



The Montreal Economic Institute's

Flashpoint

Canada and the liberalization of air transport markets over the Atlantic

by Pierre Jeannot (www.pierrejeannot.com) • June 27, 2006

Last April, Canada and the United Kingdom announced an "Open Sky" agreement which, when concluded, will represent another major step in the liberalization process of the air transport market between the two countries.

The agreement was reported to provide for unlimited so-called "Fifth Freedom Rights" for both countries to enable Canadian airlines to carry traffic to and from third countries through the U.K. The same reciprocal rights are to be available, of course, to British carriers through Canada.

It remains to be seen whether the European Commission, which has successfully contested the rights of the European Union members to negotiate air bilateral deals independently of Brussels, will choose to challenge this agreement.

While every step taken to further liberalize air markets should be welcomed, one wonders why we continue to use such timid steps. A large part of the world aviation continues to operate under a bureaucratic system of intergovernmental agreements which pretend to know better than the market, and thus dictate which carriers are allowed to fly to what destination, how often and still, in some cases, at what tariffs.

Following this recent agreement, and considering the state of negotiations between Europe and the United States, Canada should take the lead and try to influence the liberalization of air transport markets over the Atlantic in a more significant way.

Recent successes

The U.S. has, until recently, led the drive towards fully liberalized markets with its Open Skies Agreements, the first having been signed some fifteen years ago with the Netherlands. The Canada-

U.S. air bilateral agreement signed by the two countries in November of 2005 represented the 73rd Open Skies agreement signed by the Americans to that date.

The rather spectacular growth of the U.S. airlines during the 1980's, as a result of their own internal air market liberalization, was the trigger for liberalization of domestic air markets in many other countries, including Canada. A little more than a decade ago, the EU took steps to dismantle its old regulatory regime. The process culminated in the total liberalization of the air market within the fifteen European countries which were then part of the Union.⁽¹⁾

In retrospect, it can be said that the results have been very positive. Fares have dropped significantly, many new routes have been established, and regional airports have blossomed. Many new carriers have emerged, most, if not all, of the low-cost variety, bringing innovative ways of stimulating the market. The result has been spectacular growth in internal traffic, with new consumer demand being created and addressed.

With the European Union growing from fifteen countries to twenty-five in the last few years, the integration of the European air market was expanded accordingly. More recently, the EU has taken steps to expand the Common Aviation Market area even further by proposing to include nine south-east European nations as well as Norway and Iceland. Once completed, the addition of more than fifty million people will have extended the aviation market to more than 500 million consumers.

Negotiations between the U.S. and Europe

Opening skies between the U.S. and Europe, the two largest aviation markets in the world, would constitute a major breakthrough in this liberalization process. However, the efforts by the European Union to achieve an air bilateral agreement with the Americans have thus far not been successful, in large part because of

American concerns for security and sovereignty.

After a failed attempt earlier, negotiations between the Americans and Europeans were re-started in the second half of 2005. The aim is to do away with the existing patchwork of bilateral agreements existing between the various EU members and the U.S., and to set up one system to regulate Trans Atlantic air transport.

Under a tentative Open Skies agreement reached late last year, all EU and U.S. airlines would be allowed to fly from any point in the Union to and from any point in the United States, provided they can reach agreements with airports for landing rights. Airports would be required to give equal treatment to all EU and U.S. airlines in assigning these rights. Currently, European airlines can fly to the United States only from the countries where they are based.

A separate tentative agreement was reached on the question of foreign ownership. This proposed rulemaking would allow European carriers to participate in the commercial business of U.S. airlines commensurate with the equity investment held in that company. The Transportation Department would continue to make sure that safety, security, basic corporate documents, and any decision-making involving U.S. national security would remain under the control of U.S. citizens.

The question of ownership and control of U.S. airlines has become highly contentious however. Those supporting the change have argued that foreign airlines taking an interest in a U.S. carrier would give struggling domestic airlines new options to raise money and potentially invigorate travel options to consumers. But Congress has refused to raise the cap of 25% of the voting stock and 49% of the total stock. The implementation of both agreements has been delayed and remains uncertain.

Canada's options

What are the various options available to Canada, given the developments to date, the concerns raised by some, and the market expansion opportunities suggested by the current trends? More than many other nations, Canada was created and developed with the help of transportation. The growing importance of international trade to Canada requires the continued support of an enlightened transport

policy, and thus the need to remain at the forefront of the liberalization process of air transport markets.

