

Foreign Ownership of Flag Carriers – A Contradiction or a Necessity?

(Presented by World Bank)

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In many countries of the world, public perception reigns that their national air carriers are some sort of public good, which needs to be preserved and controlled by its national owners. In addition, it is perceived that a national carrier fulfills a special role as it represents its nation of origin by “carrying its flag.” As the so called “Flag Carrier,” it is acting as an ambassador which not only represents a nation when arriving at a foreign airport, it also fills the hearts and minds of the citizens it represents who, in return, display a remarkable loyalty to the carrier when travelling by air. Both notions, maintaining national ownership and the role of a flag carrier, are wrong. Eliminating such outdated perception would constitute a significant contribution to the development of air services, especially in poor or emerging countries.

Foreign Ownership Limitations and Flag Carriers

The historical background of the concept of limiting foreign ownership is nearly as old as commercial aviation. In 1925, the United States Congress discussed and created the first citizenship requirement on air carriers to “*assure aircraft availability for national defense purposes.*”¹ The U.S. Congress and representatives of the military “*advocated government intervention in commercial air carrier development for the dual purpose of training a reserve corps of pilots and maintaining an auxiliary air force for the United States military service during national emergencies.*”² In other words, the limitation of foreign ownership in an airline was derived from the strategic necessity to prevent foreign control over an “*auxiliary*” of the country’s military.³ This concept was introduced in the U.S. Air Commerce Act of 1926, which required that air carriers maintain a fifty-one percent voting stock under U.S. citizenship and a sixty-six and two-thirds percent U.S. citizen contingent on their board of directors.⁴ However, these defense considerations of the military were increasingly replaced by economic protectionism during the so called New Deal era of the 1930ies. Calls to better protect the airline industry as “*part of the commercial arm of the nation*” led in the Civil Aeronautics Act of 1938 to an increase of the airlines’ voting stock that must be in U.S. hands. To qualify as an U.S. operator, the voting stock requirement increased from fifty-one percent to seventy-five percent U.S. ownership.

¹ James E. Gjerset, Comment, *Crippling United States Airlines: Archaic Interpretations of the Federal Aviation Act’s Restriction on Foreign Capital Investments*, 7 AM. U. J. Int’l & Pol’y 173, 180 (1991)

² Gjerset, *supra* note 7, at 181.

³ *Id.*

⁴ Air Commerce Act of 1926, Pub. L. No. 69-254, para. 1-14, 44 Stat. 568 (1926)

Foreign ownership limitations in air carriers were first discussed on a multilateral basis during the Chicago Convention in 1944. Under the impression of the still ongoing Second World War, the United States pushed for the right to prohibit air carriers in their territory “*if substantial ownership and effective control raised questions of a political nature or threat to national security.*”⁵ However, this general rule was strongly opposed by Latin American countries, which had substantial foreign investments in their carriers, including by U.S. carriers, such as Pan Am and TWA. As a result, the inclusion of foreign ownership restrictions in the Chicago Convention was prevented, allowing each Signatory State to include or omit such restrictions in their national law. Nevertheless, foreign ownership restrictions were applied from the onset in most bilateral air service agreements. The Bermuda Convention of 1946, which regulated air services between the United States and the United Kingdom, included the “*right to withhold or revoke the exercise of rights specified in the Annex [...] in the event that it is not satisfied that substantial ownership and control of such carriers are vested in nationals of either Contracting Party.*” This foreign ownership clause has endured seven decades and can still be found in most bilateral air services agreements, regardless of whether a signatory party has such limitation in its national aviation legislation.

Most states have followed suit and introduced legislation, which limits ownership of an aircraft and/or airline to at least a simple majority or fifty-one percent in the hands of its nationals. The nationality of an aircraft is defined by its state of registry, and the air carrier’s legal domicile of incorporation anchors its nationality. Nevertheless, some countries have never introduced foreign ownership restrictions on aircraft or air carriers in their aviation legislation. The most prominent one is Portugal, which for many decades allowed full foreign ownership of air carriers. However, this rule was eventually replaced by legislation of the European Union (EU), which limits majority ownership in air carriers to EU nationals. Nevertheless, the principle of allowing foreign ownership in air carriers endured in the aviation legislation and regulation of Portugal’s former colonies and territories. For example, the aviation legislation of Mozambique and Cabo Verde still allow for full foreign ownership of aircraft and of an airline registered in their country. Only bilateral air services agreements sometimes do limit foreign ownership in these countries when applying reciprocity of conditions and terms of the agreement.

