



Airline Liberalisation

IATA ECONOMICS BRIEFING N° 7

➤ Lessons from other industries
on the impact of removing
operational, ownership and
control restrictions



IATA Economics Briefing N° 7:
AIRLINE LIBERALISATION

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00 | Foreword

Further liberalisation of international air transport is essential. Airlines facilitate global travel but are among the last companies to benefit from globalisation. Greater commercial freedom for airlines is vital for the long-term health of the industry and for the global economy.

Air transport is governed by a 60 year-old set of rules, the bilateral system. It was designed for another age. Sixty years ago IATA members were flying 9 million passengers. Now we fly over 2 billion passengers per year. We operate in the world of the internet, but our rules come from the age of paper and telexes. It is a different world today. We need different rules. The future success of our industry rests on greater commercial freedom to serve markets where they exist and to merge and consolidate where it makes business sense.

From the 1970s a number of governments have had the vision to deregulate parts of the industry. But failure to follow-up with broader liberalisation made this a half measure. There are still well over 3,000 bilateral air service agreements, with operational and ownership restrictions. The good news is that 200 of them account for 75% of traffic, so changing only a few agreements can have a big impact.

But Open-skies agreements are only part of the answer. The bilateral system turned commercial opportunities into national rights. This made some sense when governments owned airlines. But now the flags on the tails of our aircraft are so heavy they are sinking our industry. It prevents meaningful consolidation and it perpetuates inefficiency. The only way to be successful is to run the industry as a real commercial business. Who cares who owns an airline – so long as markets are served with safe and secure operations?

The IATA Operational Safety Audit (IOSA) is the first global standard for airline safety management. It will become a condition of IATA membership from 2008. Combining



IOSA with ICAO's enhanced Universal Safety Oversight Programme can deliver high quality safety standards, regardless of nationality. On the issue of security, why should airlines be treated differently than telecoms or banking? All are strategic assets. Governments do not need ownership clauses to request delivery of goods in a national crisis. Commercial markets can take up the challenge.

This report demonstrates how other industries with global markets have generated significant economic benefits through liberalisation. The parallels of these industries to air transport are tremendous: strategically important, network oriented and customer-focused. The air transport industry, and its consumers, have nothing to fear from liberalisation or consolidation.

After 60 years, change is long overdue. Airlines have done a fantastic job building an industry that is safer, more accessible and more efficient than ever before. My challenge to governments is to bring policy in line with the changes airlines have achieved; and deliver the leadership vision that our industry needs for the next 60 years.

A handwritten signature in blue ink, reading "Giovanni Bisignani". The signature is fluid and cursive, written in a professional style.

Giovanni Bisignani - Director General & CEO, IATA

Key Conclusions and Recommendations



Further liberalisation of airline operational and ownership restrictions is not an easy process. However, it can be a very beneficial one. Experience from other industries demonstrates the positive impact liberalisation can have for both consumers and producers. A modern, commercial and global airline industry requires modern, commercial and global rules.

Governments must now provide the leadership that the airline industry needs. Policy needs to be brought in line with the progress that airlines have made and continue to make. Governments will not all be able to liberalise markets at the same pace. But it is important that they all recognise the need to move in the right direction. This direction has already been set, at ICAO's Fifth Air Transport conference in 2003. It is now time to turn this into clear reforms.

SCOPE OF THIS REPORT

IATA worked closely with consultants OXERA to analyse the impact of operational (i.e. product market) and ownership (i.e. capital market) liberalisation in four different industries:

- **Retail banking;**
- **Energy (i.e. gas and electricity markets);**
- **Telecoms; and**
- **Media**

Each industry was chosen for its shared characteristics with the airline industry. The analysis looks at the impact of liberalisation for both consumers and producers. It looks at its influence on competition, efficiency, prices and costs, along with the strategic responses of firms to liberalisation.

This report summarises the key findings and the potential lessons for the airline industry. A more detailed report by OXERA on the impact for each industry is also available¹.

KEY LESSONS FOR THE AIRLINE INDUSTRY

1. Further liberalisation is not a seamless process, but it is possible.

Lessons from the other industries show that full liberalisation is often not a seamless process. Liberalising markets over different timescales or removing restrictions on operations without removing those on ownership can create distortions and reduce the potential benefits that are available. However, a recent report² shows that a clear pathway to full liberalisation for the airline industry, that is consistent with optimal safety and security standards, does exist.

2. Full liberalisation is required to maximise the potential benefits.

The benefits of liberalisation are maximised where both operational and ownership and control restrictions are removed. The structure of the airline industry means that removing operational restrictions can lower barriers to entry to the industry. But it will not maximise the potential benefits to customers, airlines and the wider economy unless ownership restrictions are also removed. The barriers to exit or to adjust capacity that are faced by the airline industry must also be reduced in order to improve the long-term position of the industry as a whole.

3. Further liberalisation can provide substantial consumer benefits.

Further operational and ownership liberalisation can protect and enhance the consumer benefits, in terms of greater choice and lower fares, already obtained from liberalisation so far in the airline industry. It can also widen and expand these consumer benefits to new regions and routes that currently have highly regulated markets. Therefore, it can continue to provide benefits for airline users, while also providing significant benefits for the wider economy³. For example, a recent study⁴ found that liberalising some of the current major restricted country pair routes could increase traffic by 63% and generate an additional \$490 billion of GDP.

4. Greater commercial freedom allows airlines to further improve productivity and efficiency.

Liberalisation can create the freedom for airlines to operate on a fully commercial basis. This will allow them to allocate capital more efficiently, to respond better to changes in demand in markets and to improve productivity. It provides a platform for the airline industry to expand or rationalise capacity and ownership in accordance with customer needs and to improve the return on capital invested that is earned by the airline industry as a whole.

5. Liberalisation can provide benefits for a flexible and efficient firm.

In a fully liberalised market, the key for an airline is to recognise where its competitive advantage lies and to focus on it. Liberalisation provides opportunities for expanding into new markets as well as threats to existing markets. There will be winners and losers from liberalisation. However, experience from the other industries has shown that firms who are efficient, flexible and responsive to customer needs – regardless of their size – are best placed to benefit.

6. A multilateral approach to liberalisation is preferable.

A multilateral approach is likely to have more substantial and positive implications for both consumers and airlines. Bilateral negotiations remain the main forum for discussion and a useful mechanism for reform, but the rationale for more supranational leadership is strong. In some areas (e.g. the European Union), supranational bodies already lead liberalisation negotiations, and have the ability to add new countries to an existing Open Aviation Area. Globally brokered agreements (e.g. through ICAO or the WTO) are desirable but face practical difficulties. Therefore, at least for the short-term, co-ordinated bilateral and/or regionally focused negotiations can offer the best way forward.

¹ See OXERA (2007), "What are the economic impacts of relaxing product and capital market restrictions? Lessons from other industries", available from www.iata.org/economics

² See UK Civil Aviation Authority (2006), "Ownership and Control Liberalisation: A Discussion Paper", www.caa.org.co.uk.

³ See US Government Accountability Office (2004) "Transatlantic Aviation: Effects of Easing Restrictions on US-European Markets"

⁴ See Intervistas (2006), "The Economic Impact of Air Service Liberalisation"

01 | Executive Summary

Further – and fuller – liberalisation of the global airline industry is required. It can provide even greater benefits for passengers and allow airlines to operate on a fully commercial basis. It will not be an easy process and will not, by itself, solve all of the industry's problems. But it is an essential part of improving the long-term health of the industry; creating significant benefits for users, the industry and the wider economy.

CURRENT RESTRICTIONS

International aviation is governed by a complex web of bilateral air service agreements (ASAs) that were first developed according to the principles of the 1944 Chicago Convention. IATA estimates there to be over 3,000 ASAs in existence, though just 200 of them account for around 75% of the total traffic covered by the agreements.

There has been a degree of airline liberalisation in some regions and on some routes (e.g. the intra-EU market, Australia and New Zealand, the March 2007 US-EU “open-skies” bilateral agreement). But only 17% of international air traffic is currently conducted in a liberalised operational environment. Even in many of these cases, such as for intra-EU flights, there are still some restrictions on airline ownership and control for investors based outside of the region. Open-skies agreements do not remove nationality rules.

The current system constrains the ability of airlines to operate on a fully commercial basis, due to:

- **Operational (or product market) restrictions**

An ASA can include restrictions on the number of airlines permitted to operate on a certain route, restrictions on the frequency of flights and restrictions relating to the fares charged on such routes.

- **Ownership (or capital market) restrictions**

An ASA can give country X the right to reject country Y’s airline carrier if the carrier is not “substantially owned and effectively controlled” by nationals of country Y. These restrictions are often supplemented by statutory provisions in a country. For example, in the US, the Civil Aeronautics Act requires all US airlines to be at least 75% owned and controlled by US citizens.

TYPES OF LIBERALISATION

Therefore, liberalisation can take two forms; product market liberalisation providing greater freedom on operations and capital market liberalisation providing greater freedom on ownership and control. These processes can be – though need not be – mutually exclusive. Indeed, different timings and objectives between the two processes can be complementary but can also, in some cases, be conflicting. Experience from other industries shows that longer-term benefits can be maximised when both forms of liberalisation are undertaken.

For airlines, liberalising product markets without also removing ownership restrictions (e.g. “open-skies” agreements) can increase competition, improve incentives for efficiency and provide substantial benefits for consumers. But if airlines do not have the full commercial freedom to restructure capacity in response, it limits their ability to properly meet changing customer needs in the long-term and restricts their ability to achieve a sustainable level of return on their invested capital – at a long-term cost to all stakeholders in the aviation industry.

