



# What do we mean by a level playing field in international aviation?



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## ABSTRACT

Over the past several decades international airline markets have been progressively liberalized. An issue that has emerged is whether there is a level playing field (LPF) between the carriers of the two nations that are party to a bilateral air services agreement. While the International Civil Aviation Association (ICAO) has drafted a model LPF clause for air services agreements and the European Commission has negotiated a few agreements with LFP clauses, the issues involved are at best vaguely specified and often ignore key elements of economics. This paper represents an initial attempt to develop a more comprehensive discussion of aspects of LPF definition. The paper categorises issues as either legitimate concerns or as issues that are matters of comparative advantage in international trade or that can and should be dealt with by competition or general international trade law rather than by sector specific bilateral trade treaties. The topic of subsidies in LPF assessments is particularly addressed as economic welfare optimization can justify subsidies in some cases and because subsidy to infrastructure is more widespread than some stakeholders may realize.

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## 1. Introduction

The “level playing field” has re-emerged as a major issue in international aviation. This concern has been around for decades but has emerged with new urgency and is being linked in recent policy debates to the question as to whether liberalization of air transport has gone too far. One policy forum in which LPF has risen to become a subject of negotiations is the European Commission's proposed revision to regulation 868/2004, which some view as a response to allegations by some legacy carriers to the rapid growth of the Middle East carriers such as Emirates, Etihad Airways and Qatar Airways. Another dimension to the concern over LPF is the evolution in foreign ownership rules, such as the type of treaty clauses being negotiated by the European Union. Could potential broader acceptance of service by carriers owned by third-party nationals create conditions for a flag of convenience regime that characterises parts of maritime liner shipping? The flag of convenience issue has been discussed in the U.S. media with regard to Norwegian Air Shuttle. Norwegian's long haul services are operated by subsidiaries Norwegian Long Haul AS and Norwegian International Ltd. The former is registered in Norway while the latter is registered in Ireland and operates flights for its parent. Some long haul flights have operated with contract flight attendant labor based in Thailand.

On the flip side Findlay and Goldstein (2004), in looking at the aviation sector in Asia, point out that a more liberal foreign ownership approach would provide funding and management capacity to support the adjustment process of incumbent airlines dealing with key pressures to change, including demand side shocks and the rise of low cost carriers. They also note that a greater role for private investment, including foreign investment, will support the movement to regulatory reform.

The LPF issue has received some, but limited attention in the literature. Some see it as a disguised attempt to seek protectionism (e.g., De Wit, 2013). Others see it in light of a post-mercantilist strategy (Dresner, 1989). Legacy carriers, and in particular their employees, view the issue as one affecting the aviation business environment and defending local jobs (ALPA, 2012).

In the debate thus far, there have been allegations of a lack of a level playing field in some markets. Some have tried to link aviation liberalization in general with fair competition and level playing field issues, suggesting a desirability to halt or even reverse further liberalization of air access. However, no one has precisely defined what constitutes a level playing field in aviation, or its converse, what constitutes a genuine unlevelled playing field. In fact, while ICAO has drafted a model level playing field clause, it has gone so far as to state that it “...is unlikely that consensus on a comprehensive definition can be achieved at this time, given the widely different circumstances of States and their aviation sectors...” (ICAO, 2013; p. 3). This is borne out by major differences in the level playing field clauses that the European Commission has negotiated with the U.S. versus Canada. This

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paper is an initial step to fill this gap and address ICAO's challenge to develop a comprehensive definition by articulating these issues and linking the level playing field with air transport liberalization.

## 2. Historical context

The preamble of the *Convention on International Civil Aviation* (the "Chicago Convention") has the objective that "...international civil aviation may be developed in a safe and orderly manner and that international air transport services may be established on the basis of equality of opportunity and operated soundly and economically..." (ICAO, 1944).

Consistent with the Chicago Convention, the bilateral air services agreements that were negotiated between nations usually had some form of wording that referring to the provision of fair and equal opportunity to compete. In practice, however, governments hardly seemed willing to allow their carriers to really compete. Rather, they seemed to more heavily weigh the objectives of establishing operations that were relatively sound and economic (i.e., preventing service failures and destructive competition) than they were on actually providing equality of opportunity. This is not to say all services provided by flag carriers were economic. In the early days, and to some extent today, governments were willing to subsidize some services that were not commercially viable to achieve some other governmental purpose, such as access to low population regions. What they did not want, however, is for the carriers to actually compete with each other as that could mean even greater levels of subsidization would be necessary.

