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RULE-BASED APPROACH MUST TRIUMPH

MUTUAL HYPOCRISY BETWEEN AIRLINES CRYING FOUL OVER STATE AID HIGHLIGHTS THE LIMITATIONS OF THE INDUSTRY'S ARCHAIC REGULATORY ENVIRONMENT. ACTION IS NEEDED TO ADDRESS THIS

by Philipp Goedeking

On his very first day in office at the start of February, US Secretary of State Rex Tillerson received a letter from the chief executives of the three biggest US airlines encouraging the administration of President Donald Trump to side with them in a long-running dispute with their Gulf rivals.

Delta Air Lines, United Air- lines and American Airlines again accused Emirates Airline, Qatar Airways and Etihad Air- ways of profiting from competition-skewing "massive subsidisation". The accused airlines, once again, were not shy to point their fingers at their US – and European – rivals, complaining about protectionist barriers hindering free access to key markets.

The dispute between the "no subsidies" and "open skies" camps has been a long and increasingly heated one. Both camps, however, are missing the point: this is a dispute no side can win, because a regulatory system of some 3,500 bilateral traffic- rights agreements is structurally unable to resolve the conflict. For example, to further constrain traf- fic rights and open-skies agreements would "de-compete" the airline industry at least as much as Gulf state-aid does. Protectionism comes in different guises.

It is unacceptable for a government – especially one in the open-skies camp – to give a preferred national airline zero-interest loan after zero-interest loan. Or for it to shield a carrier using complex ownership structures; for example, when a government runs a seemingly profitable airline, which is actually owned by a loss-making holding company. But at least as "decompeting" are the comparatively low hurdles of US Chapter 11 insolvency procedures, which are used by many members of the no-subsidies camp. Both systems socialise airline losses to the detriment of tax- payers, as well as shareholders, lessors and employees. As the saying goes, people in glass houses shouldn't throw stones.both regions will not be as broad or as frequent as under the existing deals Britain must lead the fight for a global 'open skies' system.

Major vacuum

This mutual hypocrisy and resulting deadlock are rooted in an international agreement dating back to 1944. The Chicago Convention closely regulates the air traffic between two countries and any countries along the way. It reflects the technical standard of 1940s aircraft, the realities of 1940s international relations and the condition of 1940s national carriers. Euphemistically, the rules were called "freedoms of the air", although they were always anything but that. Ironically, they left a major vacuum.

	Constraint based	Rule based
Purpose	Preserving the status quo	Encouraging competition
Means	Constraining traffic rights	Defining internationally binding rules of the game
Dispute settlement	• Escalating to inherently biased governments as diplomatic dispute • Lack of rules to settle • "Time will help"	• Independent and rule-based referee

The idea of a large hub in a third country offering large-scale transfer connections between two other countries was not on the radar of regulators in 1944. Today, this "sixth-freedom" traffic is a rapidly growing segment of the airline industry. Led by the open- skies camp from the Gulf, airlines are exploiting this loophole to circumvent traditional constraints and business models. They enjoy much broader opportunity than the tight regulation of the original "five freedoms" can offer.

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The success of sixth-freedom carriers shows how outdated bilateral traffic rights have become. To compound the problem, the Chicago Convention has spawned a web of now anachronistic rules – for example, the requirement of national ownership and effective control. This deems that a carrier serving a "national purpose" must be controlled by the citizens of that nation. Security-sensitive companies in banking, telecommunications and cyber security can buy peers in other countries. Airlines, as a rule, can't. Airlines need to break free from these archaic constraints. Open- skies agreements point in the right direction: they spur competition, growth, and value creation for all stakeholders. While some open- skies agreements are more open (the European Union's) than others (the ASEAN's), there is no evidence that deregulation and increased competition have created any threat to national interests of the countries involved.

