HERMES
AIR TRANSPORT ORGANISATION

# 2018_RECOMMENDATIONS

## OWNERSHIP AND CONTROL IN AIRLINES

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# OWNERSHIP AND CONTROL IN AIRLINES

Air transport promotes freedom of movement and brings people closer together. Yet the providers of this freedom, the airlines, operate in a cage of regulatory complexities second to no other international industry. One of these complexities is the "ownership and control clause" found in international air services agreements and most national (or regional – EU) legislations alike. Ownership and Control (O&C) restrictions, by the way applicable only to airlines and no other part of the aviation value chain (airports, manufacturers etc), have caused airlines some headaches:

First, the restrictions prevent cross-border mergers which are an important component to expansion, consolidation of operations and growth in any other industry. Airlines have had to make do with (awkward) structures of joint ventures and airline groups (even within the EU where O&C has been fully liberalised). These were the only ways to achieve economies of scale and expand networks to better accommodate consumer demands but do not replace or fully realise the potential and benefits of full mergers.

Second, the airline industry is highly cost intensive, characterised by cyclical demands, vulnerability to external shocks, and very low profit margins compared to other industries. These difficulties are aggravated by airlines' limited access to financing. For some airlines securing capital from foreign investors is vital to their survival. Limiting foreign investment also negatively impacts transfer of know-how to the airline business and may deprive passengers from stronger competition.

Considering all this, why stick to the O&C restrictions? What purpose do they still serve today? And what impact would their removal or liberalisation have on the industry, workers and consumers?

Some of the arguments put forward in favour of maintaining O&C restrictions are: the maintenance of traffic rights under bilateral air service agreements, providing a clear identity and link to a regime of national labour law and safety and security oversight, preventing "abuse" of traffic rights by nationals of States that do not have rights under the governing air services agreement.

The requested position papers will provide a good opportunity to evaluate these arguments as well as the impact of O&C restrictions on changes in the aviation market. For example, an interesting current development is the effort at international level to promote recognition and acceptance of clauses that focus on the principal place of business of airlines rather than their ownership and control. At the same time however, new business models based on reducing operating costs by outsourcing have arguably eroded the notion of principal place of business in the EU. What is the experience in other parts of the world?

Is O&C the only remaining element giving airlines an identity allowing a strong link to safety, security and social oversight? Must the liberalisation of O&C go hand in hand with the creation of a new concept of regulatory control? What would this look like? How can national and international authorities provide the best business environment for airlines while ensuring the highest standards in quality and safety to passengers?

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**2018 Hermes Leaders Forum**
Ownership and control in Aviation

**Conclusions**

Foreign inward investment restrictions in the aviation sector do not exist in any other economic activity. Even within the aviation industry, they apply only to a single stakeholder in the value chain, namely airlines, while they do not apply to airports, ground handlers, IT providers, caterers and other concessionaires.

These restrictions are often “justified” by factors other than economic or based on misperceived effects on areas such as safety, security, defence, labor/social.

Why are those political concerns not justified in reality?

Safety, security and defence regulations and requirements would remain and apply under national jurisdiction, irrespective of the airline ownership structure.

Inward investment strengthens the airlines economic health, thereby enhancing and amplifying employment prospects and making airlines more attractive for future generations to work in.

On the other hand, there is a multitude of strong economic reasons to relax ownership and control restrictions.

New finance injection opportunities will allow new airlines to enter the market and incumbents to expand and improve their products, all to the benefit of the travelling public including enhanced connectivity, better value for money, higher convenience resulting from wider variety of service choice, greater ability to boost economic development, with positive externalities to all involved stakeholders.

Aviation facilitates globalisation and yet the industry is unjustifiable prevented from having free access to trans-border funding investment opportunities.

Strong consideration should be given to a step-wise relaxation of existing restrictions in the interest of a healthy and sustainable air transport sector not least to the direct advantage of consumers.

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POSITION PAPER

R18-PP/01
25/4/18

# Ownership and control in airlines

(Presented by Arab Air Carriers Organization - AACO)

AACO member airlines have supported the Agenda for Freedom initiated in Istanbul in 2008 and endorsed in Montebello in 2009. Hence, AACO supports removing restrictions on the ownership and control in airlines. At the same time, we understand that removing such restrictions cannot happen overnight; therefore, we believe that possible avenues may be taken that would allow for the gradual removal of restrictions on ownership and control in airlines, and that would allow new entrants to have lesser restrictions paving the way for all airlines to have no restrictions at all.

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# Liberalization of Ownership and Control - How quick and how far for Africa

(Presented by Airlines Association of Southern Africa - AASA)

Liberalization of the skies and its evolution from the regulated environment of the 1944 Chicago Convention, continues to be one of the hottest discussion topics and the often expressed solution to the long term sustainability, profitability and success of the global aviation industry. Many States or regions within the USA, Europe, Asia, the Gulf, South America, have liberalized to varying degrees, with Africa probably making the least progress in this regard. Liberalization has been achieved largely through:

- Unlimited third and fourth freedom frequencies,
- multiple designation of airlines,
- free and fair competitive pricing,
- use of sixth freedom traffic rights,
- granting of fifth freedom rights (although this is still a contentious issue in several regions, not liberally implemented, and normally the subject of negotiation between the interested parties), and
- the liberalization of ownership and control, the subject of this discussion.

Although liberalization is taking place between some States and within some African regions, the agreed implementation of a continental wide policy envisaged through the Yamoussoukro Declaration of 1988, thereafter the Yamoussoukro Decision (YD) of 1999, and now the recently launched Single African Air Transport Market (SAATM) of 2018, has not been realized.

The above perspective provides the context as to where Africa finds itself within the initiative of global liberalization of air transport including ownership and control. At the 39th ICAO Assembly held in 2016, there was no shortage of encouragement and the call to liberalize air transport. The Air Transport Regulation Panel (ATRP) was mandated to continue with its work in this area as well as ownership and control, where the ATRP was encouraged to look at several options. One such option is the ATRP considering bringing in principal place of business and effective regulatory control as terms that could substitute designation based on nationality of airlines. It was noted that only a select number of States, mainly from South America, openly pushed for the removal of ownership and control restrictions whilst many States varying limits of foreign ownership of international airlines.