What governments appeared to seek for their respective flag carrier(s) was an "equitable" split of a pool of revenues that were based on controlled (and high) fares to achieve sound and economic operations. Routes and capacity were typically divided among carriers in such a manner as to ensure each carrier could operate profitably, hopefully without subsidy. Stability and sustainability were the goals, rather than competition and market growth. Essentially, governments actually sought equality of outcome rather than equality of opportunity.

In large part, the issue of the level playing field plays an inordinately larger role in aviation than in other sectors, due to the fact that aviation has been separated from general trade negotiations. In general trade theory, it is recognized that countries may have a comparative advantage in some factors of production and markets, and comparative disadvantages in others. Higher trade in areas where they have an advantage will be offset by lower trade in areas where they do not have an advantage. The focus is on overall benefits – not in trying to make every nation equal to others in all elements. By separating aviation from the rest of trade, comparative advantage/disadvantage is more difficult to achieve, and thus LPF issues are brought into greater focus and the impact exacerbated.

An interesting example of aviation specific comparative advantage is that between Europe and the Gulf States. The Gulf States may have a comparative advantage in international hub operation between Europe and South Asia/East Africa, that has enabled the growth of Gulf carriers. But these carriers have purchased large numbers of A380 and other Airbus aircraft. In fact, without the purchases by the Gulf carriers it seems unlikely that the A380 would have been built at all. The exercise of Gulf carriers' comparative advantage in airline hub geography has enabled Europe to benefit from its comparative advantage in high tech manufacturing and skilled labor to engage in the production of very large aircraft. Without the first, the second would not have occurred.

In contrast, under the mercantilist approach, nations sought to boost their own economies by imposing high tariffs and imposing

non-tariff barriers to protect domestic production, banning their colonies from trading with other nations, and subsidizing exports. Under such an approach, aggregate welfare is lower as comparative advantages are artificially negated.

Thus prior to the rise of open skies agreements between nations, international air transport operated under very restrictive conditions. The air service agreements between nations typically specified which city pairs could be served, and in some cases explicitly excluded certain airports. The number of carriers that could provide service was usually restricted (generally to a single carrier from each nation), as was the capacity they offered. In addition, all fares had to be approved by the civil aviation authorities of both nations party to the agreement so as to ensure proposed fares were not "unreasonably low" such that they might threaten the profitability of the carriers. This often was effected by governments allowing or requiring the carriers to agree on prices under the old tariff regime of the International Air Transport Association (IATA).

This approach began to change with the signing of the "International Air Transportation Negotiations Statement of U.S. Policy for the Conduct of the Negotiations" by U.S. President Jimmy Carter. The statement noted:

*"The guiding principle of U.S. aviation negotiation policy will be to trade competitive opportunities, rather than restrictions, with our negotiating partners. We will aggressively pursue our interests in expanded air transportation and reduced prices rather than accept the self-defeating accommodation of protectionism. Our concessions in negotiations will be given in return for progress toward competitive objectives, and these concessions themselves will be of a liberalizing character."* (Carter, 1978)

A key element of the U.S. approach to open skies is that the objective of a level playing field is equality of opportunity, not equality of outcome. This is fully consistent with the objective articulated in the preamble to the Chicago Convention. Reliance on competition and reduction of the burden of regulation were the principles that would drive subsequent U.S. negotiations.

In 1978, the U.S. reached a partially liberalized air services agreement with the Netherlands, followed by liberal agreements with Israel and Belgium. After a lull in liberalization efforts during the 1980's the U.S. reached its first open skies agreement with the Netherlands in 1992. By the end of 1995, it also had open skies agreements with Belgium, Finland, Denmark, Norway, Sweden, Luxembourg, Austria, Iceland, Switzerland and the Czech Republic. Today it has open skies agreements with over 100 nations. The typical open skies agreements allows service between any point in one country to any point in the other, with no restrictions as to number of carriers or the capacity they offer. In addition to open 3rd and 4th freedoms, they also provide for 5th and 6th freedom services, and sometimes 7th freedoms for all-cargo services. Sixth freedom services are an important part of open skies agreements as such hubbing services were often capacity restricted in traditional bilateral air service agreements. The profound economic advantages of operating hubs were effectively blocked by traditional agreements.

The concept of equality of opportunity also guided other liberalization initiatives such as the EU Common Aviation Market, the Australia-New Zealand Single Aviation Market, and the Multilateral Agreement on the Liberalization of International Air Transportation (MALIAT) between Brunei Darussalam, Chile, Cook Islands, Mongolia, New Zealand, Samoa, Singapore, Tonga and the U.S. The preamble to the MALIAT refers to the promotion of "...an international aviation system based on competition among airlines in the marketplace with minimum interference and regulation...". IATA's Agenda for freedom initiative also supports the equality of

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