Conflict resolution

Today's airlines are much more competitive than their predecessors and the framework of international relations has advanced since 1944. Today's aviation markets are both cause and consequence of global striving for mobility. It is no surprise that a regulatory model from the first half of last century appears increasingly unable to resolve the intensifying conflicts between market participants. To understand why these conflicts are structural and not cyclical, it is helpful to differentiate the purpose and means (see table).

In a framework of thousands of bilaterals only time settles conflicts – they last until one party gives up. The structural deficit is an absence of rules beyond the constraining of access. With cross-border traffic rapidly expanding, hubs increasingly depending on international feeder traffic, and airlines serving long-haul markets considered marginal just a few years ago, the interdependencies of modern aviation are too complex to be properly regulated by a system of 3,500 case-by-case agreements. What is needed are clear, simple and mutually agreed rules that can be applied to the full spectrum of situations. A rule- based regulatory framework such as the World Trade Organization (WTO) and its General Agreement on Trade in Services (GATS) would encourage competition rather than hemming it in.

Hub economics

Ingrained protectionist reflexes from airlines – like asking the US secretary of state for help – hide the fact that large hubs and their home airlines don't need regulation to defend their market positions. The economics of hubbing serve this purpose much more effectively than regulation.

As a result of market-driven scale effects, most major hubs today are dominated by a single airline. These airports have a higher proportion of connecting traffic than smaller ones (up to 65% of passengers using the world's biggest hubs are connecting). The larger the hub, the higher the share of connecting traffic – traffic drives traffic. Secondly, hubbed airlines offer local companies real advantages because they can offer more destinations than other airlines serving that airport. Thirdly, loyalty programmes create a strong passenger preference for hubbed airlines, again giving them a real local advantage.

Today's top airlines are no longer dependent on anticompetitive and protectionist rules. In summer 2016, 31% of all analysed airlines exceeded an important benchmark denoting strategic quality, a marked improvement since 2008, when only 23% met the same threshold. This trend shows that a rising number of air- lines are fully competitive and no longer need old-style constraints.

And yet, airlines and states all feel the system protects their interests. Governments like bilateral agreements because they guaran- tee political control over an industry attributed great national importance. So fixated are they on balancing the reciprocity of their bilaterals that they don't think to question the point of this symmetry. Airlines tolerate bilaterals because of their transparency, stability and predictability – including the predictability of bail-out programmes. Investments are easier to make if an airline trusts the stability of the regulation.

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Any replacement for bilaterals would have to satisfy three central conditions, all of which could be satisfied by the WTO/ GATS framework:

1
Transparency, predictability and stability: WTO/ GATS-based rules would need to provide at least the same level of transparency, predictability and stability as the current system. The WTO/ GATS system does have its critics. However, its rules are built around the straightforward principle of the "most favoured nation". This principle would probably need to be complemented by annexes tailored to the industry. But this would be more about the "how", not about the "if".

2
Ensuring a level playing field: This will require discarding the archaic system of "freedoms world long past. A level playing field requires rewriting of the rules to allow free and fair competition. Again, the concept of "most favored nation" – along with WTO mechanisms to settle disputes and sanction wrongdoing – surely point airlines in the right direction.

3
A pragmatic transition to the new framework: As difficult as change would be, the alternative is to maintain a deeply flawed system – with all its mutual hypocrisy and long-running stand-offs.

Historically, governments have worried the WTO mechanism could lead to sanctions against an airline in retaliation for a dispute in a different industry sector – for example, retail. But this is unfounded because WTO provisions can limit cross-sectorial sanctions. A wide range of sanctions and retaliation mechanisms would make WTO/ GATS more effective in ensuring a level playing field.

After decades of consciously "de-competing" the industry through a regulatory framework that suppresses rather than encourages competition, airlines need to take urgent counter- measures. And not just them: airlines, governments, and international bodies like the WTO and ICAO finally need to discuss bringing this global industry into the WTO/GATS regime or an equivalent. Doing nothing is not an option.