The extent of liberalization of ownership and control is therefore issue. Most States have policies limiting foreign ownership percentage to maximum levels ranging from 25% to 49% for international airlines. This model has worked in several jurisdictions in Australasia, Europe, South America and in Africa. For example, Ethiopian Airlines has a 49% share in Malawi Airlines and KLM has a 7.8% interest in Kenya Airways (reduced from a previous 26% stake). However, widespread ownership investment has not taken place, probably due to investors not being able to take a majority stake in the airline. Without that control, investors could have concern over the security of their investment. Whilst there may be limited foreign investment in airlines as noted

above, certain jurisdictions which advocate open skies, have not liberalized ownership and control, for example, the USA (maximum 25% foreign investment), the Gulf and some Asia jurisdictions which only permit minority ownership by foreign investors in their international airlines. From a World Economic Forum report 2016, only Chile was noted as allowing 100% foreign investment in its airlines.

The benefits for liberalization of ownership and control are clear. Taking Africa as an example, many African airlines are undercapitalized, and require financial restructuring and significant investment to implement turnaround strategies. Removing restrictions on ownership together with effective control in the hands of a controlling interest would open the doors for investment, with opportunities for possible mergers and acquisitions across Africa, creating a base for the necessary growth and development of the industry.

Why is there a reluctance to relax ownership and control restrictions? The national pride and desire of States to retain control their national carriers is probably at the heart of retaining the status quo. In Africa, the YD does make provision for relaxing ownership and control conditions, but with renewed hope from the launch of the SAATM, States want to strengthen African Aviation through growth and development of an integrated network, and want their airlines to participate in this process. Foreign investors will invest in airlines based on commercial and business principles, not on sentiment. Long term commitment may not be guaranteed and this carries some risk for long term investment support. On this basis, some African States are probably reluctant to relinquish control to foreign interests at this stage.

What is the way forward? ICAO cannot dictate policy on international aviation to States, but makes recommendations to States. To change policy on issues such as ownership and control, States need to be convinced of overriding benefits to the State to change their views and policy on ownership and control. Over the past 30 year journey of the Yamoussoukro Declaration, the YD and now the SAATM, numerous studies have shown the benefits of liberalization, but for several reasons, this has not been implemented. These include some States being concerned at the perceived potential negative impact of liberalization on their airlines and a fear that larger airlines will dominate a liberalized market. Resolving this impasse will need to be dealt with, and then ultimately, complete relaxation of ownership and control conditions will remain the final hurdle to full liberalization particularly in Africa.

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R18-PP/03
14/8/18

# Ownership and control in airlines

(Presented by European Airline Association - ERA)

***ERA's comments to the proposal of Hermes for launching a call for position papers on Ownership and Control Rules of EU air carriers:***

**About ERA:**

ERA is a trade association currently representing 51 airlines and 140 associate and affiliate members covering the entire spectrum of Europe's aviation sector - airlines, airports, manufacturers and suppliers.

ERA protects its members' interests by lobbying the European regulatory bodies on policy, safety and technical matters and promoting the social and economic importance of air transport and its environmental commitments.

ERA's airline members keep Europe connected; transporting more than 70m passengers per year on over 1.15 million flights using a mix of jet and turboprop aircraft.

**Comments:**

1. The European Regions Airline Association (ERA) welcomes Hermes' initiative, to call for comments or position papers on the subject of Ownership & Control (O&C). We acknowledge the discriminatory applicability to airlines vs other businesses within the aviation industry and vs other industries.

2. ERA members support any attempt to bring clarity to authorities and non-EU investors as to how the Commission interprets the O&C rules, based on the practice adopted in previous assessments carried out by the Commission and taking into account the interpretative guidelines developed by EU national civil aviation authorities. The EC guidelines seem to meet this objective and reflect the current state of play regarding the O&C rules.

3. The airline industry is a capital intensive business that operates on small margins. As such it continually needs investment and new capital. With the prospect of often limited returns, the pool of potential investors is often small and regulatory restrictions to foreign investment in the airline business (which by definition is a global business) artificially limits the potential

of non- EU investors to put capital into European businesses. This in turn restricts Europe's competiveness versus some non-EU operators.

4. Relaxing the rules will no doubt bring more "fuel" in our business, promoting jobs, routes and investment in the European airline industry. A European aviation industry that is more open to foreign investment would be fully consistent and in line with other industries (e.g. the financial and banking industry, pharmaceutical industry, etc.). Persevering with a protectionist regime on O&C would simply and artificially isolate the European aviation sector from current and future global business opportunities.

5. ERA would welcome the EC's acceptance of the importance of attracting investment from third countries through the reduction of restrictions in relation to foreign investment and market access.

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HERMES
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POSITION PAPER

R18-PP/04
20/8/18

# Ownership and control in airlines

(Presented by International Air Transport Association - IATA)

- **Why, to your opinion, are there restrictions in aviation sector, whereas they do not exist in other transport sectors (such as maritime or railway)?**

First, ownership restrictions are not unique to the aviation sector, as the question assumes. In the marine sector, for example, domestic shipping in the U.S. is restricted to vessels owned and operated by U.S. citizens. Similar restrictions on the ownership of vessels can be found in other countries. Foreign investment is frequently restricted in other sectors as well, such as communications and energy.

In international aviation, there are two sources of these restrictions: (i) national law, and (ii) bilateral air services agreements. Historically, national law restrictions are attributable to national security concerns and a desire to ensure the availability of air transportation adequate to the country's requirements. (Foreign investors may be seen by smaller, developing economies as "fair weather friends" who cannot be relied upon to maintain a country's essential connectivity in times of economic hardship.)

The restrictions were typically incorporated in bilateral air services agreements to prevent "free riding." If Country A makes certain destinations available to the airlines of Country B in an agreement with Country B, it will not want an airline of Country C to enjoy those benefits merely by investing in a Country B airline.

The restrictions are likely maintained today for a number of other reasons linked to trade policy, labor relations, lingering national security concerns and so on. One must also not discount the importance of national pride in some markets.

Some governments have taken a proactive stance on loosening foreign ownership restrictions. A domestic Australian airline can, for example, be 100% owned by non-Australians. This is, however, a very rare exception. And it does not extend to international operations.