The role of the “Flag Carrier” is often overstated and does not constitute a valid argument that an airline needs to be in the hands of nationals or even be state-owned. First, the meaning of the term “Flag Carrier” is largely misunderstood. Many argue that the flag carrier is the airline that must have the nation’s flag painted on its aircraft, be it for international identification purposes or be it to just serve as a promotional tool of its country. However, the expression “Flag Carrier” has its roots in maritime law, which requires that ships display the state flag of the country of their registry. Before the establishment of an international regulatory framework for civil aviation by the Chicago Convention and its Annexes, aviation was regulated in most countries by adopting principles of maritime law. As a result, airlines conducting international flights had to carry, on the flight deck, flags of the country of registry and of the country of destination. When on the ground, these flags were displayed after landing or prior to take-off through open cockpit windows. The only country in the world, which has a regulatory requirement to display its national flag on its fuselage is Switzerland, which is a leftover tradition of the times of conflict in Europe when Switzerland had to be recognized as a neutral nation. In conclusion, a national airline, say a flag carrier, does not

⁵ Dr. Marc L.J. Dierikx, *Bermuda Bias: Substantial Ownership and Effective Control 45 Years On*, 16 AIR L. 118 (1991)

constitute any rules that the airline needs to be owned by a national of a given state, nor does of serve any national purpose when displaying its flag.

Opening ownership limitations as an opportunity for emerging markets

Airlines are not only a very capital-intensive business, they also represent one of the least profitable industries with the highest risk for investors. For decades, the global airline industry has not managed to earn its weighted average cost of capital, and many airlines are only surviving thanks to massive support by their, often public, shareholders. In the past, some wealthier nations maintained the argument that support provided to a struggling carrier was necessary as it served as a tool of national development. However, most of these nations concluded that the large amount of public finance necessary to maintain their airline was not compensated by the economic benefits which the carrier generated. For developing countries, support for non-profitable airlines is an even larger issue, as it syphons public funds away from other, more imminent development needs, such as basic infrastructure in water, energy, health, or education.

Financing airlines depends on the availability of long-term capital, and on the private sector accepting the investment risk. In many developing countries, long-term capital, which stems for example from pension funds, is very limited or not available at all. As a result, airlines in these countries depend on foreign debt financing or on leasing arrangements. In most cases, these solutions are quite costly, and expose the borrower to foreign exchange risk. Opening-up capital of an airline to foreign investors is a far better solution. However, an equity investor often requires a high degree of control to manage risk, which implies that a majority stake in an airline is necessary to make important operational and financial decisions. Most countries, however, limit foreign ownership and control for non-nationals, which renders their investment risky.

There are numerous examples of air carriers in developing countries, which established some sort of joint-venture with other carriers, and eventually failed. In Africa, for example, Air Sénégal International established a joint-venture with Groupe Royal Air Maroc in 2001. However, the carrier struggled financially, and after the Government of Senegal increased its stake to 75 percent, the airline collapsed in 2009. This was followed by the establishment of Senegal Airlines in 2011, which was 64 percent owned by Senegalese nationals and firms, and 36 percent by the government. This carrier collapsed in 2016, after generating more than 100 billion CFA francs (US\$ 175 million) in debts. In 2018, the Government of Senegal launched yet a new carrier, Air Senegal, which operates two ATR 72-600, and ordered two A330neos with which it will be launch carrier in Africa. Another example is Kenya Airways whose long-time partner Royal Dutch Airlines (KLM) lost three-quarters of its shareholding value in the national carrier in a new ownership structure, which put the Government fully back in control. The change in ownership was necessary after years of struggling financially, and the necessity to refinance the carrier. Both examples have in common that ownership always remained to a large extent with the national public partner, which often resulted in the inability for management to make swift and tough operational decisions.

Examples of full foreign ownership of an airline in developing countries are rare. One such example is Air Corridor, which operated from 2004 to 2008 on domestic routes in Mozambique. The carrier, which operated two Boeing 737s, was entirely owned and financed by foreign investors. This was and still is allowed under the aviation laws of Mozambique. Even though the shareholders decided to discontinue operations after only four years, no public or private capital was lost in Mozambique, as foreigners provided all the financing. Another example of foreign ownership is TACV Cabo Verde Airlines. The carrier spun-off its domestic operations in a joint-venture called Binter Cabo Verde airline, which is majority owned by Binter Canarias, a Spanish operator. Its

international operations were restructured and rebranded Cabo Verde Airlines, and the Government of Cabo Verde is currently finalizing the sale of a majority stake to the Icelandic operator Loftleidir Icelandic.

Conclusion

Maintaining a so called “*Flag Carrier*,” which is majority owned by nationals or governments of developing or emerging countries, should be considered a model of the past. It tends to lead to losses and collapse due to poor management performance and continued interference by its [public] shareholders. The main shareholder may often not have a sound commercial agenda but may be driven by political considerations. The collapse of a major national carrier often drains domestic private and public funds and may even damage a country’s fragile financial sector. Furthermore, the funds lost may be badly needed in other sectors of the country.

Opening, say liberalizing ownership of an airline to the extent that a foreign investor can establish full control, has only advantages. First, it reduces the risk for the investor, which facilitates the decision to invest. Second, it prevents interference by outsiders, such as the public sector, in management decisions, which is key for managing a successful airline. And third, should the venture fail, it limits losses to the investor and its foreign investments, while the local financial sector may not be affected at all.

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