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Industry Agenda

A New Regulatory Model for Foreign Investment in Airlines

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Executive Summary

The World Economic Forum's Global Agenda Council on the Future of Travel & Tourism proposes a new regulatory model for foreign investment in airlines. Despite the importance of international aviation to the globalized economy, the airline sector has historically been segregated from broader international trade talks, allowing antiquated and protectionist sectoral restrictions to persist relatively unnoticed and unchallenged.

This White Paper proposes to eliminate one such restriction – the "nationality rule" that prohibits foreign ownership of airlines. This rule limits airlines' potential investors, thereby increasing the cost of capital. It also denies airlines the opportunity to use transnational mergers or foreign subsidiaries to achieve efficiencies of size and scope, to fully integrate their networks in order to offer passengers expanded route selections, and to benefit from knowledge transfer between management groups. In short, airlines have played an essential role in bringing globalization to the world but are prevented from operating like any other global business.

The rule consists of national statutes capping foreign investment in airlines and clauses in bilateral air services agreements that can deny foreign-owned airlines the opportunity to operate international routes. These redundant layers of regulation have made global liberalization unachievable to date.

The industry has responded by creating transnational alliance and airline groups to secure many of the benefits of a multinational organization, albeit with less efficiency and higher transaction costs. Governments have begun to recognize the futility of ownership restrictions, but liberalization efforts to date, aside from a few isolated cases and the in-region abolition within the European Union, have been incremental and unambitious.

The nationality rule persists largely through inertia, combined with concern over potential negative consequences for safety and security oversight, the prospect of "flags of convenience" emerging that would undermine national labour and environmental regulations, and the possibility that airlines from states with restrictive markets would use foreign subsidiaries to take advantage of liberalized markets where their home states have not bargained for entry (the "rule of origin" problem).

The proposed solution is to replace hard numeric caps and other restrictions on foreign investment in and foreign control of airlines with a requirement that all airlines possess the "regulatory nationality" of the country in which they base their operations and under whose designation they are operating international routes. Implementing this proposal in both domestic law and in international treaties satisfies the concerns above by requiring that any airline, regardless of which state's citizens own or control the airline or its operations, must be subject to the oversight of its state of regulatory nationality.

In the absence of any current initiatives to relax or abolish the nationality rule, this White Paper is a new effort to stimulate reform. It explains the restrictions imposed by the nationality rule, surveys the rule's history and present operation, and proposes a specific change that may be attractive to the airline industry's various stakeholders. The aim in setting out these ideas is to encourage advocates inside and outside the industry to take up this agenda on behalf of travellers everywhere.

1. An Overlooked Restraint on Travel and Tourism

Travel and tourism are vital to the globalized economy. If the travel and tourism sector meets its projections for annual employment growth of 4% over the coming decade,[1] it will only be because of positive contributions from the dominant mode of international transport, the aviation sector.[2] Any inefficiencies, inflated costs or lack of service offerings in air transport will have ramifications up and down the travel and tourism supply chain.

Fortunately, the industry has undergone a wave of liberalization with regard to market access, frequency, pricing and related services that has greatly benefited international travellers over the past two decades. Yet restrictions on foreign investment in airlines remain largely unchanged from the strict regulatory regime installed in the middle of the previous century when the DC-3 dominated air travel. Under the "nationality rule" most of the world's airlines are severely restricted in their ability to sell equity shares, seek investors, or to merge with other airlines.[3] These restrictions, in turn, increase the cost of capital for airlines and deny them efficiencies of size and scope – leading to higher prices for travellers and reduced demand for travel services.

The nationality rule works by effectively requiring airlines to be majority-owned and de facto controlled by nationals of the airline's home state. This requirement, by excluding transnational airline mergers and acquisitions as well as the setting up of foreign-owned airline subsidiaries, makes it impossible to create the kind of multinational corporations that are commonplace in other global industries. It also puts restraints on how much equity capital airlines can attract, which may be particularly problematic when airlines seek to grow in compact capital markets such as Australia (which, despite its vast geographical size, represents only 2% of the global capital marketplace, for example). The nature of the industry magnifies these effects. Not only is it highly capital intensive, but in most countries the industry has few participants, providing few opportunities for domestic mergers. To borrow a phrase favoured by the International Air Transport Association (IATA), the nationality rule prevents airlines "from doing business just like any other business".[4]

Case Study: Global Airport Management

Government officials searching for an example of how increased openness to foreign investment might benefit airlines need not leave the air transport sector to find an instructive case: airports.