- **Is ownership and control an issue for IATA airlines?**

Quite frankly, it's not. There appears to be no dearth of capital available to airlines from domestic sources, which means that the airlines have not found a compelling need to campaign for a change in national law that they know would be controversial in many countries. Moreover, the advent of immunized joint ventures among airlines and global branded alliances is delivering most if not all of the consumer benefits (seamless, global connectivity; robust competition on a global scale) that cross-border mergers, if permitted, would deliver. In short, because the restrictions on foreign

investment in airlines do not appear to have impeded the industry's growth or development, the issue is not on IATA's agenda.

- **Do you consider current restrictions regarding ownership and control in the aviation industry adequate?**

If the purpose of the restrictions is to retain national ownership, then they are doing what they were intended to do. Again, within that framework, they have also allowed for the development of alliances and joint ventures which gives airlines the flexibility to join forces where necessary to serve the needs of their customers.

- **What could be the benefits of fully relaxing foreign investment in airlines?**

Access to global capital markets is often cited as a benefit. While that is appealing—indeed taken as normal for most industries—I don't see a crisis in access to capital that would compel governments to seek this policy solution. The fact of the matter is that the global airline industry is doing rather well financially. Consumers have cheaper fares than ever. The global network is denser that it has ever been. And more people are flying—some 4.1 billion passengers are expected to board aircraft this year. So I am not sure that governments will see a compelling reason in that very good news story to seek change.

- **Do you believe in the creation of truly global airlines?**

No airline can serve all its customer needs by itself. The first work-around is the global alliance structure. It allows airlines to work together to ensure smooth journeys for travelers. Immunized joint ventures take that up a notch by allowing airlines to work together to develop specific markets in a very efficient way.

On the cargo side, the integrators are probably the closest that we have to truly global airlines. Cargo is absolutely vital to national economies, but somehow it does not carry the same national emotional attachments. That has allowed these airlines to go further towards a global airline model with logistics hubs dispersed globally and Seventh Freedom rights allowing them to operate far more efficiently. But even at that, they still face restrictions and rely on partnerships as efficient work-arounds.

- **Would it be sufficient for a few States to remove ownership and control restrictions between themselves to allow their airlines to fly globally? Does it not require ICAO to work on the topic to ensure that relaxation of ownership and control between States are fully recognized and accepted by all States?**

You are referring again to the restrictions that appear in bilateral agreements. That is essentially what has happened within the EU. The benefits of the European common aviation area are there for all to see. ASEAN is, to a certain extent, replicating that with its open aviation area---but without addressing ownership and control. There are similarly interesting developments taking place in Latin America (e.g., the LATAM and Avianca groups of airlines).

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Beyond what has happened to date, nothing prevents a state from deciding not to enforce the nationality requirements in a bilateral agreement where the other state has liberalized its national law to allow foreign ownership and control of its domestic airlines.

If governments want to broadly pursue changes in ownership and control rules, ICAO as a whole, or its regional groupings would certainly need to play a role. But let's remember that ICAO is a membership organization of states, and there does not appear to be anything close to a consensus among states on the question of foreign ownership. And, in the current climate—financial sustainability among airlines at the global level and a general trend of more protectionist policies—I don't see the impetus for governments to move this forward.

- **Removing the ownership and control rules could result in worldwide consolidation of the airline industry. Do you think this would occur? If so, what do you see as the potential benefits and pitfalls of this potential consolidation?**

Experience is the best teacher. The U.S. domestic experience shows us that a fragmented industry in a single very large market benefits from consolidation. And thanks to deregulation consumers continue to enjoy robust competition among large and small carriers. The European experience demonstrates that, given the opportunity of relaxed ownership and control rules, airlines will pursue consolidation in various forms. And that has not stopped new entrants, particularly LCCs, from intensifying competition. In Latin America, trans-national airline groupings have been the solution reviving aviation in a region that has had more than its fair share of challenges.

Bottom line: I doubt that relaxing the ownership and control restrictions would result in a worldwide consolidation of the industry. And even if it did, the products of that consolidation could look forward to strong challenges from existing new model airlines and new entrants.

- **Some states argue that there is a public service role for air carriers; for example, serving remote communities and promoting trade and tourism. There is concern that that the removal of ownership restrictions would impede this public service function. How would you respond to this concern?**

Airlines are called on to perform public service functions in many markets. Business always works best when it operates on purely commercial terms. But I don't see this discussion as being either a major blocker or a major proponent to any reconsideration of ownership and control rules.

A recent study of the U.S. market by FlightGlobal should be a source of reassurance to anyone concerned about consolidation. The study notes that, despite the consolidation that has taken place there, smaller airports throughout the U.S. have experienced new levels of growth in the past few years due to the advent of LCCs and ULCCs, and that the larger airlines are responding by increasing their own regional services.

- **Removing the ownership and control restrictions may require the redrafting of hundreds of air services agreements. How would the regulatory structure for the aviation industry change with the removal of the restrictions? Would the current bilateral system be replaced by a multilateral system? What are the advantages and disadvantages of reworking the aviation regulatory structure?**

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The only provision in a bilateral air service agreement that would be implicated by a removal of ownership and control restrictions is the so-called nationality clause, which enables, but does not require, either party to revoke the permission given to an airline of the other party when that airline is not substantially owned and effectively controlled by nationals of the other party. In other words, it is a "permissive" provision, meaning that each state has the unilateral discretion to waive its enforcement. Bilateral air services agreements therefore are not an impediment to a removal of ownership and control restrictions, nor would the removal of such restrictions necessarily require overhauling the current regulatory structure.

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# Airport ownership through the lens of ACI World

(Presented by Airport Council International - ACI)

Until relatively recently, nearly all major commercial airports were government-owned and government-operated, primarily on a cost-recovery basis. Initially, deregulation in the aviation sector predominantly focused on airlines, although several countries have also divested their airports and air traffic control services.

The evolution of ownership patterns in the airport sector reflected the changing government attitudes towards airports. The view that airports are a quasi-public utility to be run and financed by local or central government has progressively been replaced by the view that airports could be run as commercial enterprises.

ACI does not prescribe any specific type of ownership model, appreciating that a range of ownership models have proven to be effective in achieving the value an airport brings to a community or state. Local circumstances vary but ownership and governance structure should allow the airport operator flexibility in its business and ensures that the interests of passengers are protected by the application of sound business and operating principles.

