have sometimes been short-lived (for example, Singapore Airlines' minority shareholdings in Air New Zealand from 2000 to 2004). As of August 2006, among 1020 airlines, it is estimated that about 74 airlines had shareholdings in foreign airlines while about 278 airlines had equity owned by foreign investors in various degrees.

3.10 **Privatization.** The motives for privatization have been highly diverse, ranging from purely economic considerations, to improving operating efficiency and competitiveness, to a more pragmatic desire to reduce the heavy financial burden for governments for financing capital investment in new equipment. Whatever the reasons, the privatization of airlines has accompanied a more commercially oriented outlook within an increasingly competitive environment. Since the mid-1980s, about 135 governments announced privatization plans or expressed their intentions of privatization for approximately 206 State-owned airlines. During this period, 126 of these targeted airlines have achieved privatization goals to some degree. Airlines fully or partially privatized since 2004 include Air China, Air France, Air Lithuania, Alitalia, China United Airlines, El Al, FlyLal, Kyrgyzstan Airlines and Mexicana.

3.11 It should be noted that achievement of privatization has not been easy. Many of the initial privatization plans had to be deferred or postponed because of the complexities encountered in the process or the economic condition of the airlines concerned, or local circumstances, although in most such cases the intention to privatize remains. The uncertainties surrounding the privatization process are also illustrated by a small counter trend of renewal, usually as a temporary measure, of government ownership as a national interest response to the potential demise of a privatized airline. Air Jamaica, Air Moldova, Air New Zealand, BWIA West Indies Airways, LIAT, Malaysia Airlines, LOT Polish Airlines, Pakistan International Airlines and South African Airways are examples of privatized airlines, in which the governments raised their shareholdings for past five years.

3.12 Some African States established new national airlines, which replaced debt-ridden State-owned incumbents, in partnership with foreign investors. The examples of these airlines are Swazi Airlink (1999, a replacement to Royal Swazi Airways with SA Airlink having 40 per cent), Air Senegal International (1999, a replacement to Air Senegal with Royal Air Morocco having 51 per cent), Ghana International Airlines (2004, a replacement to Ghana Airways with the U.S. consortium having 30 per cent), Virgin Nigeria Airways (2004, a replacement to Nigeria Airways with Virgin Atlantic Airways having 49 per cent and Nigerian Institutional Investors 51 per cent) and Air Gabon International (2006, a replacement to Air Gabon with Royal Air Morocco having 51 per cent).

3.13 **Airline business models.** In recent years, successful low-cost carriers (LCCs) have been challenging the full service network models of major airlines. The common features of the business model of LCCs are, with some variations: point-to-point network focussing on short-haul routes, high frequencies, simple low fare structures, high-density single class with no seat assignment, simple in-flight services, staffing flexibility and minimal overheads, and intensive use of electronic commerce for marketing and distribution (including on-line booking via the internet and electronic ticketing). To sustain low-cost structures, these airlines usually operate a single aircraft type with higher daily aircraft utilization. They also use less congested secondary airports to ensure short turn-rounds and high punctuality and to save airport related costs. It is the low operating costs that enable LCCs to allocate all their seats to low fares.

3.14 This low-cost formula is not new but has been adopted by many new entrants in the United States following domestic deregulation. Although only few of the earlier new entrants survived, successful LCCs have established sustainable significant cost advantages, and grown rapidly not only at

the national level (for example, Southwest Airlines and jetBlue Airways in the United States, Virgin Blue Airlines in Australia, Gol in Brazil, Westjet in Canada, Air Deccan in India and Skymark Airlines in Japan) but increasingly regionally (for example, Ryanair and easyJet in Europe, Air Asia and Valuair in South East Asia, and Pacific Blue Airlines in Oceania, Air Arabia and Jazeera Airways in Middle East). Some of them have offered sufficient incentive to become attractive to business passengers. The low-cost formula is likely to spread to other regions and increasingly to international services where market conditions allow and regulatory arrangements permit.

3.15 Facing growing cost pressures and an inability to continue to charge higher fares, major airlines have been forced to change their business priorities towards redesigning their business concepts and developing alternative models for their operations in order to increase efficiency and cost effectiveness. One of the models chosen by the major airlines is to set up separate organizations or subsidiaries to handle operations on short-haul routes to be able to compete with LCCs and to avoid the potential threat of new entrants. This low-cost “airline within an airline” strategy tries to combine key ingredients of LCCs’ approach with the reputation and quality of their own brand. Despite limited success of earlier attempts, more airlines have been adopting this strategy. Again, an “airline within an airline” is a formula that is developed mainly for domestic services (for example, Song of Delta Air Lines, Ted of United Airlines, Click Mexicana of Mexicana, Jetstar of Qantas, Nok Air of Thai Airways International and Kulua of Comair) but is also extended to regional/international services (for example, Jetstar Asia minority owned by Qantas, Tiger Airways minority owned by Singapore Airlines, bmibaby of bmi British Midland, Centralwings of LOT Polish Airlines, and SnowFlake of SAS Scandinavian Airlines).

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