OVERCOMING BARRIERS TO FURTHER LIBERALISATION

Liberalisation of current restrictions on airline operations and ownership and control appears to make commercial sense to airlines, their users and their employees. However, liberalisation must only take place if the highest standards of safety and security can be maintained in a more commercial environment. Care needs to be taken but a clear pathway to full liberalisation for the airline industry, that is consistent with optimal safety and security standards, does exist.

SAFETY

National and regional safety authorities will need to cooperate more closely to share information and functions across national boundaries. The airline industry is also taking steps to improve and standardise its own safety audits. The IATA operational safety audit programme (IOSA) is mandatory for its members and applicable to any airline. Several governments are now using IOSA audit data to assist them in their discharge of their safety oversight functions, with IOSA becoming a key tool in raising the safety bar on a global basis.

SECURITY

There has been no diminution of security standards where liberalisation has taken place (e.g. the EU open aviation area) and there is no reason why there should be. National security procedures are a matter of national sovereignty. National laws on mergers and acquisitions typically provide powers for a government to block a deal where it is considered to pose a threat to national security. Therefore, a blanket ban on operational or ownership liberalisation is unnecessary on security grounds.

WHY DO AIRLINES NEED GREATER LIBERALISATION BUT AIRPORTS NEED GREATER REGULATION?

There are significant potential benefits from greater liberalisation of the airline industry. There are also significant potential benefits from more effective economic regulation of airports and air navigation service providers (ANSPs). These statements are not contradictory. Instead, they reflect the different degrees of competition and market power held within the aviation industry.

This report discusses the case for liberalisation of the airline industry and the significant potential benefits that it can provide. By contrast, the different characteristics of airport and ANSP infrastructure providers mean that more effective regulation is required to prevent them from exploiting their monopoly power at the expense of users. Economic regulation for airports and ANSPs can act as a powerful catalyst for improvement. It improves efficiency and productivity throughout the aviation industry. It encourages timely and cost-effective new investment. It benefits all stakeholders, from the regulated airports to passengers, other users and the wider economy⁵.

EXPERIENCE OF LIBERALISATION IN OTHER INDUSTRIES

To understand the impact of further liberalisation for the global airline industry it is important to consider the experience and lessons from liberalisation in other major global industries. IATA worked closely with consultants OXERA to analyse the impact of operational (i.e. product market) and ownership (i.e. capital market) liberalisation in four different industries:

- **Retail banking;**
- **Energy (i.e. gas and electricity markets);**
- **Telecoms; and**
- **Media**

Each industry was chosen for its shared characteristics with the airline industry. These characteristics include a strategic and political importance, network-based operations and a strong customer focus. The focus is on particular regions or countries where liberalisation took place within the industries. In each case there is a definitive point in time at which liberalisation took place, following which its impacts can be assessed.

THE BENEFITS OF LIBERALISATION FOR CONSUMERS

Liberalisation can provide significant benefits for consumers through lower prices, greater output diversity and better quality of service. Experience in the other industries shows that liberalisation can:

▪ **Lower prices**

For the EU countries that have liberalised their energy markets, electricity prices are 10-20% lower and gas prices 35% lower than they would have been without liberalisation. In Korea and Japan, liberalisation of the telecoms industry has also seen the cost of long-distance calls fall by up to 50%, partly due to engaging in price competition with incumbents;

▪ **Increase output and choice**

Liberalisation of TV and radio markets has increased the available output and increased the number and diversity of options, including specialist channels for different consumer tastes (e.g. Indian TV, New Zealand radio);

▪ **Improve service quality**

For example, relaxing ownership restrictions in the US banking sector has increased both service quality and the ease of access to it. In particular, liberalisation has led to an increase in the density of branch networks. Customer service quality has increased, as shown through satisfaction surveys. Service fees have risen to cover the extra costs involved but consumers are willing to pay for higher quality.

⁵ For more details, see IATA Economic Briefing (2007), "Economic Regulation", available to download at www.iata.org/economics

However, while liberalisation can be expected to result in a general downward trend in prices, it may also result in increased price volatility, at least in the short-term, as firms respond more quickly to changes in market conditions. But changes in prices can also act as a more effective signal for new investment or capacity restructuring. In addition, removing capital restrictions does create opportunities for industry consolidation, with the risk of firms acquiring a dominant market position. But these concerns should be protected by a robust, well-functioning competition law regime not by industry-specific ownership restrictions.

Experience in the other industries shows that consumers can benefit more where both product market and capital market liberalisation is undertaken. In the long-run, developments which affect the viability of producers, either positively or negatively, will have a similar positive or negative effect on consumers. As such, future removal of airline ownership restrictions will not put at risk the consumer benefits obtained from existing product market liberalisation – instead it can enhance these benefits and place the industry as a whole in a more sustainable position.

THE BENEFITS OF LIBERALISATION FOR FIRMS

Full liberalisation that provides firms with the full commercial freedoms to respond to increased competition can also improve the efficiency, productivity and even profitability of firms. Experience in the other industries shows that liberalisation can:

- **Improve capacity utilisation** towards its optimal level. Full liberalisation can lead to new competition followed by consolidation (e.g. UK energy markets).
- **Increase productivity** for both incumbents and new entrants (e.g. telecoms in Japan). Firms also increasingly look to compete over the longer-term through innovation and increased R&D expenditure.
- **Transfer best practice.** Removing ownership restrictions helps to transfer managerial and technological knowledge and best practice (e.g. New Zealand media sector).
- **Increase investment.** Removing ownership restrictions can also lead to increased investment in the sector (e.g. telecoms) and a lower cost of capital as firms have access to wider and more efficient sources of finance.
- **Improve profitability.** Liberalisation can help firms to lower costs, improve efficiency and to develop economies of scale – resulting in improved industry profitability (e.g. EU banking).
- **Increase a firm's market value.** Liberalisation of ownership restrictions allows for a greater potential for takeovers and hence for shareholders of target companies to benefit from the significant share price appreciation that characterises such activity (e.g. Nestlé).

STRATEGIC RESPONSES TO LIBERALISATION

Liberalisation is not a seamless process and can lead to a degree of volatility, as initial new market entry can lead to excess supply and unsustainable yields before a period of consolidation helps to restructure capacity (e.g. UK energy). However, industries where both product market and capital market liberalisation have taken place (e.g. European banking) have tended to see more immediate consolidation. Improved capacity utilisation is typically linked to consolidation. However, in many industries the optimal utilisation level is often less than 100% (e.g. for greater resilience or to protect customer service quality), with the possibility that liberalised markets may overshoot this level in the short-term before correcting themselves (e.g. US electricity).

In addition, greater commercial freedom does not eliminate the risk of management failure. Relaxing ownership restrictions can facilitate increased mergers and acquisitions (M&A) activity. But, in most industries, there are past examples of companies over-estimating the potential benefits and cost savings from M&A deals. Liberalisation can increase the attractiveness of M&A but does not remove all of its risks.

Experience in the other industries shows that firms have typically reacted to liberalisation through one, or more, of the following strategic responses:

▪ **Expansion into new markets**

Liberalisation can lead to greater competition in a firm's main market, but can also provide significant opportunities for firms to expand into new geographical markets and to compete on a wider scale. However, if liberalisation is not introduced at a similar pace (e.g. EU energy markets) it may not provide a level playing field for firms to compete.

▪ **Diversification into new products**

In response to increased competition, some firms have looked to offer a wider range of product choice (e.g. Indian media sector), helping to attract a wider customer base.

▪ **Specialisation in niche products**

Liberalisation can lead firms to concentrate on where their competitive strength lies, ensuring that a core customer base is retained and revenues are maximised among these clients (e.g. US banking).

▪ **Market exit**

Incumbents may be forced to exit some markets in response to competition, but new entrants have also found that they are unable to gain a foothold in some markets when faced with efficient incumbent firms or a culturally-different customer base and are forced to exit (e.g. German TV sector).

The key factor for a successful strategic response is for a firm to recognise where its competitive advantage lies and to focus on it. Liberalisation provides opportunities for expanding into new markets as well as threats to existing markets. There will be winners and losers from liberalisation. However, experience from the other industries has shown that firms who are efficient, flexible and responsive to customer needs – regardless of their size – are best placed to benefit.



02 | Report Outline

There are strong arguments for further liberalisation in the airline industry. Not least are the significant consumer benefits arising where some liberalisation has already taken place. However, to understand better the potential impact of further liberalisation it is important to consider the experience and lessons from liberalisation in other major global industries.

IATA worked closely with consultants OXERA to analyse the impact of operational (i.e. product market) and ownership (i.e. capital market) liberalisation in four different industries:

- **Retail banking;**
- **Energy (i.e. gas and electricity markets);**
- **Telecoms; and**
- **Media**

Each industry was chosen for its shared characteristics with the airline industry. The focus is on particular regions or countries where liberalisation took place within the industries. In each case there is a definitive point in time at which liberalisation took place, following which its impacts can be assessed. The analysis looks at the impact of liberalisation for both consumers and producers. It looks at its influence on competition, efficiency, prices and costs, along with the strategic responses of firms to liberalisation.

This report summarises the key findings and the potential lessons for the airline industry. A more detailed report by OXERA on the impact for each industry is also available⁶.

The case for further airline liberalisation

Chapter 3 outlines the arguments for and potential benefits of further liberalisation in the global airline industry. It discusses the current restrictions that are in place and the impact of the limited amount of liberalisation that has so far taken place.

The experience and process of liberalisation

Chapter 4 outlines the rationale for choosing the four industries in which the experience of liberalisation is studied. It sets out the characteristics they share with the airline industry. It also discusses the process of liberalisation and the mechanisms through which it can create economic and financial impacts.

The potential benefits for consumers

Chapter 5 outlines the consumer benefits and costs that have arisen from liberalisation in the other industries. It looks at the quantitative impact on prices as well as the qualitative impact in terms of consumer choice and service quality.