Over the past few decades, countries have increasingly allowed their airports to be transformed from cash-starved, sate-owned monopolies to privatized entities open to global investors.

The change has brought in much-needed capital for infrastructure investments and allowed airports to reap the benefits of world-class management expertise and efficiencies of scale, resulting in improved financial performance.

Thus, eliminating restrictions on foreign investment in and ownership of airlines would decrease capital costs, allow airlines to take better advantage of economies of scale and scope, provide enhanced network effects from the expanded routes and more centralized planning made possible by truly global airlines, and offer the benefits of knowledge transfers that typically accompany cross-border mergers in any industry. All of these boons would reduce prices and facilitate better service for travellers.

Despite these clear benefits, no airline industry organization is currently advocating for the abolition (or even major reform) of the nationality rule. A campaign by IATA a few years ago appears to have been wound down.

The International Civil Aviation Organization (ICAO) has advocated for relaxation of these restrictions and reports regularly on the vitality of the rule. While ICAO proposes liberalized modifications, however, it has formed no consensus on what a coordinated global approach might look like. The reluctance of these international organizations stems in part from the fact that many major air carriers have in recent years become more concerned with protecting their own turf against foreign intrusion. Airlines are also worried that advocating for the freedom to enter permanent commercial arrangements with foreign carriers would upset labour groups that oppose outsourcing and wage competition.

2. The Nationality Rule: A Double-Bolted Locking Mechanism

Why is the nationality rule so sticky? Unlike in other industries, capital controls are common not just at the national level but in international agreements as well, creating a double-bolted lock that the industry is unable to open.

An airline cannot operate without explicit authorization from the state in which the airline is seeking to base its operations. Virtually every state, as a matter of national legislation, regulation or administrative policy, makes operating authority for airlines setting up in its territory contingent on those airlines being majority-owned and in effect controlled by nationals of that state or by the state itself. For an airline to fly international routes, it not only needs international operating authority from the airline's home state but also permission from the foreign state or states to which the airline seeks to fly. This permission is typically granted through aviation-specific trade agreements known as air services agreements (ASAs). There are currently more than 4,000 such agreements in force, most of which are bilateral.

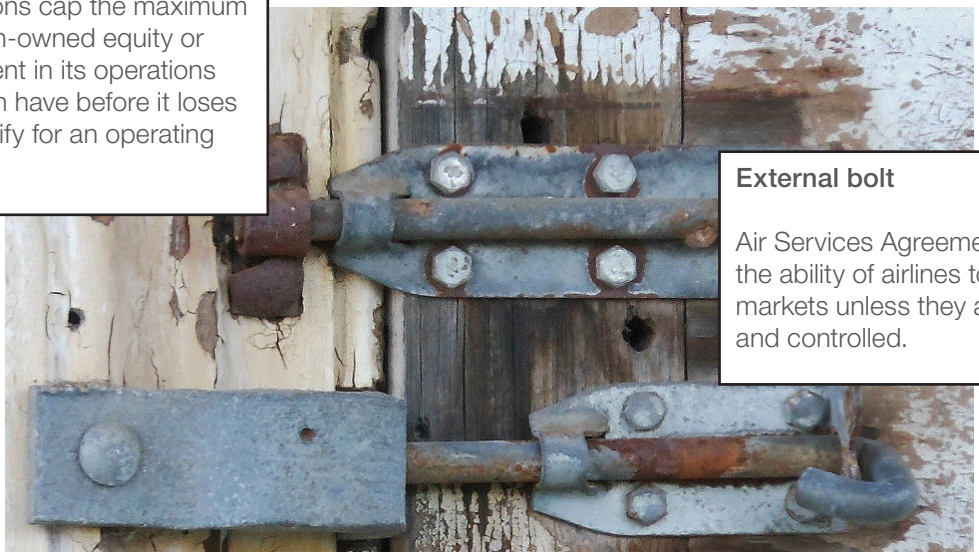
ASAs, in fact, consist of a mutual exchange of traffic rights between states, along with a description of the various airport-to-airport markets each state's airlines will be permitted to serve and any conditions attached to that service. One key condition – the designation clause – limits the airlines that can be assigned to use the traffic rights secured under the ASA. These clauses commonly permit states to refuse an airline designated for international service by another state if that airline fails to comply with the nationality rule, i.e. if it is not majority-owned and in effect controlled by the designating home state or its nationals.