Realistically, however, in an economic climate where States are increasingly cutting government expenditures to reduce the growing debts that hang over many of their economies, the continuation of government financing and full ownership of airports may not be sustainable and in many cases, is not necessary. In addition, the surge in air transport demand in many jurisdictions is outstripping the infrastructure available to accommodate it and non-traditional sources of capital and implementation capacity may be available.

**A brief history of privatization**

In chronological terms, the bifurcation point occurred in the mid-1980s, when a White Paper on Airports Policy was published in the UK. It emphasized the government's commitment to non-subsidization of airports, arguing that (a) airports should operate as commercial undertakings, and (b) airports policy should be directed towards encouraging entrepreneurship and efficiency in the operation of airports by providing for the introduction of private capital. This position materialized shortly after the full-scale divestment of the former British Airports Authority. Since then, the genie got out of the bottle and the world witnessed over three hundred successful privatization transactions resulting in full or partial transfers of over six hundred airports to the private sector.

However, the largely overlooked trend that preceded and facilitated privatization was corporatization – the process of transforming government units and the associated public assets into corporations, mostly with independent legal status, financial and operational autonomy. Corporatization was viewed as a means to improve efficiency of service delivery and often as a step towards a potential privatization. Corporatization, as an interim step or a transitory period, aimed at putting an airport enterprise on commercial rails to achieve greater cost control and efficiency. These encompassed relying on maintenance and other service provisions by governmental entities, not accounting for and hence not recovering their respective costs; having inadequate or no provision for depreciation; excessively depending on government's grants and subsidies and so on.

That's how we can see the bigger picture of the airport ownership issue and the entire historical context for the privatization phenomenon.

Nevertheless, it is important to mention that still nowadays most airports around the world are directly owned and operated by the public sector, most often via some kind of an airport authority. The rationale behind such scheme is retaining ownership at large but allowing management and operation of airports with greater autonomy at an arm's length from the government.

**Policy choices – Creating fertile grounds for private investment**

The air transport sector has been growing in line with the overall economy and even at an accelerated pace in the recent years. Just like with any other sector, the question of economic efficiency and competitiveness became of paramount importance. That is why corporatization and privatization were focused on establishing airport administrations with greater professional skills to radically improve short-term performance but also to undertake long-term plans of expansion, development and sustainable operations. The airport sector is competing with the other infrastructure as well as non-infrastructure sectors for the best human capital as well as finances. In the case of financial capital, the industry demonstrated that it is relatively easy to get the right expertise and high professionalism even for corporatized government-owned airports. This is very much the case for the developed Asia, North America as well as other parts of the world. However, capital is more difficult to attract since it requires competitive returns, which are measured on a large scale given the size of airport infrastructure. The real economic question is why investors should put their money into airports, rather than IT, for example, in case the returns are higher in the latter sector? What would make airports a lucrative investment opportunity? The stumbling block in this entire process is well-known, it is economic regulation.

Privatization is one way to fund needed infrastructure investment. Privatization is one option for governments—they may choose not to privatize their airports and fund airport investment themselves. The decision whether to privatize is subject to social, economic, political and other factors unique to each nation and each airport and is the sole prerogative of the government that owns/operates the airports.

The most important theme to understand is the current context of facing a capacity crunch in various parts of the world. Many airports, regardless of their ownership structure, require more capital investment to accommodate growing passenger and cargo traffic. However, the world now has more than 30 years of experience with airport privatization, which testifies to the fact that it is a viable option for sustainable infrastructure development. Privatization of airports is an accomplished fact; it is a robust trend supported by facts. Out of 100 busiest airports in terms of passenger traffic throughput, over a half have some form of private sector participation, with some 43% of global passenger traffic handled by airports with private sector participation.

Indeed, one can notice that these are mainly large airports that attract private investment, except for privatized networks where small airports also benefit from the private capital injections. Big challenges reflect big opportunities, while high traffic throughput ensures economic viability of an investment.

ACI has released two Policy Briefs in two years which touch upon the subject of ownership and private sector participation, a reflection of the relevance in the context of a commercial aviation capacity crunch and uncertain future of sustainable infrastructure development. If we look at the US – the largest economy in the world generating over USD 18 trillion annually in Gross Domestic Product, we will also note that it requires over USD 4 trillion in the short- and medium-terms to bring its infrastructure to an acceptable standard. The lesson that we can learn from here is very

simple: you shouldn't neglect your infrastructure for too long; you need to plan and build today to ensure economic growth in the future.

In this regard, the airport sector is no different from any other infrastructure – be it roads, seaports or basic utilities such as water and electricity supplies. The demand for air transportation is growing twice as fast as the global GDP. What differentiates airports from the other infrastructure in terms of commercial attractiveness is the fact that airports are a two-sided business, with a good balance of aeronautical and non-aeronautical service lines. This is an important fact in the context of airport ownership, as the inherently low returns on the aeronautical side can be offset by higher profit margins on the commercial side of the business. Even with the increased competition, a constant passenger traffic throughput is a lucrative opportunity to generate money through an array of services, such as retail, parking, dining and so on. This is what many private companies have in mind when it comes to investing in airports.

**Contemporary approaches to privatization**

As for the actual mechanics of privatization, the recently issued Policy Brief - *Creating Fertile Grounds for Private Investment in Airports* highlights the most important points. First of all, governments need to identify clearly what they are seeking to achieve with privatization – be it efficiency in operations, building new infrastructure, minimizing public expenditure or generating revenue for other sectors of the government. The specific policy objectives should guide the choice of privatization model, such as a management contract, a Build-Operate-Transfer (BOT) concession or trade sale or lease. Second, any successful privatization will depend whether a government ensured clear and consistent legal framework prior to the privatization process, complying with national legislations as well as international policies. Third, privatization models should include incentives for investors. From a regulatory perspective, these can encompass the till regime, which accounts for the treatment of non-aeronautical revenues – with hybrid and dual tills being more desirable for investors, but also determining the right level of the weighted average cost of capital (WACC) to ensure fair returns to both equity- and debt-holders.

If privatization processes are well-planned, with a win-win paradigm in mind, then not only the government will achieve its objectives and the private investors will generate fair returns, but also the wider economic benefits will be attained. These is referred to the catalytic effects of improved connectivity on trade, tourism, foreign investment and so on that eventually impact the national economy.

