Air Transportation Regulatory Environment:
Ownership Liberalization and Open Skies

MIT Global Airline Industry Program

Norma Campos
Alex Cosmas

October 25, 2007

Faculty Advisor: R. J. Hansman
Research Advisors: P. Belobaba, B. Swelbar

Outline

- Open Skies Model
- Global Alliances and Antitrust Immunity
- Alliance Impacts in the Context of EU-US Open Skies Agreement
- EU-US Foreign Ownership Issue
- Issues of Liberalization
- Stakeholder Interests
- Research Approach

EU-US Open Skies Agreement

- On April 30, 2007 EU and U.S. authorities signed a preliminary Open Skies accord to be enforced starting on March 30, 2008
  - Allows EU airlines to operate direct flights between U.S. and any EU country (and some others)
  - Allows U.S. airlines reciprocal right, and ability to fly between EU city-pairs
- EU officials have made liberalized foreign control a prerequisite for a permanent agreement
  - Match EU's 49% foreign control restriction
  - Main focus on second stage of negotiations to begin 60 days after implementation of provisional Open Skies agreement

Limitations of Open Skies Model

Type of agreement	Open service capacity and frequency ?	Freedom in setting fares ?	Extended traffic rights (e.g. onward 5ths)? (see Note 1)	Foreign ownership and control allowed ?	"Cabotage" (see Note 2)
Traditional Bilaterals	x	x	x	x	x
"Open Skies"	✓	✓	✓	x	x
Open Aviation Area (OAA)	✓	✓	✓	✓	✓

Note 1: 5ths are the right to pick up passengers from a foreign country (B) and fly them to another foreign country (C).

Note 2: "Cabotage" is the right of a foreign carrier to operate purely domestic services in another country.

Source: Civil Aviation Authority, "Ownership and Control Liberalization," CAP 769, October 2006.

- Cabotage rights only granted to US-incorporated airlines
- U.S. allows only 25% of foreign ownership of the voting stock of U.S. carriers

Impact of Open Skies Agreements on Global Strategic Alliances

- One of the biggest impacts of the EU-US Open Skies agreements is enabling the creation of strategic alliances

- Global strategic alliances are granted **antitrust immunity** by the U.S. DOT, which enables them to:
  - Cooperate in fare setting, capacity planning, and direct revenue and profit sharing
  - Maximize degree of integration and mitigate effect of current restrictions on foreign ownership and control

- DOT grants antitrust immunity based on:
  - Pre-requisite of an Open Skies agreement between the countries of registry of the alliance members
  - Analysis of effect that immunity would have on alliance partners, competition, and consumers

Open Skies and Antitrust Immunity

- DOJ analysis suggests that capacity expansions associated with Open Skies are primarily due to expansion by immunized carriers on routes between their hubs (*)

  - DOJ predicts an <u>output increase</u>:
    - Immunized alliances: 51-88%; Code sharing: 22-45%
  - DOJ predicts <u>fare reductions</u> for interline itineraries:
    - Immunized alliances: 14-22%; Code sharing: 5-10%

* Source: Whalen, T. "A Panel Data Analysis of Code Sharing, Antitrust Immunity and Open Skies Treaties in International Aviation Markets," US Department of Justice, Antitrust Division, Economic Analysis Group, May 2005.

MIT ICAT

Airline Alliances

US DOT Antitrust Immunity Applications in Progress

Star Alliance

- Adria Airways (JP)
- Air Canada (AC)
- Air New Zealand (NZ)
- ANA (NH)
- Asiana Airlines (OZ)
- Austrian Airlines (OS)
- Blue1 (KF)
- Bmi (BD)
- Croatia Airlines (OU)
- LOT Polish Airlines (LO)
- Lufthansa (LH)
- SAS (SK)
- Singapore Airlines (SQ)
- South African (SA)
- Spanair (JK)
- Swiss Intl Air Lines (LX)
- TAP Portugal (TP)
- Thai Airways Intl (TG)
- Turkish Airlines (TK)
- United (UA)
- US Airways (US)