The net effect of this treaty-based nationality restriction is that even if a state were to grant operating authority under its domestic laws to an airline with majority foreign ownership and de facto foreign control, that airline would be unable to serve any international routes from and to that state under the terms of the state's multiple ASAs.

The nationality rule, therefore, has a built-in systemic redundancy. National policies against foreign ownership and control of airlines are reinforced by treaty provisions that can prevent multinational or foreign-owned or foreign-controlled airlines from offering international services. One way to understand this tightly managed system is to think of the domestic and treaty rules operating together as a **double-bolted locking mechanism.**[5] The restrictions on foreign ownership and control of airlines in national codes act as the internal bolt. The inability to operate internationally without localized ownership and control represents the external bolt. Working together, these bolts have the pernicious effect of increasing capital costs in the industry and outlawing the most efficient potential business models.

Internal bolt

National regulations cap the maximum amount of foreign-owned equity or foreign involvement in its operations that an airline can have before it loses the ability to qualify for an operating certificate.



External bolt

Air Services Agreements can restrict the ability of airlines to serve foreign markets unless they are locally owned and controlled.

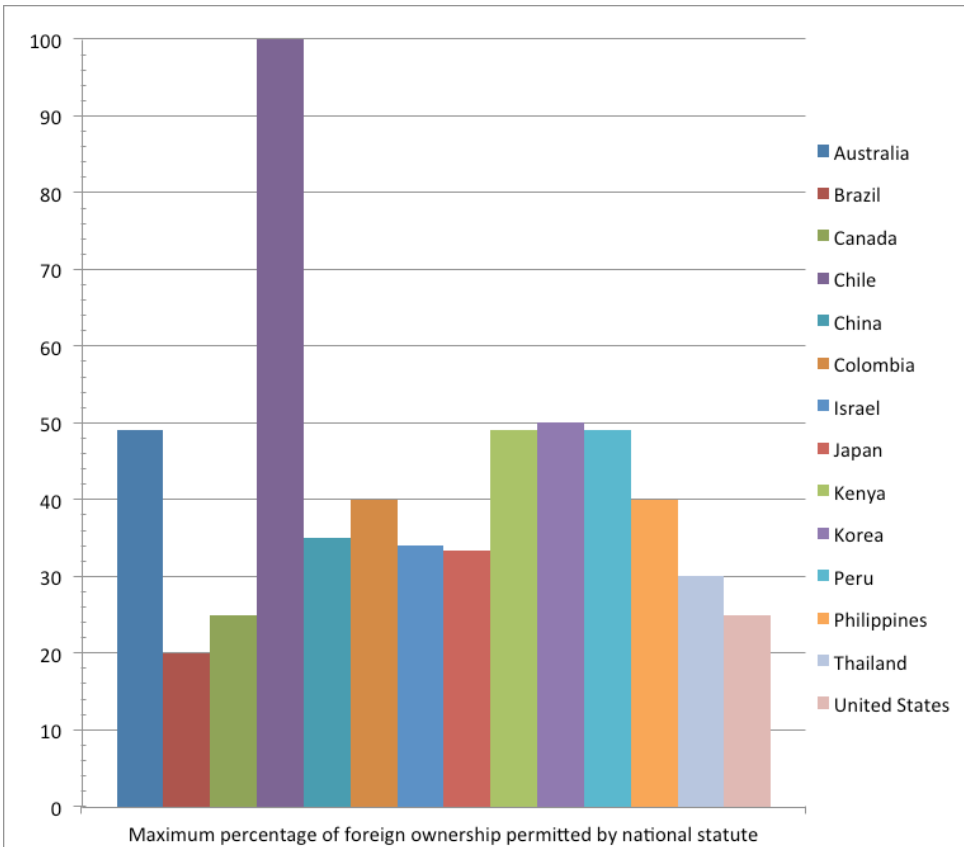
a. Restrictions at the national level: The internal bolt