Privatization or private form of airport ownership is not a panacea for a particular set of challenges present in the airport business. Any form of ownership has its merits, and we see equally successful public and private airports. The issue of ownership, however, becomes more heated in the context of a capacity crunch and constrained public budgets: in certain cases, governments just do not have enough money to invest into the airport infrastructure to meet the growing demand. That is when the private sector can shoulder the required large-scale finances as well as bring the efforts of the private sector, such as efficiency, innovations, ingenuity and entrepreneurship.

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# Ownership and control in airlines

(Presented by European Civil Aviation Conference - ECAC)

Replying to the call for a position paper on the Ownership & Control (O&C) of airlines by Hermes Air Transport Organisation, the ECAC Economic Working Group decided to contribute to the discussion with a position paper to share the outcome of the discussions held on this interesting issue within the Economic Working Group and the European ad hoc Coordination Group.

Ownership and control of the airlines is one of the key aviation challenges that needs to be addressed under the economic regulation perspective.

As mentioned in the background information provided by Hermes, air transport promotes freedom of movement and brings people closer together. According to the IATA Director General, aviation is the business of freedom. Still, this freedom for airlines finds a constraint in the ownership & control clause included in the bilateral and multilateral air services agreements. Airlines are the only stakeholders of the aviation industry that are subject to such regulatory restriction.

**Liberalisation**

Air transport liberalisation started with the US deregulation in 1978. Almost ten years later, Europe launched a gradual removal of bilateral restrictions. In 1987, ECAC developed two international agreements to promote a partial liberalisation of capacity and tariffs. In December 1987, the process towards the full liberalisation began within the European Union (then the European Community) with a First Package of measures. In 1992, the third and last package of measures was adopted. Based on this regulation, starting from 1 April 1997 EU carriers were authorised to operate between any two points, including domestic destinations (cabotage), within the EU. The European Union's internal aviation market was completely liberalised in terms of traffic rights, tariffs, capacity and commercial opportunities. In 2017 the European Union celebrated 25 years of the EU internal aviation market which has revolutionised air travel within the EU and generated very significant economic benefits for EU citizens and new opportunities for the aviation industry.

The liberalisation led to more air services, new airline business models and enhanced competition with lower fares as a result. Air travel changed drastically for passengers, operators and regulators.

The former flag carriers, fully or largely state controlled, have started a transformation process.

However, the liberalisation and the privatisation were, and still are, facing the limit of the ownership and control provisions in case of third country investment.

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**Ownership & Control**

European regulation on internal aviation market introduced the concept of community air carrier replacing the national ownership and control clause with the concept of European Community air carrier[1].

Notwithstanding the replacement of the national majority ownership requirements with the EU majority ownership clause, the O&C majority system was and is still applied at European level which has been a big step forward.

In 2008, the European Commission recast and consolidated the previous three EU internal aviation market regulations into one single regulation - the Regulation (EC) No 1008/2008 on common rules for the operation of air services in the Community. This regulation, that currently regulates the internal EU aviation market, refers to Community air carrier[2], providing for EU ownership and control. The EU majority ownership requirement can be waived through EU comprehensive agreements with partner countries which would allow for foreign majority ownership and control of EU airlines and vice-versa.

The European Commission challenged the nationality clause for designation applied by EU Member States in their bilateral air service agreements with third countries and in 2002, the European Court of Justice ruled that bilateral aviation agreements of Member States with third countries were in breach of fundamental provisions of the EU Treaty ("freedom of establishment").

Based on the Court's judgement, the European Union started developing an external aviation policy and in order to restore legal certainty to the bilateral agreements negotiating the so-called Horizontal Agreements with partner countries which aimed at replacing the national designation clause with the European one. At the same time, EU Member States had to start negotiations with third countries in order to replace the national designation clause with the EU designation clause which was developed on EU level

Since 2003, European Union started negotiations for a Common Aviation Area with neighbouring countries and negotiated comprehensive agreements with key international trading partners. In some of these agreements there are clauses allowing for fully liberalised investments in the carriers of the other Party.

However, some of the major international partners continue to apply more restrictive provisions for O&C of national air carriers.

For instance, Canada and the US limit foreign investments in national airlines to 25% (voting rights) of ownership and effective control, with strict requirements on the effective control. Mexico have recently raised the cap for foreign investments to 49%. China limits it at 35% and Brazil at 49% - a recently proposed increase to the full liberalisation has been rejected by the Congress. India is at 49%, with restrictions on Air India. These restrictions have been recently lifted in order to promote the privatisation of the national carrier. Japan imposes the limit of 33% and Australia

restricts to 49% the foreign investments in international Australian air carrier. Chile has no limit on foreign investments and applies the *"principal place of business"* concept.

The ECAC Economic Working Group regularly monitors the developments of market access among ECAC Member States and conducts surveys. The results of a 2017 survey showed that among ECAC Member States barriers to market access still exist and that the national ownership and control clause is one of the limitations to the liberalisation. In December 2017, the Directors General of ECAC Member States considered these results and recognised the need for an evolution of the ownership and control concept, preferably at ICAO level.

The limits of the model clearly emerged during the economic crisis. Bankruptcies and takeovers were rare in the air transport sector during the era of national flag-carriers. In recent years, such developments are more common and are reshaping the market and the competition landscape. The consolidation, as it already happened in the US, is gaining momentum in Europe as well as in other regions.

Mergers and takeovers are the main response from airlines facing financial difficulties that has affected the aviation sector in recent years. Airlines are participating in the capital of other carriers, in some cases creating international and cross-border groups of carriers.

The International Airlines Group's as well as Lufthansa's acquisitions are major examples of this. The exchange of shares completed between Air France/KLM, Delta Airlines and China Eastern is another example of a consolidation taking place among members of an alliance (i.e SkyTeam).

This consolidation is underway in Europe, but also at the international level. However, the limits imposed by Ownership and Control rules included in domestic legislation and in the international Air Services Agreements still restrict the possibility of majority ownership and control of foreign investments in air carriers.

**Challenges**

As it emerged from the ECAC/EU Dialogue on aviation financing held in June 2017 in Rome, there is capital available to be invested in the sector. However, the legal framework should facilitate and support these developments.

There is a clear trend in lifting existing limitations to the ownership rule in order to attract investment in airlines. Some countries have replaced the O&C clause with the concept of *"principal place of business"*. However, there are no common and agreed criteria to define the *"principle place of business"* at international level.