The potential benefits for firms

Chapter 6 outlines the impact on incumbent and new entrant firms from liberalisation in the other industries. It looks at the impact on capacity in terms of new capacity and/or consolidation. It also looks at the impact on cost efficiency and productivity as a result of greater competition. It then considers the impact this can have on the short-term and long-term profitability of firms.

The strategic response of firms

Chapter 7 outlines the strategic choices that incumbent and new entrant firms can face in response to liberalisation. It looks at the potential for international expansion and diversification but also considers the possibility of firms looking to specialise and/or exit some markets.

The opportunities and challenges

Chapter 8 outlines the opportunity for further and fuller liberalisation in the airline industry but also notes the challenges that are faced. It discusses how barriers to further liberalisation, such as safety and security concerns, can be addressed. It discusses the potential for achieving further liberalisation through both bilateral and multilateral approaches.

Chapter 9 provides a summary and conclusions.

⁶ See OXERA (2007), "What are the economic impacts of relaxing product and capital market restrictions? Lessons from other industries", available from www.iata.org/economics

03 | The Case for Further Liberalisation

The global airline industry is governed – and constrained – by a 60 year-old set of rules, the bilateral system. These rules limit the commercial freedom of the industry to respond to market demand changes and to adjust capacity levels. A degree of liberalisation in some regions has produced clear benefits for passengers and other airline users. However, further – and fuller – liberalisation is required; it can provide even greater benefits for passengers and for the airline industry as a whole.

The global airline industry has changed significantly over the last two decades. In particular, the following key trends can be identified:

- In many regions, network airlines have either been privatised or have adopted an even greater commercial focus while remaining within the public sector.
- A degree of operational liberalisation within some airline markets, such as the US domestic market or intra-EU routes, has facilitated the growth of no-frills, low cost carrier (LCC) airlines; resulting in strong price competition on short-haul routes.
- In the absence of full liberalisation, several network airlines have joined alliances with other airlines. Alliances allow airlines to extend their available network through code-sharing with partners and to reduce costs through shared operational facilities.
- Large markets in North America and Europe continue to grow, but the fastest growth rates have shifted elsewhere. Strong economic growth in Asia, especially in China and India, has seen the emergence of major new aviation markets with high growth rates and substantial potential for further growth. The Middle-East, Latin America and Africa have also seen faster growth in airline demand in recent years.
- Cost efficiency levels have improved significantly as airlines respond to higher fuel costs and strong competition. Higher productivity and improved efficiency has been achieved across many internal cost items. In particular, greater use of e-commerce has created significant savings in sales and distribution costs.

The airline industry has changed significantly but, in general, the rules governing international operations and ownership have not. The global airline industry has consistently delivered returns on invested capital that are below the cost of capital levels (i.e. not achieving the level of returns expected by investors)⁷. Structural constraints, including the bilateral system and foreign ownership restrictions, are one of the causes of low returns. Greater liberalisation is not a panacea for all of the airline industry's problems, but it will allow airlines to take operational, capacity and investment decisions on a full commercial basis. A modern, commercial and global airline industry requires modern, commercial and global rules.

⁷ See IATA (2006), "Value Chain Profitability", available from www.iata.org/economics

CURRENT RESTRICTIONS

International aviation is governed by a complex web of bilateral air service agreements (ASAs) that were developed according to the principles of the 1944 Chicago Convention. IATA estimates there to be over 3,000 ASAs in existence, though just 200 of them account for around 75% of the total traffic covered by the agreements. Only 17% of international air traffic is conducted in a liberalised operational environment. However, even in many of these cases, such as for intra-EU flights, there are still some restrictions on airline ownership and control for investors based outside of the region.

The current system constrains the ability of airlines to operate on a fully commercial basis. These constraints arise as a result of:

- **Operational (or product market) restrictions**

Each ASA contains limits on the services that airlines are able to provide. An ASA can include restrictions on the number of airlines permitted to operate on a certain route, restrictions on the frequency of flights and, though less common now, restrictions relating to the fares charged on such routes.

- **Ownership (or capital market) restrictions**

Limits on the foreign ownership of airlines can take a variety of forms. ASAs often contain conditions giving country X the right to reject country Y's airline if the carrier is not 'substantially owned and effectively controlled' by nationals of country Y. These restrictions are often supplemented by statutory provisions in a country. For example, in the US, the Civil Aeronautics Act requires all US airlines to be at least 75% owned and controlled by US citizens.

LIBERALISATION SO FAR

Since the 1970s a number of governments have taken steps to deregulate parts of the airline industry.

For example:

- The first major step was the liberalisation of US domestic flights in 1978, removing operational restrictions on US airlines flying on domestic routes.
- In Europe, a series of liberalisation measures, culminating with the "Third Package" in 1992, created an "Open Aviation Area" within the EU. This removed product and capital market restrictions on all domestic and intra-EU international flights for Community airlines (i.e. majority owned and controlled by Europeans). Restrictions remain for airlines from non-EU states.
- Similar Open Aviation Area agreements have been reached in other regional blocs, such as Australia and New Zealand, the Caribbean States, and some Latin American countries.
- Since 1992, some bilateral arrangements (e.g. between the US and the Netherlands) have moved to an "Open Skies" agreement. Under these agreements, all restrictions relating to airlines, frequencies and destinations with respect to flights between the two countries are removed. However, this relates only to airlines that are majority owned and controlled by nationals of either signatory country to the agreement.

However, while these deregulations are welcome, the failure of governments to follow-up with broader liberalisation has tended to make them half measures. Only 17% of international traffic is conducted in a deregulated operational environment. In addition, with the exception of the EU Open Aviation Area, "eighth freedom" cabotage rights (i.e. the right for a foreign airline to offer routes entirely within the domestic borders of another country) remain prohibited.

Liberalisation of ownership restrictions is also much less advanced than for operations. For example, Open Skies agreements do not remove national ownership clauses. The nature of these restrictions can affect the ownership and management structure of airlines. The corporate structure adopted by Air France-KLM, following its merger in 2003, seeks to preserve a “Dutch” element for the KLM operations in order to retain its rights within the US-Netherlands Open Skies agreement.

The European Court of Justice (ECJ) effectively ruled in 2002 that the nationality clauses within bilateral (including Open Skies) agreements involving an EU country are illegal. These clauses are deemed to restrict a European airline’s right to do business across the EU (eg. by not allowing Lufthansa to fly to the US from Madrid), in direct contravention of the EU single market. To comply with the ECJ ruling every EU member state must grant equal rights of access to all EU airlines for routes from the EU to non-EU destinations.

In response, the European Commission was granted a mandate by EU governments to negotiate new agreements on their behalf. Negotiations have been held on a liberalised US-EU aviation agreement. An agreement reached in March 2007 will implement a more liberal (though still not fully liberal) environment from March 2008 onwards. It is a step in the right direction, but should also act as a stepping stone for further deregulation in the future.

The benefits from liberalisation already undertaken

The examples of deregulation undertaken so far have created clear benefits. Passengers, in particular, have derived significant benefits as the market has been liberalised. For example, deregulation of the US domestic market is estimated to provide additional welfare gains of around \$6 billion to passengers from greater choice and lower fares⁸.

Open skies agreements have also tended to generate greater competition on long-haul international routes, helping to improve airline efficiency and to offer greater benefits for passengers. For example, liberalisation between India and the UK in 2005 has resulted in a doubling of weekly flights to 200 in less than a year. Passengers on the route have much greater choice, with both UK and Indian airlines taking advantage of the opportunity to enter the market or to expand their existing services.

Regional liberalisation can lead to an increase in the number of airlines, but this often tends to be followed by consolidation and/or market exit. New entrants into the US domestic market have often failed to survive⁹. Those that are successful have tended to focus on a sustainable low cost base (e.g. Southwest). This increase in lower cost competition has, in turn, forced existing airlines to improve their productivity and cost efficiency in order to remain competitive¹⁰.

A recent study by Intervistas¹¹, that was co-sponsored by IATA, found significant evidence that the liberalisation of air services creates significant benefits. It found that restrictive bilateral agreements constrain air travel, tourism and business, and, consequently, constrain economic growth and job creation. Intervistas’ study highlights that liberalising just 320 of the current major restricted country pair routes could increase traffic by 63%. This could create 24.1 million additional jobs and generate an additional \$490 billion of GDP, equivalent to an economy the size of Brazil. Therefore, liberalisation of air transport is a critical decision that must be taken for the health of the global economy.

⁸ Morrison and Winston (1986), “The Economic Effects of Airline Deregulation”, The Brookings Institution.

⁹ See Forsyth, P (1998), “The Gains from the Liberalisation of Air Transport: A Review of Reform”, Journal of Transport Economics and Policy.

¹⁰ See Reed, R. (1998), ‘Pricing and Deregulation in the Airline Industry’, in M. Gaudry and R. Mayes (eds), Taking Stock of Air Liberalisation, Centre for Research on Transportation, University of Montreal

¹¹ See Intervistas (2006), “The Economic Impact of Air Service Liberalisation”.

However, while passengers and other users derive clear benefits from product market liberalisation, in cases where there is not also capital market liberalisation, airlines may be restricted in their ability to adjust capacity. As such, in these cases, product market liberalisation has reduced barriers to new entry and placed competitive downward pressure on yields. But with barriers to restructuring or exit remaining high for existing airlines, they have been unable to adjust capacity on a full commercial basis. This has created a situation of excess capacity in some areas and capacity bottlenecks in others. It is a key structural constraint causing low returns on invested capital across the airline industry.

Airline liberalisation vs. Airport regulation

There are significant potential benefits from greater liberalisation of the airline industry. There are also significant potential benefits from more effective economic regulation of airports and air navigation service providers (ANSPs). These statements are not contradictory. Instead, they reflect the different degrees of competition and market power held within the aviation industry.