Oneworld

- American Airlines (AA)
- British Airways (BA)
- Cathay Pacific (CX)
- Finnair (AY)
- Iberia (IB)
- Japan Airlines (JL)
- LAN (LA)
- Malév (MA)
- Qantas (QF)
- Royal Jordanian (RJ)

SkyTeam

- Aeroflot (SU)
- Aeroméxico (AM)
- Air France (AF)
- Alitalia (AZ)
- Continental (CO)
- Czech Airlines (OK)
- Delta (DL)
- KLM (KL)
- Korean Air (KE)
- Northwest (NW)

Immunity Application In Progress
(to be effective immediately after enforcement of EU-US Open Skies)

Given capacity constraints at LHR, some airlines are interested in accessing this market by trading slots with alliance partners

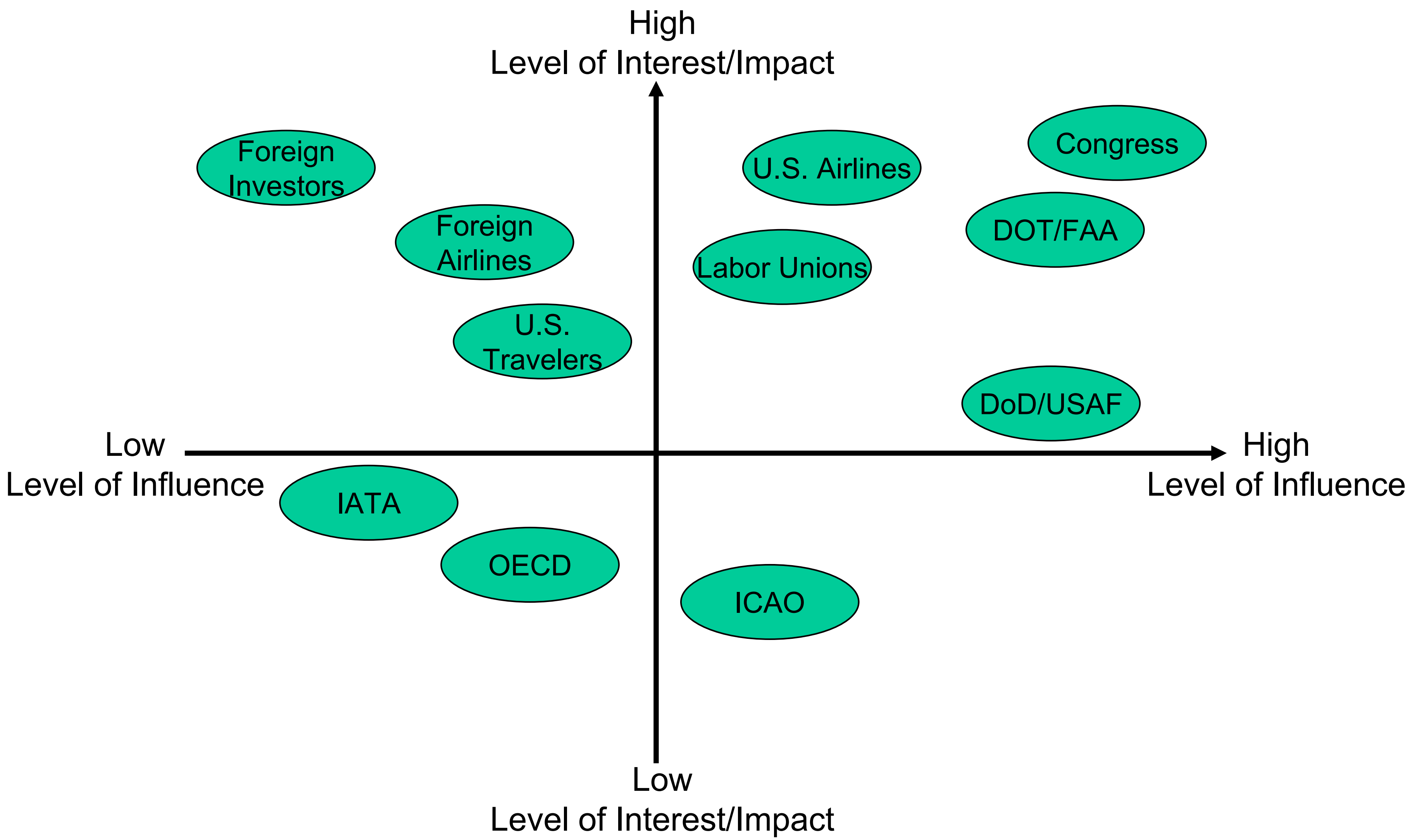
Source: Air Transport World Online News, Wikipedia, BTN Online
Prof. John Hansman, Norma Campos

