The Regulatory Environment for a Successful Airline Industry

Air transport is a major contributor to the world economy characterised by solid growth and in need of large capital injections. Global air traffic was estimated at 3.7 billion passengers in 2017 (about 10 million passengers and 105,000 flights daily) and is expected to double by 2035. This amounts to a growth rate of approximately 4.5%, which is about twice as high the growth rate of world GDP. To accommodate this growth, it is forecasted that about 37,500 new passenger and dedicated freighter aircraft at a value of US$5.8 trillion will be needed over the next 20 years, compared to the current fleet of around 26,000 aircraft. These already immense capital requirements are intensified by the need of airlines to fund other processes including investments in big data analytical systems, product customization and baggage handling. At present, the Rate on Invested Capital (ROIC) is approximately 10%, while the Weighted Average Cost of Capital (WACC) is about 8%. Yet, this is only an industry average across the 1,400+ commercial airlines operating today in almost 4,000 airports around the world on about 53,000 routes. At a micro level, airlines are characterised by mixed success. Out of the six different airline business models that currently exist (i.e. full-service network, low fare, charter, regional, all-business, all-cargo) two seem to be prevalent, namely network and low fare with a noticeable trend of hybridization too. Several low fare airlines seem to perform well in terms of recording high profits and increased market shares thus putting additional pressure on network carriers to reduce their cost base and improve their product offering to lure not only passengers but also investors.

Securing airline financing is faced by severe difficulties. As in every industry including other parts of the air transport supply chain, investors are expected to carefully balance expected returns against undertaken risks. Small markets and inability to reap economies of scale and scope may significantly discourage investors who also prefer to avoid funneling money into fragmented sectors characterized by hyper-competition. Moreover, complexities in the regulatory environment and legal uncertainties create further disincentives for investment. These regulatory barriers may limit market size; allow inefficient carriers to remain afloat; and raise investment risks from a legal perspective. In fact, these barriers may significantly inhibit financial/portfolio investors, while the inability to effectively control an airline may discourage strategic investors and deny any potential synergies emerging at a systemic airline level. Securing financing from governmental sources is also a difficult issue. In some regions, like in Europe, subsidizing airlines is forbidden for competition reasons. In several cases, governments have other priority sectors to finance rather than aviation.

Current attempts to circumvent the regulatory restrictions, whilst producing benefits, are not allowing the industry to realize its full potential. In particular, there seems to be empirical support that effectively dealing with ownership and control clauses either through circumvention or through non-application by governments may have a positive impact for the airline sector. The European Union has created new industry dynamics by substituting national with community ownership and control clauses thus encouraging inter alia the development of low fare airlines and allowing consolidation through mergers and acquisitions among network carriers. In Latin

America, LAN has successfully engaged in transnational acquisitions, creating among others LATAM, while Australia and New Zealand have also adopted a liberal stance vis-à-vis international ownership and control of their carriers. It is of interest also to note that even in parts of the world where national clauses in ownership and control are powerful, alternative market responses are also possible. In fact, the establishment of the three strategic alliances (i.e. Star, SkyTeam and oneworld) among network carriers about twenty years ago is certainly a success story in terms of creating a seamless global network experience. Similarly, low fare airlines such as Air Asia/JetStar and Air Arabia have managed to establish a sold presence in Australasia and Middle East/North Africa respectively by establishing local subsidiaries. Yet, all these circumvention efforts, irrespective of how successful they may prove in the short- and possibly in the medium term, add costs; raise complexity; and create legal uncertainties. Thus, they fall short of achieving the benefits of full integration offered by a relaxation of ownership and control clauses. Even the community clause introduced in the European Union may face legal challenges on international routes and markets when third (i.e. non-EU) countries are reluctant to accept it in the renegotiation of their bilateral agreements.

In any case, financing will flow to the airlines that investors believe are most likely to be successful. Successful airlines will be the carriers that have the lowest operating costs and/or the greatest ability to generate revenues. For example, airlines that can best use customer data to develop ancillary revenues may be able to gain market share, since the ancillary revenues will allow the carriers to lower base fares.

We see the future industry as one dominated by carriers pursuing cost leadership and/or revenue generation models that extend beyond national boundaries. These carriers will have the access to private financing necessary for fleet acquisition and will be able to gain market share over carriers that are more reliant on government financing. Clearly, the industry will require a shift from a nationally-based industry to a market that better allows for international growth. As an example, the European Union community carrier approach has allowed for the development of carriers with successful business models that offer consumers increased choices in air travel. This approach requires individual states to recognize community-wide ownership and control of carriers domiciled in the community of states. Other regional blocs could adopt similar approaches to facilitate the creation of successful carriers.

The successful airline industry that will emerge will be well-managed, attract investments, benefit travelers and drive GDP growth. Regulatory barriers, such as ownership and control, are obstacles to the movement towards this emerging industry, but are not insurmountable obstacles. The barriers can be lifted by governments or circumvented by airlines. However, the barriers may remain in certain regions of the world due to the political will and priorities of the countries in those regions. Ultimately a new multilateral approach to airline regulation will only emerge under the auspices of ICAO.

In conclusion

Decision makers should consider the benefits of being proactive in creating the environment that will allow airlines access to the capital necessary to effectively compete in the industry. This may include relaxing ownership and control restrictions within a regional context. States should consider

acting in concert with like-minded states to seek regional solutions to develop the environment needed to support aviation growth. Moreover, regional blocks should develop a dialogue with other regional blocs to facilitate aviation growth for the benefit of their populations and economies.

Although ownership and control may not be seen as a major problem to some governments and airlines given the advent of alliances and the other workarounds employed to facilitate air transport, it may be the case that the states that are proactive in developing policies that facilitate aviation growth will produce the winning airlines in the long run.

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