This report discusses the case for liberalisation of the airline industry and the significant potential benefits that it can provide. It draws lessons from the experience of liberalisation in other industries that share similar characteristics to the airline industry, including strong, customer-focused market competition (see Chapter 4). By contrast, the different characteristics of airport and ANSP infrastructure providers mean that more effective regulation is required to prevent them from exploiting their monopoly power at the expense of users.

More effective economic regulation of airports and ANSPs creates significant benefits because¹²:

- Airports and ANSPs are, for the most part, natural monopolies with market power. They face very limited competition from other airports or ANSPs in their city or regional market, in terms of competition for airline customers and routes. Any competition between major hub airports for transfer passengers primarily reflects competition between the fares, service and routes provided by different airlines rather than between the airports themselves. In other words, where there is some degree of competition passengers largely choose on the basis of airlines not airports.
- Airports and ANSPs have the potential to exploit (and, in many cases, actually are exploiting) their natural monopoly position. Market power allows an airport to arbitrarily raise its prices, resulting in excessive and unjustified profits and/or the inefficient delivery of services. Since 2001, airlines have significantly improved their efficiency and lowered their non-fuel unit costs. However, our infrastructure partners have, in general, not shared in this efficiency drive. Instead, in many cases, as their costs have increased they have sought to pass this on to users through significantly higher charges.
- Economic regulation can act as a powerful catalyst for improvement. It improves efficiency and productivity throughout the aviation industry. It encourages timely and cost-effective new investment. It benefits all stakeholders, from the regulated airports to passengers, other users and the wider economy. Regulation is a second-best solution to effective market competition, but where such competition does not exist – as for many airports and ANSPs – it is both necessary and valuable.

Indeed, a well-designed and effective regulatory framework can provide mutual benefits for airports, ANSPs and airline users. An incentive-led process helps to improve efficiency and the business investment planning process, often through consultation with users who can provide constructive help. Independent and transparent economic regulation can reduce uncertainty on both sides, helping to reduce investor risks and financing costs. The stability provided by an effective regulatory framework can also attract sustainable, longer-term investment finance into the industry.

¹²For more details see IATA Economic Briefing (2007), "Economic Regulation", available to download at www.iata.org/economics.



04 | Liberalisation in other Industries

The experience of liberalisation in other major global industries provides important lessons for the airline industry. It helps to understand better the impact of further liberalisation for the global airline industry. It provides insights into the optimal process, timing and scope of liberalisation to help to maximise benefits and to minimise potential disruptions and problems.

IATA worked closely with consultants OXERA to analyse the impact of operational (i.e. product market) and ownership (i.e. capital market) liberalisation in four different industries. Each industry was chosen for its shared characteristics with the airline industry. The analysis looks at the impact of liberalisation for both consumers and producers. It looks at its influence on competition, efficiency, prices and costs, along with the strategic responses of firms to liberalisation.

Choosing the relevant industries

IATA and OXERA decided that the industries with the most relevance to the global airline industry, in terms of the lessons and experience of liberalisation, are:

- **Retail banking;**
- **Energy (i.e. gas and electricity markets);**
- **Telecoms; and**
- **Media**

The focus of the analysis is on particular regions or countries where liberalisation took place within the industries. In each case there had to be a definitive point in time at which liberalisation took place. This provides a distinct 'before' and 'after' aspect, allowing a meaningful assessment of the effect of the policy change. This ruled out some sectors (e.g. the automobile sector) which, although very liberalised, do not have definitive policy changes that had a major impact on the scope and timing of liberalisation.

To be relevant, the industries chosen also had to share several, or all, of the following key characteristics:

▪ **Political importance**

In common with the airline industry, the industry is considered to be of significant political or strategic importance for a country. This is often used as the justification for the original imposition of restrictions on ownership and operations.

▪ **Customer-facing**

In common with the airline industry, the industry has a direct interaction with individual customers as the service is supplied. This has important implications for corporate strategy within the industry, for example, through the importance of brand loyalty.

▪ **Wider economic benefits**

In common with the airline industry, the industry generates significant 'spillover' economic benefits in other sectors. It provides a key infrastructure asset that benefits direct users but also facilitates benefits for the wider economy through, for example, access to larger markets and to new technology.

▪ **Network effects**

In common with the airline industry, the industry has significant "network effects" associated with the growth in its usage. For example, adding a new service to an existing network benefits not just users of the new service but also existing users in other parts of the network due to the increased options and potential connections it provides.

▪ **Cost structure**

In common with the airline industry, the industry has a high share of fixed costs and the potential for economies of density (i.e. marginal costs are relatively low). As such, the industry is tempted to lower prices to attract an extra customer and increase utilisation rates. This can benefit consumers but also potentially reduce prices below sustainable and profitable levels.

BOX 1: THE CHOICE OF INDUSTRIES BASED ON SHARED CHARACTERISTICS.

	Airlines	Banking	Energy	Telecoms	Media
Political Importance	Generates considerable political interest.	Important, though interference has reduced in recent years.	Energy security is of significant importance to the economy.	Still considered strategically important in many countries.	Strategic importance recognised in most countries.
Customer-Facing	Direct interaction. Service quality is a key factor in consumer choice and loyalty.	Customers continue to interact with individual branches/representatives.	Some interaction at the point-of-supply; limited at generation.	Customer service quality is a key factor in consumer choice and loyalty.	Limited day-to-day interaction, but potentially growing with digital technology.
Wider Economic Benefits	Significant wider economic benefits for productivity and investment.	Underpins the financial system, facilitating transactions in other sectors.	Essential infrastructure, providing a key input for other industries.	Essential infrastructure, facilitating improved communications across the wider economy.	Some externalities in consumption. Allows other industries to reach a wider market.
Network Effects	Available connections increase as new routes are added to the network.	Lending capacity depends on number of deposits.	Limited network effects.	Network becomes more attractive, the greater the number of customers connected.	Interaction between advertising revenues and customer numbers.
Cost Structure	Large share of fixed costs. Marginal cost of filling an extra seat on a plane is low.	High fixed costs in a banking network. Marginal cost of an extra transaction or customer is low.	High fixed costs in generation. Lower share of fixed costs in supply.	High fixed-cost network, e.g. large investment required for 3G networks.	Relatively low fixed costs (apart from for broadcasting).

THE PROCESS OF LIBERALISATION

Liberalisation within an industry typically consists of two linked, but often separate, processes. Product market liberalisation removes restrictions on the level, type and price of service that is provided. Capital market liberalisation removes or relaxes restrictions on who can own a company and, in particular, allows greater ownership and control rights to be granted to foreign investors.

These processes can be – though need not be – mutually exclusive. Product markets can be liberalised but controls retained on ownership (e.g. open-skies agreements), while ownership restrictions can be relaxed without changing operational restrictions (e.g. attempts to attract foreign investment in a company). Indeed, different timings and objectives between the two processes can be complementary but can also, in some cases, be conflicting. Therefore, before examining the experience of liberalisation in the other industries, it is important to understand the “transmission mechanisms” through which each process can have an economic or financial impact.

i) Product market liberalisation

The lifting of restrictions on the range of services that can be offered typically creates a more competitive and efficient operating environment. The lowering of regulatory barriers increases the threat of competitive new entry. The removal of protected markets forces firms to serve the needs of their customers more effectively. Firms are forced to respond by increasing the competitiveness of their products; improving productivity, cost efficiency and the quality of service offered.

There are three main routes through which product market liberalisation can impact upon efficiency levels:

- **Productive efficiency**

This ensures that, for a given standard of quality, each level of output is produced at the minimum level of costs. Greater liberalisation increases competition and widens available markets, providing incentives for firms to minimise costs in order to boost profitability and to increase volumes and market share.

- **Allocative efficiency**

This ensures that capacity is allocated and adjusted in line with market demand, with the level of output determined by where marginal cost equals marginal revenue. Greater product market liberalisation can lead to stronger competition and allow capacity to adjust to changing market needs, but without capital market liberalisation does not provide full commercial freedom.

- **Dynamic efficiency**

This ensures that the level of quality and output improves over time to meet customer needs. In other words, it ensures that investment and new services are delivered in a timely and cost-effective manner. Greater liberalisation can provide an increased incentive for firms to develop the range and quality of their products to meet new and changing customer demands.

The benefits arising from all three of these routes are evident from the degree of product market liberalisation already undertaken in the airline sector. However, in cases where there is no complementary capital market liberalisation, the effect can be to increase incentives for efficiency but to restrict the ability of airlines to translate this into a sustainable level of return on their invested capital.

ii) Capital market liberalisation

Deregulation of capital market controls on foreign investment has been a key factor behind globalisation and the growth in international trade and investment flows. The legal and regulatory barriers to international investment have been reduced or removed in several global industries, in both developed and emerging economies.

There are three main routes through which capital market liberalisation can create positive economic and financial impacts within an industry:

▪ Facilitating higher investment

Relaxing ownership restrictions can reduce the cost of capital of firms, in turn making investment finance cheaper and increasing international mergers and acquisitions (M&A) activity. The cost of capital can be reduced in three main ways. Firstly, the ability to diversify across several countries allows firms to diversify and offset specific risks in individual countries (while something 'bad' is happening in one part of the world, something 'good' might be happening elsewhere). Secondly, improved controls on corporate governance can reduce the "asymmetric information" between management and investors, thereby lowering the risk for investors and the level of return that they require. Thirdly, lifting ownership restrictions provides improved access to capital, widening the supply of funds available to a firm.

▪ Facilitating the transfer of managerial best practice

Access to a wider pool of management can lead to an effective transfer of best practice techniques, leading to more efficient firms and better products for consumers. Empirical evidence shows that foreign investment can improve labour productivity¹³, while foreign subsidiaries can have a higher total productivity level than similar domestically-owned firms. Though of course, in the case of the latter, a firm may already be highly productive and therefore more attractive to foreign investment. However, increased productivity among foreign subsidiaries may also have spillover benefits, as domestically-owned firms are forced to emulate productivity improvements in order to remain competitive.