Foreign Ownership Regulations

Australia	49% intern'l (25% single); 100% for domestic
Canada	25%
China	35%
Chile	Principal place of business
European Union	49%
Japan	33.33%
Korea	49%
Malaysia	45%
New Zealand	49% international; 100% for domestic
Singapore	27.51%
Taiwan	33.33%
Thailand	30%
United States	25%; one-third of board at maximum; cannot be Chairman of Board

Source: Odoni, Amedeo, "International Institutional and Regulatory Environment" 2006 based on Chang and Williams, 2001

Stakeholder Level of Influence



Issues of Ownership Liberalization

1. Domestic Competition
   - Will liberalized foreign ownership benefit or hurt U.S. consumers by changing the competitive landscape?
2. National Security
   - Does foreign stake mean foreign control? Will the Civil Reserve Air Fleet become ineffective?
3. Employment
   - Will increased foreign ownership put U.S. jobs at risk or create new domestic jobs?
4. Safety
   - Does either foreign stake or foreign control imply lower safety standards? Would a/c re-registrations burden the FAA?
5. International Competition
   - Will relaxing ownership laws increase international competition? Will U.S. airlines benefit from increased competition?
6. National Prestige & Political Intangibles
   - Will increased foreign presence hurt the U.S. position as a world leader? Will it present a risk of aviation system disruption?

Stakeholder Issue Perceptions

Source: Literature Review and Stakeholder Interviews

	Domestic Competition	National Security	Employment	Safety	International Competition	National Prestige
U.S. Airlines	↑ 🔴		🟢 ↑		↑ 🔴	↓ 🔴
Congress	🟢 ↑ 🔴	↓ 🔴	🟢 ↑↓ 🔴	↓ 🔴	↑ 🔴	↓ 🔴
DOT/FAA				↓ 🔴		
DoD/USAF		↓ 🔴				↓ 🔴
Labor Unions	🟢 ↑ 🔴		↓ 🔴		🟢 ↑	
Foreign Investors	🟢 ↑				🟢 ↑	
Foreign Airlines	🟢 ↑ 🔴				🟢 ↑ 🔴	
ICAO				↓ 🔴		
IATA	🟢 ↑ 🔴				🟢 ↑ 🔴	
OECD	🟢 ↑				🟢 ↑	
U.S. Travelers	🟢 ↑	↓ 🔴		↓ 🔴	🟢 ↑	↓ 🔴

Impact of Liberalized Foreign Ownership on U.S. Airlines

- A greater pool of capital may reduce the average cost of capital
- Access to cheaper capital allows U.S. airlines to retire debt, consolidate, improve services, avoid bankruptcy
- Diversifying investor risk profiles allows U.S. airlines with weaker credit ratings to seek capital
- Foreign airline investors impact culture of acquired airlines

- However, <u>limiting</u> pool of capital may encourage stronger, less risky business plans
- Assuming quality and number of business plans remains constant, additional funding favors weaker plans

Research Approach

- Literature Review and Stakeholder Interviews
- Case Study: Cargo vs. Pax Airline Positions given differences in policies governing international markets
- Analysis 1: Airline Network Structures under competitive pressures
  - Hub model looking beyond major LCC markets saturation
  - OAG review: secondary/tertiary market coverage
- Analysis 2: Alliance Structure
  - Migration towards hub-to-hub model (i.e. Star Alliance) vs. P-to-P (SkyTeam)
  - Alliance market shares, membership vs. network structures
- Analysis 3: Fleet Composition (mix, size)
  - Orders Placed, nonstop O-D opportunities
  - Pricing response to congestion effects
  - Impacts to CRAF?

Questions