A new O&C concept could entail the full liberalisation of ownership and effective control, and keep the "regulatory" control with the designating State to ensure safety and security.

It must be noted that a liberalisation of Ownership and Control, if linked to a principal place of business requirement in the country concerned, represents no threat to employment and fiscal revenues in that country.

However, liberalisation of the O&C may be effective only if recognised at international level (e.g. ICAO).

Any liberalisation on bilateral and/or multilateral basis may prevent the air carriers from operating to/from third countries. Even the EU designation clause is not fully recognised and applied by all third countries – yet by a large number of them. Consequently, European Member States can designate to operate air services under bilateral air service agreements with third countries, only the air carriers whose majority ownership is by nationals of the Member States, unless the third country have accepted the EU designation clause or modified the ASA to allow for principle place of business. It must be noted however that most air service agreements do accept such designation.

The same will happen in case of a full liberalisation of the ownership with another country on a reciprocal basis (e.g. a European carrier owned by US nationals to operate services to/from India) unless the third country accepts to waive the national ownership and control clause for designation.

Dealing with ownership and effective control rule at international level is the only real solution.

ECAC member States supported a liberalisation in O&C already in 2013 at ATconf/6 presenting two working Papers on the subjects.

Consistently, ECAC Member States are supporting and promoting the development of a stand-alone convention for the liberalisation of foreign investments in air carriers within the ICAO Air Transport Regulation Panel (ATRP), as the first and essential step towards liberalisation of market access.

At the last meeting in July 2017, ATRP discussed and agreed on the possibility to develop a stand-alone convention on foreign investment in air carriers, while continuing the discussions on a multilateral agreement on liberalisation of market access. A draft convention on foreign investment has been developed by the European members of the panel and presented at the Panel Working Group meeting held at the beginning of April 2018.

Some states still have concerns about effective control and would prefer to retain the possibility to deny the authorisation of carriers owned by an investor from certain countries. European members of the panel drafted proposals for clauses addressing this and other concerns, aiming to develop a text to be agreed upon by as many states as possible.

In order to be effective, the convention on foreign investment should be signed by as many states as possible.

Some key aspects of the convention need to be further developed and clarified, however the discussions have started and will engage the states at the next meeting of the Air Transport Regulation Panel.

Liberalisation of O&C of airlines remains therefore one of the main challenges to be tackled by regulators at international level in the coming years.

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The European Commission has started an evaluation of Regulation (EC) No 1008/2008 which contains the provisions of ownership and control to assess whether the current rules are fit for purpose. Therefore, the discussion on the relevance of the existing rules is very timely.

[1] *Council Regulation (EEC) No 2408/92 of 23 July 1992 on access for Community air carriers to intra- Community air routes*, in the Article 2 b provided that:

"b) 'Community air carrier' means an air carrier with a valid operating licence granted by a Member State in accordance with Council Regulation (EEC) No 2407/92 of 23 July 1992 of licensing of air carriers".

*Council Regulation (EEC) No 2407/92 of 23 July 1992 of licensing of air carriers,* in article, paragraph 1 and 2 provided that:

"1. No undertaking shall be granted an operating licence by a Member State unless:

(a) its principal place of business and, if any, its registered office are located in that Member State; and

(b) its main occupation is air transport in isolation or combined with any other commercial operation of aircraft or repair and maintenance of aircraft.

2. Without prejudice to agreements and conventions to which the Community is a contracting party, the undertaking shall be owned and continue to be owned directly or through majority ownership by Member States and/or nationals of Member States. It shall at all times be effectively controlled by such States or such nationals".

[2] "Community air carrier' means an air carrier with a valid operating licence granted by a competent licensing authority in accordance with Chapter II".
*Chapter II Article 4 - Conditions for granting an operating licence -paragraphs a and f*:
"An undertaking shall be granted an operating licence by the competent licensing authority of a Member State provided that:

(a) its principal place of business is located in that Member State;

(f) Member States and/or nationals of Member States own more than 50 % of the undertaking and effectively control it, whether directly or indirectly through one or more intermediate undertakings, except as provided for in an agreement with a third country to which the Community is a party.

- END -

HERMES
AIR TRANSPORT ORGANISATION

POSITION PAPER

R18-PP/07
31/8/18

# Response to Hermes – Air Transport Organisation call for position papers on ownership and control in airlines

(Presented by Civil Air Navigation Organisation - CANSO)

## Introduction

CANSO – the Civil Air Navigation Services Organisation – is the global voice of air traffic management (ATM) worldwide. CANSO Members support over 85 percent of world air traffic. Members share information and develop new policies, with the ultimate aim of improving air navigation services (ANS) on the ground and in the air. CANSO represents its Members' views in major regulatory and industry forums, including at ICAO, where it has official Observer status. CANSO has an extensive network of Associate Members drawn from across the aviation industry.

Hermes – Air Transport Organisation has launched a call for position papers on ownership and control of airlines.

CANSO does not believe that it is appropriate for it to comment on ownership and control of airlines, beyond stating that healthy, responsible and well-governed airlines are obviously in the overall interests of the aviation industry and hence to all stakeholders who are part of the aviation value chain or who benefit from the many economic, social and other benefits of aviation.

However, as ATM is in integral part of the aviation value chain, CANSO believes that its position on ownership and control issues for air navigation service providers (ANSPs) and the principles involved may be of interest to Hermes and may help to aid understanding of options for airlines.

## Background

Article 1 of the Chicago Convention establishes that "every State has complete and exclusive sovereignty over the airspace above its territory". States therefore have exclusive competence to exercise their legislative, administrative and judicial powers within their national airspace (over land and over the high seas). BUT States are not obliged to provide air navigation services within their "own" airspace, only that when they choose to do so, those air navigation services must comply with the ICAO (International Civil Aviation Organization) Standards and Recommended Practices (SARPS).

The conventional and generally prolific 'model' in ATM is for each State to have its own air navigation services provider but these are operated under a wide range of operational formats. Considering the diverse circumstances involved, ICAO does not recommend one organizational format over another, but rather it provides guidance to States by describing relevant aspects of each format. However, keeping in view the experience gained worldwide, ICAO recommends that governments may wish to explore the possibility of establishing autonomous authorities to operate their air navigation services where this is in the best interests of providers and users.