A typical example of how domestic laws restrict foreign ownership and control of airlines is the US code limiting the ability to provide air transportation within US airspace to carriers holding a certificate of authorization,[6] restricting such certificates to "citizen(s) of the United States",[7] and specifying that for a corporation to qualify as a "citizen of the United States" it must satisfy the following ownership and control criteria:

- The corporation or association must be organized under the laws of the United States.
- The corporation's president must be a US citizen.
- At least two-thirds of the board of directors and other managing officers must be US citizens.
- At least 75% of the voting interest in the corporation must be owned or controlled by persons who are citizens of the United States.
- The corporation must be "under the actual control of citizens of the United States".[8]

Figure 1 illustrates the maximum permitted levels of foreign equity ownership in select countries. These caps demonstrate the breadth of the nationality rule's reach as well as the seemingly arbitrary level at which the numeric caps for ownership are set in domestic laws.

Figure 1: Maximum Percentage of Foreign Ownership Permitted by National Statute[9]



b. Treaty restrictions: The external bolt

Under international aviation law, no airline can serve markets in a foreign state (or even enter a foreign state's airspace) without receiving prior permission to do so. This permission is acquired in two steps: first, the governments of the two states must negotiate an ASA, as previously discussed. Second, the airline's home state must designate an airline as having permission to use the international traffic rights secured under the ASA.

The nationality rule restricts the specific airlines that a state can designate to use ASA-provided traffic rights. The language of the original formulation of the rule allows (but actually does not require) each state to make an *ex post facto* judgment as to whether the rule has been complied with by the other state party. Thus, each state party to a bilateral ASA, once it receives a designation of one or more of the other state party's airlines, reserves the right to **revoke, limit or suspend** the traffic rights of any foreign airline designated to operate service under the ASA if that airline is not substantially owned **and** effectively controlled by the other state party (or by citizens of that other state party). According to ICAO, approximately 90% of the ASAs negotiated since the end of World War II include some variation on the following language:

Each contracting state reserves the right to withhold or revoke a certificate or permit to an air transport enterprise of another state in any case where it is not satisfied that substantial ownership and effective control are vested in the national of a contracting state.

Under this formulation, the external bolt in an ASA (sometimes referred to as the "nationality clause") gives each state the right to reject another country's airline if it is not substantially owned and effectively controlled by the designating state or its citizens. Even in states that might (or do) have a more relaxed approach to certifying foreign-owned or even foreign-controlled airlines, the practice remains uncommon because of widespread external restrictions in ASAs that limit the market opportunities for these airlines.

Unlike many domestic rules, the treaty-based rules are usually vague about what benchmarks should be applied to determine ownership and control. Moreover, they are applied by the state **receiving** the designation, so that the domestic rules of the designating state in this instance merely help, but do not definitively determine, compliance with ASA rules. The substantial ownership test is quantitative (and often assumes that "substantial" means "majority" – do nationals have a majority shareholding?). The effective control test is qualitative and impressionistic (do non-nationals, even if they hold only a minority of the voting equity, nevertheless have power to determine the business decisions of the air carrier?). Interpretations and enforcement of the two tests vary, but the sheer ubiquity of the ASA nationality clauses means that airlines lack much incentive to lobby for looser foreign ownership caps or foreign control restrictions in domestic laws – winning rights to take on additional foreign investors may serve only to put at risk airlines' international operations under ASAs.

3. Reasons for the Nationality Rule

The nationality rule first emerged during an era when many states viewed aviation as a fledgling industry in need of watchful protection from foreign competition. While these concerns have largely receded for countries with mature airline sectors, economic protectionism, strategic trade considerations, and concerns about maintaining regulatory standards continue to imperil initiatives for liberalization.

a. Historical justification for the nationality rule

The future of international aviation was forged at an international conference in Chicago as World War II was drawing to a close. In part because of security concerns and in part to prevent US dominance over Europe's devastated air transport industry, a commercial airspace analogue to the *mare liberum* (freedom of the high seas) was rejected in favour of an enshrined commitment to airspace sovereignty. The external bolt first appeared in the draft agreements[10] coming out of the 1944 Chicago Conference and persists with little variation to the present day.