▪ Facilitating easier exploitation of economies of scale and scope

Relaxing ownership rules facilitates international expansion through M&A activity, providing access to new markets and creating the potential for economies of scale (lower average costs as volumes increase) and economies of scope (lower average costs as the range of products increases). For a number of reasons (e.g. brand loyalty, local market knowledge, effective distribution chains) M&A activity is often more optimal than organic growth in developing economies of scale and scope across international boundaries.

In addition, removing ownership controls can also provide significant benefits for existing shareholders by boosting the market value of a company. Box 2 discusses how relaxing foreign ownership rules was positive for the market value of Nestlé and for banks in Singapore. Some controlling (or blocking) government "golden shares" in firms have been removed (e.g. the UK government and BAA plc, German regional governments and Volkswagen), often due to legal pressure from the European Commission. In many of these cases, removing golden shares can help to improve the share price performance, not least by making the firms more attractive for M&A activity.

¹³ See Conyon et al, (2002), "The Productivity and Wage Effect of Foreign Acquisition in the UK", Journal of Industrial Economics.

BOX 2: RELAXING OWNERSHIP RESTRICTIONS AND THE “NESTLÉ EFFECT”.

International diversification and improved corporate governance can lead to a reduction in a firm's cost of capital. It helps to explain the increase in market value experienced by Nestlé following the removal of its nationality ownership restrictions.

Until November 1988, Nestlé had two main types of share, which differed in ownership restrictions. The first, ‘bearer’ shares, were available to all investors on an anonymous basis. The second, “registered” shares, were available only to Swiss investors, and did not provide anonymity. Both share types afforded the same voting rights and dividend entitlements. However, the prices between the two types differed substantially, with the shares only available to Swiss investors trading at a discount of around 50% the value of the shares available to foreign investors.

In November 1988, Nestlé announced that it was removing the restrictions on foreign ownership of registered shares. The result of this was arbitrage between the two categories of shares, with registered shares increasing in value and bearer shares falling in value. However, the important consequence was the impact that it had on the overall market value of the company. In particular, there was a substantial increase in the market value of the company following the announcement of the removal of the ownership restrictions, amounting to around 10%.

Studies of this event have concluded that the opportunities provided by greater international diversification for investors led to a decline in Nestlé's cost of capital of anywhere between 90 and 190 basis points¹⁴.

A similar outcome can be seen from the relaxation of ownership constraints in Singapore banks¹⁵. The regulation increased the cap on foreign ownership of most Singapore banks from 20% to 40%, but also required the Development Bank of Singapore (DBS) to comply with the rules where previously it had been exempt. Two banks that saw their constraints relaxed – Overseas Chinese Banking Corporation and United Overseas Bank – experienced a market value increase of 4% and 9% respectively, while the market capitalisation of DBS fell by 5%.

¹⁴ See Schulz R (1999), “Globalisation, Corporate Finance and the Cost of Capital”, *Journal of Applied Corporate Finance*.

¹⁵ See Lam S (1997), “Control versus Firm Value: The Impact of Restrictions on Foreign Share Ownership”, *Financial Management*.

05 | The Impact of Liberalisation on Consumers

Liberalisation can provide significant and sustainable benefits for consumers. Consumers can benefit from lower prices, greater output choice, better quality or a combination of the three. Removing ownership restrictions helps to support and enhance these benefits over the longer-term. Competitive pressures improve efficiency and productivity, making firms more responsive to consumer needs.

In assessing whether an industry should be deregulated, policy-makers are particularly concerned about the impact any changes may have on consumer welfare. This consideration must take a balanced view, considering whether any immediate impacts are sustainable over the longer-term. For example, considering whether increased competition and low prices in the short-term affect the long-term viability of firms within the industry. As such, consideration of how consumer benefits are maximised needs to reflect that, in the long-term, positive or negative effects on firms will have a similar positive or negative effect for consumers.

The experience in other industries shows that liberalisation can lead to substantial benefits for consumers in terms of lower prices, greater and more diverse output, and improvements in product or service quality. These benefits can be enhanced where both product market and capital market liberalisation is undertaken. Examples from each of the industries include:

- **Retail Banking**

Relaxing ownership restrictions in the US banking sector has improved output and choice, with an increase in the density of branch networks, while also reducing prices through lower margins between lending and saving rates. Customer service quality has also increased, though service fees have increased to cover the extra costs involved.

- **Energy Markets**

The liberalisation of European electricity and gas prices has increased choice, with a number of new entrants, and reduced retail supply prices for customers. EU electricity prices are estimated to be 10-20% lower and gas prices 35% lower than they would be without liberalisation. Prices are lowest in countries that have introduced the greatest amount of liberalisation.

- **Telecoms**

In both Japan and Korea, the deregulation of telecoms markets has increased consumer choice through new entrants and led to price falls of over 50% in several categories of calls. There is also evidence that countries that allow a higher degree of foreign ownership of telecoms firms benefit from higher fixed and mobile telephone penetration rates amongst consumers.

- **Media**

Liberalisation of TV and radio markets has increased the available output and increased the number and diversity of options, including specialist channels for different consumer tastes (e.g. Indian TV, New Zealand radio). Removing restrictions on foreign ownership has also, in some cases, helped to 'rescue' financially struggling firms.

This suggests that further – and fuller – liberalisation in the airline industry can provide significant benefits to consumers. Further liberalisation, including the removal of airline ownership restrictions, will not put at risk the consumer benefits obtained from existing product market liberalisation. Instead, it can enhance these benefits and place the industry as a whole in a more sustainable position.

CHALLENGES AND RISKS

While liberalisation may be expected to result in a general downward trend in prices, it may also result in more volatile prices in the short-term as firms respond more quickly to changes in market conditions. For example, prices may rise in response to external shocks due to (short-term) capacity shortages, but this can also provide an important signal to producers to undertake further investment.

Liberalisation typically leads to an increase in the number of competitors. However, over the longer-term, removing ownership restrictions can lead to consolidation within sectors, as firms seek to exploit economies of scale and scope. Increased consolidation brings with it the risk of

firms acquiring a dominant position and then abusing that dominance, to the detriment of consumers. However, this should not be used to justify maintaining operational and ownership restrictions. Instead, these concerns should be protected by a robust, well-functioning competition law regime, that can assess proposed mergers and block or alter them if necessary.

CONSUMER PRICES

The experience of liberalisation in other industries shows that liberalisation, and the increased competition it provides, has benefited consumers through lower prices, for example:

- **UK electricity market**

Liberalisation in 1998 led to a number of new entrants in each of the 14 former regional monopoly areas. New entrants charged lower prices than the incumbent monopoly supplier in order to attract customers, leading to a response in terms of lower prices from the incumbent too. For example, in 2000, the former monopoly suppliers were offering discounts of 8.5% to 16.5% for customers on standard tariffs.

- **EU energy markets**

Studies have shown a strong positive link between the degree to which markets are liberalised and downward pressure on electricity and gas prices¹⁶. Electricity prices were found to be 10–20% lower and gas prices 35% lower than they would have been in the absence of liberalisation. Greater consumer choice in gas and electricity supply was a key driver of these lower prices.

- **Korean telecoms industry**

The introduction of competition into the Korean telecoms market led to prices for most international calls falling by over 50%. The price of domestic calls did rise, though this was because the monopoly supplier had previously cross-subsidised domestic calls and prices rose as they were exposed to more liberal markets.

- **Japanese telecoms industry**

The liberalisation of Japanese telecoms led to aggressive price competition between the incumbent (NTT) and several new entrants. By 1996, the price charged by the incumbent had fallen by almost 70% from the 1976 level, yet improvements in efficiency and productivity meant that the overall market was still profitable.

GREATER OUTPUT AND CHOICE.

The experience of liberalisation in other industries also shows that liberalisation has benefited consumers through increases in the size and diversity of output. The media industry provides the best examples, such as:

- **Indian TV industry**

Liberalisation led to the number of available TV channels increasing from one in 1991 (provided by the state-owned incumbent) to 300 by 2005. The state-owned monopoly reacted to competition by increasing its own number of channels to 19 by 1998. In addition, the number of TV transmitters across the country increased five-fold to 1,000 in 1997, making TV available to a significantly larger population.

- **German TV industry**

Deregulation led to an increase in the number of available channels from three in 1984 to 60 in 1997. It also led to several new firms entering the market, providing a wide range of new channels catering towards specific consumer tastes.

- **New Zealand media**

Liberalisation opened up additional radio frequencies that have been used by niche broadcasters to cater for a diverse range of interest groups. For example, the number and diversity of youth-oriented formats increased, which led to an increase in the time that young people spent listening to the radio. On the TV side, Box 3 provides a case study of TV3, discussing how liberalisation of ownership restrictions helped to protect and enhance consumer choice.

¹⁶ See Copenhagen Economics (2005), "Market Opening in Network Industries".

BOX 3: LIBERALISATION AND THE EXAMPLE OF TV3 IN NEW ZEALAND

The New Zealand television channel TV3 proved to be unsuccessful after its launch. While it had expectations of capturing 30% of the national audience, it managed to attract only 14%. Its share price collapsed and after 157 days of broadcasting it went into receivership. In an attempt to revive TV3, foreign ownership restrictions in the New Zealand media sector were removed in 1991. After the removal of restrictions, CanWest, a Canadian TV broadcaster, bought a 20% stake in TV3, and also secured exclusive management rights to control and operate the channel. Under the ownership and control of CanWest, the performance of TV3 improved. According to a report submitted to the NZ Productivity Commission, "CanWest's management of TV3 has made it financially viable along with providing it with stability in its total broadcasting hours". By 1998, TV3 accounted for almost 25% of the audience share of peak-time viewing. Moreover, in 1997, CanWest launched a free-to-air channel, TV4, which was available to 60% of the population. TV3 offered more programme diversity to its viewers than the two incumbent channels. Other foreign-owned channels have since begun broadcasting in the New Zealand television sector (e.g., Prime television and Sky television) providing an additional source of competition to the existing channels.