CANSO believes that ANSPs should be empowered by their States to operate as normal businesses in the delivery of safe, environmentally sustainable, efficient, cost effective and seamless services that are best able to respond to the needs of their stakeholders – in particular their customers. Further, this empowerment will enable ANSPs to employ their choice of vehicles to improve their performance, e.g. enter into agreements with other ANSPs and other industry partners to create regional efficiencies.

While autonomous and commercialized ANSPs have been established in many States around the world, financing is still an issue in other States. It is important to consider the importance of further promotion of ICAO policies on the establishment of autonomous ANSPs, including separation between regulatory and operational functions. Furthermore, States should review the commercialization experiences to date and discuss its influence on the performance of ANSPs, with particular attention to governance and management structures.

CANSO believes strongly in

- Harmonisation of regulations and standards in aviation
- Separation between regulation, oversight and service provision
- A regulatory framework with a performance-based approach
- Governance and business models for ANSPs that are also performance-based to produce the best outcomes for stakeholders, in particular passengers and customers.

**Harmonisation of regulation and standards**

In order to deliver effective air navigation services, it is important for regulations and standards in aviation to be harmonised. The modernisation of ATM infrastructure requires the right regulatory framework. New technologies such as remote/digitised towers and space-based ADS-B are transforming global ATM performance. A global industry requires global standards that will further help achieve the goal of harmonised airspace worldwide. CANSO is therefore asking ICAO to advise standards organisations that their proposals should follow a standard approach to ensure global interoperability. This will lay the foundations on which a strong regulatory landscape can be built.

**Separation between Regulatory and Service Provision Functions**

The essential characteristics of a separated function include

- Separate lines of accountability between regulation and service provision
- Different lines of management and operational authority
- Individual control mechanisms within each body.

They may also include:

- Separated funding mechanisms
- Divided resource allocation
- Non-governmental insurance backing
- Removal of service provision budget from public funds
  Shareholder membership of the air navigation service provider.

The successive steps for effective separation are:

- Clearly defined objectives for the service provider
- Clear definition and understanding of roles and responsibilities

- Appropriate governance structures
- Clearly defined coordination processes between the regulator and the service provider
- Separation of budgets and budgetary freedom for the service provider
- Empowerment of service provider management
- Accountability of management.

**Performance-based regulation**

The ATM industry is often faced with prescriptive, inefficient and conflicting regulations that add cost and undermine the ability to innovate and perform effectively. Regulation must be sufficiently flexible to allow the safe introduction of new technology (e.g. remote towers) as well as new entrants to airspace such as drones. A harmonised and consistent approach to regulation in ATM globally is therefore required.

CANSO is calling for regulatory approaches that emphasise what must actually be achieved, focusing on agreed, measurable outcomes and placing more of the responsibility and accountability with the service provider in how the performance requirements will be met. But there is no 'one size fits all' solution for ATM regulation, as there is a great disparity among States in terms of oversight capabilities, maturity and culture.

Therefore CANSO prefers to see an incremental approach

- For States with a well-established (albeit prescriptive) regulatory regime, we encourage the move to performance based regulation (PBR) and the adoption of Better Regulation principles,
- For States that need to improve oversight capabilities, we need first to support the implementation of capacity building initiatives that are both innovative and effective

CANSO is asking States to adopt five key principles of better regulation; regulations should be:

- Proportionate: Regulators should only intervene when necessary. Remedies should be appropriate to the risk posed, and costs identified and minimised
- Accountable: Regulators must be able to justify decisions, and be subject to public scrutiny
- Consistent: Government rules and standards must be consistent and coordinated and implemented fairly
- Transparent: Regulators should be open, and keep regulations simple and user-friendly
- Targeted: Regulation should be focused on the problem, and minimise side effects

**CONCLUSION**

Air navigation services is a service industry, the primary objective of which is to provide safe, secure, efficient and economical services to airlines, passengers and other users. There are several alternative ownership, control and management options for the provision of these services and such options should be considered as means to achieve the end result. Therefore, a State should chose the option which is best suited for its specific circumstances in achieving this primary objective.

CANSO urge States and regulators to separate regulation from service provision and to adopt harmonised and standards together with a performance-based approach. This will truly facilitate improved safety and performance in air traffic management and aviation as a whole. It will also enable regulatory frameworks to keep pace with the increasing pace of change since they will

measure performance rather than chasing the individual technologies, systems and procedures that are used to achieve it.

- END -

HERMES AIR TRANSPORT ORGANISATION

POSITION PAPER

R18-PP/08
2/9/18

# Airline ownership and control and the Single African Air Transport Market Agenda

(Presented by African Airline Association - AFRAA)

**EXECUTIVE SUMMARY**

**This paper examines Airline ownership and control rules in Africa and their impact on the implementation of Single African Air Transport market (SAATM)**

Over the past two decades, liberalization, privatization and globalization have significantly changed the airline industry worldwide.

Most of the Bilateral Air Service Agreements (BASAs) inspired by the Chicago Convention (1944) require a designated Airline to be **"substantially owned and effectively controlled"** by the designating State.

In the context of liberalization, Airlines need to levy more equity so that to sustain their growth. It becomes a challenge to source funds only on domestic financial markets with ownership restrictions.

## 1. Why ownership and control restrictions?

Airline industry is regarded in many States as essential to the national interest and sovereignty. They believe that domestic owners are more likely, than foreign owners, to preserve the national interest.

In many countries, the difficulty to find local equity funding of Airlines has resulted to having State owned Airlines.

De facto, ownership carries control rights of these Airlines by the governments. Recently, Airline bankruptcies and financial distresses are forcing these owner governments to subsidize these Airlines with huge amounts of money. They want to reduce their financial commitments to these national carriers.

Most of these governments are trying to attract foreign equity investors not exceeding 49% in their Airlines in an attempt to continue to keep the control. Keeping 51% means that they are reluctant to loose control on these Airlines.

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## 2. What is the difference between ownership and control?

Ownership is relatively easy to establish, but effective control is more difficult. The concept of ownership of an undertaking is based on the notion of the equity capital shares.

Owners may differ with respect to their willingness and capacity to exercise effective control on an Airline. Obviously, a private investor holding 15% and an airline holding 15% of another airline have different willingness and capacity for the control this Airline.