The original (and a continuing) purpose of the nationality requirement in ASAs is to allow a state to maintain control over who precisely has access to its airspace. The early fear was that once state A had granted state B the right to designate airlines to enter state A's airspace, state A would have no recourse were state B to extend that designation, for example by allowing foreign takeovers of its air fleet, to airlines of state C which was on unfriendly terms with state A.

Many of the reasons for restrictions on foreign ownership of airlines have become anachronistic, making the rules ripe for reform. In the United States, for example, a statutory prohibition against foreign control of airlines was originally enacted in 1926 to ensure that the US military would be able to commandeer the civilian air fleet if needed in the event of a wartime emergency (see sidebar on Civil Reserve Air Fleet on page 10). In much of the rest of the world, internal bolts were unnecessary for most of the 20th century because airlines were predominantly state-owned. Foreign ownership of airlines was not seriously debated until the trend toward privatization took hold in the late 1980s and 1990s. With privatization already a politically sensitive topic, many states sought to assuage public concerns by legislating to prohibit ownership and control of their newly privatizing national carriers – bearing names such as Air Canada, Air France or British Airways – from being dominated by non-nationals. A good example of this kind of legislative mandate is the Qantas Sale Act passed in conjunction with the privatization of Australia's national carrier in 1992. The Act sets clear boundaries to foreign equity investment in Qantas and provides divestment mechanisms to allow the directors to enforce these boundaries.

b. Aviation's equivalent to a trade rule of origin

As wartime concerns and considerations of national pride have retreated, the reasons for continued ownership and control restrictions have shifted shape and taken on a more directly economic colouring. Specifically, the nationality rule can be said to operate similarly to the rule of origin requirements in non-aviation free trade agreements which dictate that tariff reduction concessions be limited to goods actually produced in the country that bargained for those concessions. For example, if the United States were to sign a liberalized ASA with South Korea granting airlines of both states unlimited traffic rights with respect to each other's markets, it would not want investors from China, with which the United States has a restrictive ASA that limits each party's access to airports and caps weekly capacity, to take advantage of the privileges in the US/South Korea ASA by either acquiring or establishing an airline in South Korea. Were that to happen, China would have a reduced incentive to further open its markets to US airlines while Chinese airlines would be free to operate unlimited services from airports in China via South Korea to and from airports in the United States.

c. Preventing flags of convenience

Probably the most compelling and frequently heard argument today in defence of keeping the nationality rule is that it helps prevent the development of "flags of convenience" business models like those that emerged in the maritime industry. Merchant ships are commonly registered in states unconnected to the ship's owners for the purpose of taking advantage of lower labour and regulatory standards and costs.

The notion of flags of convenience poses concerns that, due to the global safety-first nature of aviation, require more intense scrutiny than the maritime industry. States protect their citizens from safety breaches involving foreign airlines largely through a system of reciprocity where each state is expected to maintain internationally acceptable regulatory

standards and reserves the right to deny access to any airline from a state that fails to adhere to those standards. It is therefore critical that, regardless of who owns and controls an airline and its operations, the state with responsibility for policing the safety standards of that airline and its aircraft be clearly identified and capable of being held accountable.

This paramount concern for safety is reinforced by a requirement – embedded in the Chicago Convention – that all aircraft be registered on a national registry. According to the Convention, the state of registration is responsible for certifying the airworthiness of an aircraft and the licensing of its crew, two of the major components of the ICAO-designed global air safety regime. The actual observance of this regime, however, is the responsibility of national safety regulators. For that reason, regulatory oversight is ideally exercised by the state that is geographically closest to where the aircraft is being operated. That is why, for example, Article 83bis was added to the Chicago Convention to allow regulatory authority over leased aircraft to be temporarily transferred to an aircraft's state of operation in place of its state of registration.

It is easy to understand, therefore, that the enforcement of ICAO aviation safety standards is also based on the presumption (which is not, however, stated in the Chicago Convention) that aircraft be regulated by the state in which the principal activities of their operating airline are based. Nevertheless, large aviation powers such as the United States do not fully trust the decentralized nature of aircraft and airline safety oversight and reserve the right to restrict the access of foreign airlines to their airspace if they find the safety oversight capabilities of the airlines' home states to be inadequate. In the context of this rather unbalanced interplay between international standards and national enforcement, if foreign ownership and control of airlines were permitted it would still remain critical to ensure that the operations of each airline and its aircraft were subject to continuing and genuine regulatory oversight by particular states.