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Given the well-known reluctance, if not outright opposition, by the air transport industry to be brought under the rules of the World Trade Organization (WTO), which has not shown to be flexible enough to accommodate the various nuances which would be required by aviation, a "big bang" solution to the worldwide liberalization is most unlikely.

The way to proceed appears to be therefore:

- Continued expansion of bilateral "Open Skies" type of agreement by all like-minded nations;
- Continued expansion of regional common air markets such as achieved by the European Union;
- The pursuit of bilateral agreement between regional common air market areas and other regional areas - or block-lateralism, to use an expression coined some time ago.

The current reluctance by the U.S. to reach an agreement with the EU along the lines of their proposal is disappointing but understandable, given the highly sensitive concerns they have identified primarily but not uniquely on security. This situation could, however, present Canada with an opportunity to further provide leadership to the liberalization process.

The continuous drive towards freer trade would suggest that sooner or later, the North American Free Trade Agreement will also cover the air transport market and that a common air market area will be brought about over the Atlantic between Europe and North America. If the premise is valid, it

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would be to the advantage of Canada to keep playing an active role in bringing about such market integration.

Canada has already in place some important building blocks. The latest Open Skies agreement achieved with the U.S. late in 2005 is another major step towards a continental approach to the airline industry. The Fifth Freedom Rights negotiated provide an opportunity for Canada to link U.S. and European markets through Canadian points.

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The U.K.-Canada air bilateral agreement offers similar opportunities if we can ensure that the Fifth Freedom Rights ultimately defined would match those achieved in the U.S.-Canada agreement to permit Canadian airlines to participate in U.K.-to-U.S. markets through Canadian hubs.

Given the very significant concerns raised by a number of influential American politicians on any extension of airline foreign ownership and potential presence of non-Americans in the management of U.S. airlines, it would be most untimely to propose to the U.S. negotiators, at this time, any further liberalization beyond the major milestone achieved last year.

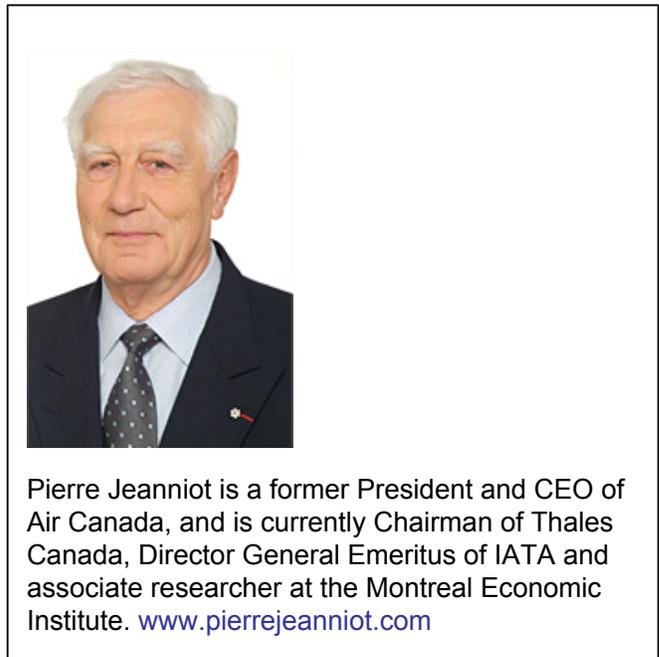
Conversely, the Europeans, given the currently seeming impasse in their negotiations with the U.S., could perhaps be interested in a discussion with Canada along the lines of their proposal to the Americans. Canada has already stated on several occasions that, given reciprocity, foreign ownership of Canadian carriers could rapidly be increased to 49%.

The advantages to both the European Community and Canada are obvious. The result would be the replacement of some 25 air bilateral agreements by one covering the total European Common Aviation Market.

Canada would gain "Open Skies" access to a market of some 450 million people. For its part, the European Union would have achieved successful implementation of its Common Atlantic Air Market approach with a major North American partner. The experience learned in such a Canada-EU Open Skies Agreement would be useful to all parties and, in time, could help overcome some of the reluctance expressed by the Americans to further Trans Atlantic liberalization.

Notes

1. See Pierre Jeannot, "Towards open skies for airlines in Canada," Montreal, Montreal Economic Institute, May 2005, available at http://www.iedm.org/uploaded/pdf/mai05_en.pdf.



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