Control may not be in direct proportion to ownership if conditions included in certain agreements or contracts confer a decisive influence to a shareholder.

A holistic assessment is needed to understand who is controlling an Airline:

- **Management Structure** – Entitlement to appoint to Directors and to Senior Management positions;
- **Key Legal documents** - Articles of Association/Shareholders Agreement providing specific rights on matters normally within the powers of the Board;
- **Aircraft Lease Agreements** – specific powers given to a shareholder to negotiate an conclude lease agreements;
- **Business Plan** – specific rights given to a shareholder to determine the business plan and therefore to have a control on the business.
- **Debt/Loan Agreements** – shareholder advance debt or loan collateral giving specific rights related with;
- **Consultancy/Advisor agreements –** influential on the business.

## 3. The critical role of corporate management

Corporate governance is also influential on the control of an Airline on the control of an Airline. There are three types of corporate governance:

➢ **Managerial governance**
***This type of governance is very rare in Africa.***
Ownership is institutional, diversified and widely dispersed, but day-to-day management is in the hands of professional executives. Under managerial governance, the strategic and operational control of an airline is in the hands of salaried executives.

➢ **Individual governance**
***This type of governance exists in Africa in small Airlines.***
Both ownership and control are in the hands of an individual. This type of governance is common in the charter, domestic commuter, and cargo segments of aviation markets. The challenge for individual airlines is attracting the capital necessary to grow to efficient scale. They remain in small market niches, as long as they don't change their mode of governance to acquire the financial resources to move successfully on a larger scale.

➢ **Stakeholder governance**
Ownership is shared by various stakeholders (State, banks, institutions, partner airlines…). Day-to-day management is in the hands of professional executives.

***State governance***
***This is the most common mode of governance in Africa.***
The 1944 Chicago Convention assured the domestic flag carrier as the dominant model in the Airlines business. States are majority shareholders and nominate the key management people to ensure day to day operations.

***Strategic partner governance***
***This is the alternative to State governance.***
In most cases, equity investment by one airline in another is designed to better secure strategic and operational control in a manner that cannot be attained by a commercial agreement such as interline, code share agreement, joint venture or alliance.

How an airline equity investor will choose to exercise that control will depend upon its own corporate and business strategy. It could be an aviation-services business approach selling a range of aviation services to the controlled airline (consulting, IT, logistics, aircrafts engineering and maintenance, catering business etc…).

For example, Ethiopian Airlines has acquired equity stakes in numerous African airlines as strategic partner.

## 4. The European experience

What would be the impact of relaxing Ownership and control rules on the Aviation industry?
What is the experience in other parts of the world?

In EU Ownership and Control rules have been fully liberalised.

Before the EU undertook the project of liberalisation, most airlines were State-owned "flag carriers". The right to operate international flights between States was governed by a network of bilateral air services agreements (BASAs). The flag carriers of the contracting countries and assigned reciprocal traffic rights to the exclusion of competitors.

The European Court of Justice's "Open Skies" judgements of 5 November 2002 found that bilateral agreements providing entitlements only for airlines owned by nationals of a single Member State contravene Community law. The judgement confirmed that the Community has exclusive competence in a number of key areas of European aviation. This meant that only the European Commission is entitled to engage in multilateral discussions with partner countries on these issues (though it needs a specific mandate from the European Council to do so).

The "three pillars" of EU aviation policy were:

1. Bringing existing BASAs in line with EU law by replacing nationality clauses with community clauses;
2. Concluding comprehensive aviation agreements with key strategic partners; and

3. Creating a Common Aviation Area within the EU, and with its neighbouring countries.

Currently, the flying rights of all EU carriers are equivalent for intra-EU flying and flying to third countries which have agreed "EU community clauses" in place of national ownership and control requirements.

## 5. SAATM and Ownership/Control rules

In 1999, the Yamoussoukro Decision (YD) was a move to follow the liberalization trend in other regions in the world. The main purpose of the YD was to remove operational restrictions on traffic rights, capacities, frequencies and fares.

The pace of the YD implementation had been very slow since.

In January 2018, the African Union (AU) launched the Single African Air Transport Market (SAATM) as one of the AU Agenda 2063 flagship projects. The SAATM is the full implementation of the YD. African countries signing the SAATM commit to fully implement the YD. So far seventy-six (26) States have signed the SAATM commitment.

To speed up the SAATM implementation, a multilateral approach was agreed upon on 28 May 2018 by the signing of a Memorandum of Implementation by fourteen (14) States.

**The Article 6.9 ((g) Eligibility criteria) of Yamoussoukro Decision requires Airlines to be effectively controlled by a State Party.**

Most African countries require majority domestic equity ownership of designated airlines to ensure effective national control. As a consequence, many Airlines are State majority owned and controlled.

Many of these airlines are characterized by low productivity, poor performance and high operating costs. While their deficiencies are recognized, many States continue to protect them from competition and continue to subsidize them. However, the burden on government for underwriting the losses of national flag carriers and the pressure of Technical Financial Partners (International Monetary Fund, World Bank) encourage many to consider alternatives to State ownership.

Annex 5 Article 7 of YD (Regulation on Air Transport Services within Africa) **"prohibits the granting of any subsidy by any State Party or regional economic community which distorts or threatens to distort competition."** The Executing Agency (AFCAC) shall propose rules on the conditions under which subsidies may be granted.

The SAATM requires a new Aviation Strategy and Policy for Africa. Opening the market access and the development of traffic is expected to create a conducive environment for Airlines.

New developments to separate ownership and control should be considered to tackle Airline equity financing in Africa.

## 6. Conclusion

Liberalisation and relaxing Ownership and Control rules may create two main concerns which can distort competition:

- The impact of different regulatory rules applying to competitors operating in the same market and in favour of a particular competitor;
- The impact of different regimes governing State subsidies to national flag carriers.

As has been witnessed in Africa, a multilateral approach of Ownership and Control along with competition rules may be more effective in opening-up aviation than a bilateral approach.

***By Abderahmane BERTHE***
***Secretary General AFRAA***

- END -

HERMES
AIR TRANSPORT ORGANISATION

POSITION PAPER

R18-PP/09
20/9/18

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

(Presented by World Bank)

By Dr. Charles E. Schlumberger

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.

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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)

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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 its 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.

- END -

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## 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

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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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