PRODUCT AND SERVICE QUALITY

In addition, the experience of liberalisation in other industries shows that liberalisation has benefited consumers through higher quality and market access, for example:

▪ US Banking

The Interstate Banking and Branch Efficiency Act (1994) allowed interstate branching for both foreign and domestic banks, hence allowing mergers to take place between banks in different states. The deregulation has led to an improvement of quality standards (e.g. the density of branch networks has increased) reflected in improved consumer satisfaction surveys. Consumers have benefited from a decline in the margin between lending and saving rates, though higher service quality has meant that some services fees have increased to reflect higher costs.

▪ Telecoms

A study of ownership restrictions and telecoms consumer penetration rates¹⁷ (i.e. the proportion of the population with access to telecoms), shows that for every 1% increase in the maximum foreign ownership cap, the penetration rate of fixed lines was found to be around 4% higher. Overall, the study shows that restrictions, including those on foreign ownership, tend to have had a negative impact on output and that consequently, liberalisation is expected to boost output and hence penetration levels.

Therefore, when foreign ownership restrictions are lifted, a greater pool of potential owners can make both existing and new companies more effective competitors. They can improve managerial and technological expertise, improving the responsiveness of firms to a broad range of consumer needs.

¹⁷ See Warren and Findlay (2000), "Impediments to Trade in Services: Measurement and Policy Implications", London: Routledge.

06 | The Impact of Liberalisation on Producers

Commercial freedom is critical for firms. Full liberalisation provides firms with the full commercial freedoms to respond to increased competition. It can improve the efficiency, productivity and even profitability of firms. It allows firms to serve markets where they exist and to merge and consolidate where it makes business sense.

It is also important to look at the experience of liberalisation in other industries on individual firms and on the market structure. In particular, it is important to focus on the potential impact for firms in terms of:

- **Consolidation and excess capacity**
- **Cost efficiency and productivity**
- **Investment and knowledge transfer**
- **Profitability and market value**

This chapter argues that experience in the other industries shows that full liberalisation can improve the efficiency, productivity and even profitability of firms and their industry. It provides firms with the full commercial freedom to respond to increased competition and to meet consumer needs.

However, liberalisation is not a seamless process and can lead to a degree of volatility, as initial new market entry can lead to excess supply and unsustainable yields before a period of consolidation helps to restructure capacity (e.g. UK energy). However, industries where both product market and capital market liberalisation have taken place (e.g. European banking) have tended to see more immediate consolidation. Improved capacity utilisation is typically linked to consolidation.

In addition, greater commercial freedom does not eliminate the risk of management failure. Relaxing ownership restrictions can facilitate increased mergers and acquisitions (M&A) activity. But, in most industries, there are past examples of companies over-estimating the potential benefits and cost savings from M&A deals. Liberalisation can increase the attractiveness of M&A but does not remove all of its risks.

CONSOLIDATION AND EXCESS CAPACITY

Liberalisation typically leads to an increase in the number of competitors, as new entrants seek profitable opportunities in the newly liberalised market. However, the wave of new entry tends to be followed by a wave of consolidation as the market rationalised. The cycle will still exist where product and capital market restrictions are removed simultaneously, but it can help to minimise the time and volatility involved. Even so, liberalisation across regions, rather than just countries, can involve a two-stage process, with consolidation in domestic markets before cross-border consolidation.

Examples of the cycle of new entry and consolidation include:

▪ **UK energy markets**

Following liberalisation, significant new entry took place in gas and electricity markets, though this has been followed by significant consolidation. In the gas market, the number of firms increased from an original monopoly supplier to 21 by 1999, before consolidating to 9 (6 of whom account for 99% of the market). A similar process occurred in the electricity markets where 14 original regional monopolies faced increased competition from each other and new entrants before consolidating to 6 major firms (the same ones as in the gas market).

▪ **German media**

Liberalisation of the TV sector in 1984 saw a large number of private sector firms enter the market to compete with the two incumbent public sector broadcasters (ARD and ZDF). Over time, M&A has reduced the number of private firms to just two (Bertelsmann/RTL Group and ProSieben Group).

▪ **EU banking**

The Single Market reforms to EU banking services, completed in 1993, reduced and harmonised national regulations. They also introduced the concept of a 'passport', where a bank authorised in its home country could conduct business in any other Member State. The response has been a steady consolidation. Initially this has focused on each domestic market, with 20-40% declines in the number of banking institutions in each major EU country between 1985 and 1998. However, increasingly, there are signs that consolidation is moving towards a second stage, with cross-border M&A deals.

Greater liberalisation of ownership can help to improve capacity utilisation within an industry. However, the new entry and consolidation cycle can lead to short-term volatility in capacity utilisation. This can occur not only through excess capacity as new competitors enter the market, but also because of too little capacity if consolidation also occurs too quickly.

In many industries the optimal utilisation level is often less than 100% (e.g. to provide resilience against external shocks or to protect customer service quality). Consolidation may result in this level being exceeded in the short-term before the market corrects itself. For example, in US electricity generation, liberalisation provided the potential for consolidation driven by efficiency gains and improvements in capacity utilisation (by balancing capacity shortages and surpluses in different areas). However, investment was focused on financing M&A rather than modernising capacity. Consequently, capacity utilisation rose too high in the early 2000s, increasing the risk of blackouts without further investment. Utilisation rates have since reduced to more optimal levels.

COST EFFICIENCY AND PRODUCTIVITY

Greater exposure to market forces tends to lead to improvements in the cost efficiency and productivity of firms, for both incumbents and new entrants. In general, they must attempt to reduce unit costs, for a given level of quality, if they are to compete effectively. It also encourages firms to compete through innovation and increased R&D expenditure. Reducing ownership restrictions supports this process. It facilitates expansion into new markets to exploit economies of scale, and can also provide more efficient financing structures, with an associated decrease in a firm's cost of capital. Examples of this process from the experience in other industries include:

▪ Telecoms

Following liberalisation, the incumbent, Korean Telecom, significantly increased its efficiency. It doubled both its value added per worker and the number of telephone lines per worker between 1987 and 1997. Similarly, in Japan, the productivity growth of the incumbent, NTT, increased significantly following liberalisation. For the five-year period prior to the announcement of liberalisation in 1982, NTT's total factor productivity increased by less than 1% per year, mainly accounted for by higher output. However, from 1982 to 1987, productivity growth increased to 5.1% a year, with the liberalisation effect, alone, accounting for 1.3% of this increase¹⁸.

▪ EU banking

Liberalisation provided significant opportunities to exploit economies of scale, particularly for the very small operators (for the bigger banks these were already largely exploited). It also provided opportunities for larger banks to exploit economies of scope by combining different banking activities (loans, securities and short-term funds) and reducing total costs. The 1990s saw a process of convergence between different financial services providers. For example, in 1995 Dresdner Bank, a large German commercial bank, acquired Kleinwort Benson, a UK securities house; in turn, Dresdner was acquired by Allianz, a German insurer in 2002. Efficiency scores, measuring how close a bank's cost structure is to best practice, increased significantly in the late 1990s. They also tended to converge, with banks in the least efficient countries (Italy and Greece) improving their performance at a faster pace than banks in the most efficient countries (UK and the Netherlands).

However, while there is general evidence that mergers tend to allow economies of scale and scope to be exploited, there is also evidence suggesting that, on occasion, the extent of the projected savings may be overstated. This is borne out by the various studies on mergers of electricity utilities in the USA, with some studies suggesting that only 15% of mergers and acquisitions achieve the expected financial objectives¹⁹.

¹⁸ See Oniki et al (1994), "The Productivity Effects of the Liberalisation of Japanese Telecommunications Policy", Journal of Productivity Analysis.

¹⁹ See Anderson (1999), "Making Operational Sense of Mergers and Acquisitions", Electricity Journal.

INVESTMENT AND KNOWLEDGE TRANSFER

Removing ownership restrictions can also lead to increased investment in the sector (e.g. telecoms), a transfer of management best practice and a lower cost of capital as firms have access to wider and more efficient sources of finance.

Examples of this process from the experience in other industries include:

- **Korean telecoms**

The incumbent, Korean Telecom, and its competitors increased both the expenditure and intensity of R&D following liberalisation. Indeed, the increase in R&D activity was most significant for the incumbent, whose R&D expenditure more than doubled between 1993 and 1997 compared to a 36% increase for one of its competitors. The increase in its R&D activities also led to a substantial increase in the number of patents sought by KT.

- **US telecoms**

Foreign investment can be seen as bringing 'positive externalities in technology and management' to the US telecoms industry²⁰, in the form of new technology diffusion and better management practices.

- **Restrictions in Canadian telecoms**

The Canadian telecoms sector saw the introduction of tighter restrictions in 1991. These restricted access to capital for some companies, causing them to adopt inefficient financial structures, and hence increasing companies' costs of capital. They also led to complex ownership and share structures, which in turn imposed additional costs. It also led to a decline in investment in the Canadian telecoms sector²¹. On average, countries that have strict restrictions on foreign ownership in the telecoms sector tend to have lower investment in the sector than countries with either minor or no restrictions in place.

PROFITABILITY AND MARKET VALUE

Liberalisation can put downward pressure on prices and profit margins for firms faced with greater competition. However, by helping to lower costs, improve efficiency and develop economies of scale, it can lead to an improvement in the level and sustainability of overall profitability. Liberalisation of ownership restrictions also provides a greater potential for takeovers. Shareholders of companies can benefit from the significant share price appreciation that characterises such activity (e.g. Nestlé).

Examples of this process from the experience in other industries include:

- **EU energy**

Liberalisation has encouraged more vigorous competition and lower margins between prices and costs. However, by lowering costs and expanding into new markets energy firms can improve their overall profitability. The large amount of cross-border M&A activity, though subject to political constraints in some cases, is a sign of the overall vitality of the sector.

- **New Zealand radio sector**

Liberalisation increased the number of competitors, but also helped to lower costs, increase profitability and generate greater value for shareholders.

- **US banking**

The averages of a number of variables (including return on assets, return on equity, net interest margins) of the different banks, grouped according to average assets, was found to improve in general following the removal of ownership restrictions²².

The experience in other industries suggests that product market and capital market liberalisation may be expected to 'pull' in different directions. More intense product market competition may be expected to lead to lower profitability, as competition between parties becomes more vigorous. By contrast, the M&A activity that generally follows the relaxation of ownership restrictions is intended to boost profitability and create shareholder value.

²⁰ See Sidak (1997), "Foreign Investment in American Telecommunications", University of Chicago Press.

²¹ See Wall Communications (2000), "Policy Study of the Canadian Telecommunications Foreign Ownership Regime".

²² See Nippani and Green (2002), "The Banking Industry after the Riegle-Neal Act", The Quarterly Review of Economics and Finance.

07 | Strategic Responses to Liberalisation

The key factor for a successful strategic response is for a firm to recognise where its competitive advantage lies and to focus on it. Liberalisation provides opportunities for expanding into new markets as well as threats to existing markets. There will be winners and losers from liberalisation. However, experience from the other industries has shown that firms who are efficient, flexible and responsive to customer needs – regardless of their size – are best placed to benefit.

The experience in other industries shows that there is a significant diversity of responses by firms to more liberal markets, both in terms of their strategic response and the success they have achieved. The four main types of strategic response that have been chosen are discussed in this chapter.

I) EXPANSION INTO NEW MARKETS

Liberalisation can lead to greater competition in a firm's main market, but can also provide significant opportunities for firms to expand into new geographical markets and to compete on a wider scale. Many firms have taken advantage of new opportunities to expand their international presence and reach a wider sales market. This expansion has typically been achieved through M&A activity, or by forming alliances with local firms, rather than through organic growth. Examples of firms adopting an international expansion strategy include:

▪ EU banking

Initial consolidation focused on deals within domestic markets, helping to improve efficiency and, in some cases, create more sizeable and competitive "national champions" (e.g. BBVA and BSCH in Spain). The industry is now seeing an increasing amount of cross-border deals, often with different objectives. Cross-border deals (e.g. BSCH and UK's Abbey National) allow firms to enter new geographic markets and business activities. Between 1997 and 2004, the assets of EU banks held in other EU countries has nearly doubled, while total assets held in non-EU countries have remained relatively stable.

▪ US banking

A series of deregulatory reforms in the US in the 1980s and 1990s provided all banks (both US and foreign-owned) with a coherent regulatory framework and the possibility to establish a US-wide network. Initially, foreign entry was driven by Japanese banks, though from the mid-1990s onwards European banks began to expand their presence significantly.

▪ German TV

Several US firms entered the German TV market by acquiring an ownership share in existing German TV companies. Other foreign firms adopted an expansion approach into the new market through alliances (e.g. Swiss and Austrian firms formed an alliance with ARD and ZDF to form 3Sat).

But international expansion is not a seamless process. For example, if liberalisation is not introduced at a similar pace (e.g. EU energy markets) it may not provide a level playing field for firms to compete. In addition, international expansion plans can often be overly-optimistic, especially where firms are entering markets with different customers or with strong brand and market knowledge advantages for incumbents. In some cases, international expansion has been less successful than anticipated and can lead to eventual market exit. For example:

▪ US banking

Profitability at foreign banks' subsidiaries, whether measured by return on assets or return on equity, was found on average to be one-third that at domestic banks over the period 1980 to 1991. One explanation may be selection bias, with assets acquired by foreign firms likely to have been among the poorer performers (and therefore open to a takeover). It may also be that foreign banks had not, by that point, had sufficient time to improve performance. Indeed several foreign banks (e.g. UBS, RBS) currently have large and profitable operations in the US that have developed over time.

▪ Indian media

Although foreign firms entered the TV market after liberalisation through their own content production, they often failed to capture a big enough audience. This was largely due to cultural differences and variable viewing habits across India. As such, localisation became essential for globalisation to be successful. Consequently, foreign firms changed their strategy. They provided finance, marketing and sales expertise, but partnered with local firms to obtain content that was appropriate to different local markets.

II) DIVERSIFICATION INTO NEW PRODUCTS

In response to increased competition, some firms have looked to offer a wider range of product choice, helping to attract a wider customer base. This has been the case particularly where economies of scope exist (i.e. lower average costs as the range of products increases).

For example:

- **EU banking**

Banks sought to diversify into fee-based activities (such as investment banking) to offset the competitive pressure on margins in the retail banking sector. As such, fee-based income as a proportion of EU banks' total income increased significantly during the 1990s.

- **UK energy**

Following liberalisation, electricity firms have diversified into the gas sector and gas firms have diversified into the electricity sector. Suppliers now make 'dual fuel' offerings that allow consumers to obtain their electricity and gas in a single contract. Suppliers have also expanded their activities beyond electricity and gas into services such as telecoms, water and the Internet. This expansion allows firms to provide a range of services as a bundled offer, thus reducing their costs of supply and taking advantage of cross-selling products to a wider customer base.

- **German media**

Liberalisation has led to considerable cross-media ownership. Two out of the top three television firms are also in the top three firms in the radio sector. Similarly, two of the top three regional newspaper companies also represent two of the three top national newspaper companies.

However, while diversification has been important in some sectors, there is a risk that too much diversification can lead to a loss of strategic focus, which could even have negative impacts on a firm's core activities. For example, British Gas acquired the Automobile Association in 1999 and One.Tel (a telecoms firm) in 2001, but has since sold both businesses as it refocuses its strategy towards core energy services.

Too much or too rapid diversification can cause problems such as significant financial over-stretch, customer confusion or damage to a brand name. As such, the ability of a firm to manage, monitor and respond to diversification is critical to its success.

III) SPECIALISATION IN NICHE PRODUCTS

In some cases, greater competition arising from liberalisation can lead firms to concentrate on where their competitive strength lies. This helps to ensure that a core customer base is retained and that revenues are maximised among these clients. Some firms have adopted this strategy through an explicit "national" focus to their activities, while others have identified a narrow set of activities (rather than geographic markets) where they perceive their firm to have an advantage.

- The UK bank Lloyds TSB provides an example of a firm adopting a "national" focus. It focused its strategy on retail banking, primarily within the UK. The strategy aimed to be a market leader in its chosen segments, focused on the needs of its key customer base and on low day-to-day operating costs. Lloyds TSB withdrew from the US retail banking market and from several other lines of business. It has enjoyed a degree of success in terms of high returns on equity compared to peers.
- The telecoms sector provides examples of firms focusing on a narrower set of activities. Some firms (e.g. BT, Korea Telecom) have sought to focus on fixed-line networks, selling their mobile activities and focusing investment on developing new products (e.g. broadband) within their fixed-line networks.

In each case, it is clear that liberalisation does not mean that the largest firms – who are able to offer a universal business model – will automatically be the most successful. Indeed, larger firms face significant risks in terms of over-expansion or over-diversification in response to liberalisation. A flexible and efficient firm that can focus on its customers needs can still be successful, regardless of its size. Local market knowledge and/or niche products can still be clear competitive advantages for firms.

IV) MARKET EXIT

Nevertheless, there will be losers as well as winners from greater competition, and some firms may be forced to exit particular geographic or product markets. In the case of a specialisation strategy this can be through choice, but in other cases it may reflect over-ambitious expansion plans or, simply, the inability of some firms to improve efficiency in response to competition.

Indeed, liberalisation provides the opportunity for international expansion but does not remove the risks associated with M&A activity. For example, Box 4 provides a case study of BT's expansion into and subsequent exit from the US telecoms market.

In other sectors (e.g. German TV sector) new entrants have often found that they are unable to gain a foothold in some markets, especially when faced with efficient incumbent firms or a culturally-different customer base, and are forced to exit. A similar trend is also seen in airline markets where a degree of liberalisation has already taken place (e.g. the EU Open Aviation Area). Several new entrant no-frills airlines have been unable to make a profit and have been forced to exit the market.

BOX 4: THE INTERNATIONAL EXPANSION OF BRITISH TELECOM (BT)

In 1989, BT entered the US telecoms market by acquiring a 22% stake in McCaw Cellular Communications. However, by 1994, McCaw became a wholly owned subsidiary of AT&T, which left BT with only a very small holding in AT&T. By 1995, it had sold all its shares in AT&T.

Determined to operate in the US telecoms sector on larger scale, BT purchased a 20% stake in MCI in 1995/96 (then second largest company in the USA), with the intention of purchasing the rest of the shares. In 1996, together with MCI, BT launched a firm called Concert. BT's intention to purchase all of MCI highlighted its interest in operating Concert as a wholly owned subsidiary. However, BT's attempt to fully acquire MCI was unsuccessful. In 1998, BT purchased MCI's shares in Concert, and then went into partnership with AT&T in its ownership of Concert.

By 2001, in the wake of the dotcom crash, BT had divested of Concert, along with many of its other international subsidiaries. Several reasons have been suggested for the failure of Concert:

- Fundamentally, Concert suffered from poor performance. It failed to develop a sufficiently large customer base, while maintaining a high cost base, which made it unprofitable. Part of the reason why Concert failed to attract a large customer base was that it was competing with AT&T and other subsidiaries of its parent companies for customers, and the parent companies were reluctant to share their customer base with Concert.
- BT's ownership was restricted to 20%, which contributed to reducing Concert's profitability. The main reason for BT's relatively small share was the restrictions on foreign ownership, which were capped at 20% at that time by US regulators.
- Regulatory requirements for BT to commit to regular investments in the home telecoms sector put a strain on its financial resources. Coupled with this, BT had accumulated substantial debt owing to its expansionist strategy.

08 | The Opportunities and Challenges for Further Airline Liberalisation

There is a strong case for further – and fuller – liberalisation in the airline industry. It is now for governments to provide the leadership that the airline industry needs. Policy needs to be brought in line with the progress that airlines have made and continue to make. Airlines need a leadership vision for the future, not a 60 year-old set of rules.

Of course, comprehensive liberalisation is not possible overnight. Governments and policymakers will not all be able to liberalise markets at the same pace. But it is important that they all recognise the need to move in the right direction. This direction has already been set, at ICAO's Fifth Air Transport conference in 2003, providing a way forward for progressive liberalisation.

Negotiations on a US-EU liberalised agreement have taken a long time but, with the March 2007 agreement, now offer a clear way forward. The agreement is a step in the right direction and should now offer a stepping stone to further liberalisation.

Elsewhere, there are some pockets of progress, particularly in some key emerging airline markets. China is opening parts of its market. Greater commercial freedoms in India have led to significant growth in domestic and international traffic. A liberalised approach in Singapore, the United Arab Emirates and other parts of the Middle East and Asia is helping to support rapid growth in passenger and freight volumes.

This chapter shows how potential barriers to liberalisation can be overcome and how the necessary progress can be taken forward through bilateral and multilateral agreements.

OVERCOMING BARRIERS TO FURTHER LIBERALISATION

Commercial freedom is critical for airlines. The future success of the industry rests on its ability to serve markets where they exist and to merge and consolidate where it makes business sense. However, liberalisation must only take place if the highest standards of safety and security can be maintained in a more commercial environment.

The UK Civil Aviation Authority (CAA) examines the regulatory barriers to change in a recent report²³. It analyses whether there is any objective justification, particularly on safety and security grounds, to maintain strict restrictions on airline ownership and control. It shows that care needs to be taken in moving to a liberalised environment, with some adjustments to the traditional regulatory approach needed. However, a clear pathway to full liberalisation for the airline industry, one which is consistent with optimal safety and security standards, does exist

i) SAFETY

The CAA identifies potential practical issues relating to the day-to-day enforcement of safety regulation in a globally liberalised aviation sector. For example, in liberalised markets, an airline will be free to operate services outside of its "home" country and beyond the reach of its existing safety regulator. Changes to the licensing process can help to overcome this issue. The CAA proposes strengthening the existing licensing requirement to ensure that a significant level of an airline's operations is based in the country where it is licensed and regulated. This would prevent airlines "brass-plating" their operations in countries with little or no operational connection to the airline (i.e. no "flags of convenience"), and strengthen the effectiveness of day-to-day regulation of a significant part of the carrier's operations.

Governments wishing to join an Open Aviation Area, will have to demonstrate, as a prerequisite, the necessary high safety standards. This is an opportunity to provide an added incentive for all countries to raise their safety standards, as without improvement countries and their airlines will not be able to fully access liberalised markets.

In this environment, national and regional safety authorities will need to cooperate more closely to share information and functions across national boundaries. Options for greater cooperation include basing regulatory staff abroad to check on overseas operations, or a licensing authority "contracting out" its operations to safety authorities in other countries. The development of supra-national safety agencies may be possible, with common and homogenous standards supranationally set but enforced locally. However, even in Europe where the concept - in the form of EASA - is most advanced, more time is needed before the system can be seen to be delivering consistent performance across the whole of the EU.

The airline industry is also taking steps to improve and standardise its own safety audits. IATA operates an operational safety audit programme (IOSA) that is mandatory for its members but is also applicable to any airline. IOSA audit standards are based on ICAO provisions, as well as those from key regulatory regimes and industry best practices. Several states are now using IOSA audit data to assist them in the discharge of their safety oversight functions, with IOSA becoming a key tool to help raise the safety bar on a global basis.

²³ See CAA (2006), "Ownership and Control Liberalisation: A Discussion Paper", www.caa.org.co.uk.

ii) SECURITY

The CAA found no evidence to suggest that the security measures in place at present should be inapplicable in a liberalised world. For example, there has been no diminution of security standards in the EU open aviation area and there is no reason why there should be. National security procedures are a matter of national sovereignty and are unrelated to the nationality of an airline's shareholders or their management. A mechanic, pilot or passenger should be subject to the same checks irrespective of whether Europeans, Asians or Americans have a majority shareholding. In any event, national laws on mergers and acquisitions typically provide powers for a government to block a deal where it is considered to pose a threat to national security. Therefore, a blanket ban on foreign ownership is unnecessary on security grounds.

NEXT STEPS TO LIBERALISATION

ICAO's Fifth Air Transport conference in 2003, provided a way forward for progressive liberalisation across the airline industry. However, while it sets out a framework, it does not provide a globally brokered agreement for implementing the necessary reforms. Global agreements (e.g. through ICAO or the WTO) would be welcome in a global industry, but in practice are highly unlikely. Significant differences in view still exist between governments on the pace and extent of liberalisation. Therefore, at least for the short-term, co-ordinated bilateral and/or regionally focused negotiations can offer the best way forward.

Bilateral negotiations remain the main forum for discussion and a useful mechanism for reform, but the rationale for more supranational leadership is strong. Indeed, while bilateral agreements still contain national clauses on ownership, their overall benefit will remain constrained. In some areas (e.g. the European Union), supranational bodies already lead liberalisation negotiations, and have the ability to add new countries to an existing Open Aviation Area.

Governments (and their aviation policymakers) must show leadership in implementing necessary reforms, overcoming opposition from vested interests. There may be concerns that differences in the pace of liberalisation may create distortionary impacts, with different regulatory approaches applying to competitors in the same market. Such differences could be biased in favour of particular airlines. Principal concerns relate to the operation of different regimes governing state aid and competition but could also cover other areas such as environmental regulation.

These concerns are not easy to tackle; differences in local law and practice may make it nearly impossible to harmonise regulation of aviation across a number of countries. In its report, the UK CAA proposes a pragmatic approach that accommodates these differences whilst establishing acceptable broad principles. This is best described as "regulatory convergence". Prohibitions on, amongst other things, anti-competitive behaviour and the granting of state aid could be enforced through the application of this code of practice. A dispute settlement procedure would be necessary, either in the form of an ICAO-based arbitration process or the existence of a special committee of members tasked with examining and investigating complaints.

Another concern is "free-riding", where a third party seeks to exploit the advantages of liberalisation between other states, but does not liberalise its own market. Therefore, the CAA proposes offering liberalised agreements only to those countries prepared to institute similar arrangements. Such "non-circumvention" agreements would remove the concerns associated with "free-riders" whilst broadening the available pool of capital and management expertise. However, such an approach would require signatory states to continue to monitor the nationality of ownership and control to enforce compliance.



09 | Summary

Experience from other industries demonstrates the positive impact that liberalisation can have for both consumers and producers. It supports the strong case for further – and fuller – liberalisation in the global airline industry. This will not be an easy process. But it is one that is necessary for the long-term health of the industry.

This report has examined the impact of liberalisation in four different industries: retail banking, energy, telecoms and media. Each of these industries provides encouraging lessons on the potential benefits of liberalisation for both consumers and firms, but also highlights the challenges and risks in the process.

The experience from the other industries provides the following key lessons for the airline industry:

- Full liberalisation is often not a seamless process, but it is possible. Liberalising markets over different timescales or removing restrictions on operations without removing those on ownership can create distortions and reduce the potential benefits that are available. However, a clear pathway to full liberalisation for the airline industry, that is consistent with optimal safety and security standards, does exist.
- The benefits of liberalisation are maximised where both operational and ownership and control restrictions are removed. The structure of the airline industry means that removing operational restrictions can lower barriers to entry to the industry. But the barriers to exit or to adjust capacity that are faced by the airline industry must also be reduced in order to improve the long-term position of the industry as a whole.
- Further operational and ownership liberalisation can protect and enhance the consumer benefits, in terms of greater choice and lower fares, already obtained from liberalisation so far in the airline industry. It can also widen and expand these consumer benefits to new regions and routes that currently have highly regulated markets.
- Liberalisation can create the freedom for airlines to operate on a fully commercial basis. This will allow them to allocate capital more efficiently, to respond better to changes in demand in markets and to improve productivity. It provides a platform for the airline industry to expand or rationalise capacity and ownership in accordance with customer needs and to improve the return on capital invested that is earned by the airline industry as a whole.
- In a fully liberalised market, the key for an airline is to recognise where its competitive advantage lies and to focus on it. Liberalisation provides opportunities for expanding into new markets as well as threats to existing markets. There will be winners and losers from liberalisation. However, experience from the other industries has shown that firms who are efficient, flexible and responsive to customer needs – regardless of their size – are best placed to benefit.
- A multilateral approach is likely to have more substantial and positive implications for both consumers and airlines. Bilateral negotiations remain the main forum for discussion and a useful mechanism for reform, but the rationale for more supranational leadership is strong. At least for the short-term, co-ordinated bilateral and/or regionally focused negotiations can offer the best way forward

The airline industry has changed significantly but, in general, the rules governing international operations and ownership have not. Governments must now take a clear lead in reforming the outdated, 60 year-old rules that continue to constrain the industry. A modern, commercial and global airline industry requires modern, commercial and global rules.



Greater commercial freedom for airlines is vital for the long-term health of the industry and for the global economy





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