Moreover, concerns about attempted regulatory arbitrage extend beyond safety to much less harmonized areas such as tax, environmental rules and labour policy. The prospect that airlines might move their commercial operations to low-cost jurisdictions has made organized labour one of the most vigorous opponents of the liberalization of the ownership and control rules. Labour on both sides of the Atlantic has condemned the award of an Irish air operator certificate to Norwegian Air Shuttle for operations between several European airports (other than Irish airports) and the United States.[11] Moreover, in the quite conceivable event that airlines become subject to an uneven patchwork of national and regional carbon emissions regulations over the coming decade, states will also want to ensure that airlines are not able to decamp to states with lower environmental standards.

The Civil Reserve Air Fleet

One commonly cited rationale for foreign ownership restrictions in the United States is the uncertain consequences that non-national ownership and control of airlines would have for the Civil Reserve Air Fleet (CRAF) programme.

Under CRAF, US commercial airlines provide supplementary airlift capacity in exchange for peacetime US Government business. Opponents of change have worried that foreign-owned airlines would not participate in the programme or would not comply in the event of a crisis. While participation in the CRAF programme is financially beneficial for carriers, there is concern that the US government would hold less legal leverage over foreign owners and that in the event of a controversial military action, like the 2003 Iraq war, the public relations pressure on the parent airline might work against cooperation with US military objectives.

While the Department of Defense has in the past been sceptical of removing the internal caps on foreign ownership, it has demonstrated a willingness to consider change if proper safeguards are included. After all, foreign-owned ships have been allowed to participate in CRAF's maritime equivalent, the Voluntary Intermodal Sealift Agreement (VISA).

4. Reasons for the Nationality Rule

Today's globalized economy is dramatically changed from the international business environment that was in place for much of the 20th century. Despite the largely anachronistic persistence of the nationality rule, airlines and governments have found ways to move beyond the rigidly nationally oriented profile of the airline industry that emerged immediately following World War II. Any hopes of building an agenda for reform will need to take account not only of the distortions the rule has created but also of the extent to which it is currently being applied.

a. Industry work-arounds of the nationality rule

Aside from boosting the cost of capital by limiting the pool of investors and the market for an airline's equity, the most significant consequence of the nationality rule is the prevention of transactional corporate events like cross-border mergers and acquisitions and the establishment of subsidiaries. Unlike other industries, international aviation has no authentic multinational corporations and no legally reliable regional or global branding operations.

Airlines are already subject to the artificially tailored markets (the "freedoms of the air"[12]) that are negotiated by their states under ASAs, and the nationality rule adds further impediments to their business models by preventing the efficiencies of scope and scale that mergers and the setting-up of foreign subsidiaries make possible. Network effects are vital to international air transport because the value of services that an airline offers between two points can be greatly enhanced if properly synchronized with complementary offerings. For example, a British Airways flight from London to New York could be planned to benefit substantially more passengers if those passengers could be transferred to smaller aircraft upon landing in New York to connect to regional destinations such as Buffalo, Hartford and Burlington. But British Airways as a foreign airline lacks the authority to operate any of those domestic "feeder" routes within the United States directly and therefore cannot arrange its London-New York flights to ensure optimal connectivity. While airlines do arrange for passengers to code-share on their partner airlines' services, allowing the passenger to travel with another carrier as part of a continuing service, airlines in that artificially induced setting are not collaborating to maximize the complementary nature of their offerings.

This network problem has been alleviated to some extent by the emergence of airline alliances. Alliances are groupings of carriers that integrate their services, at least on some routes, to a far greater extent than mere code-sharing. Operating under a common alliance brand such as Star Alliance, oneworld or SkyTeam, the airlines cooperate on services ranging from lounges to frequent flier programmes and will jointly plan certain routes, sometimes distributing the revenue in ways that even makes competition unnecessary. The alliance structure, however, ultimately hinges on government forbearance in granting certain kinds of antitrust immunity (originally a feature of US administrative practice in regulating international aviation but now manifest in other countries as well). Alliances are also subject to defections and ultimately dissolution in the absence of more permanent legal arrangements to bind the partners.

A different cooperative model, often referred to simply as "airline groups", has appeared primarily in South-East Asia. There, a number of successful low-cost carriers have expanded into surrounding states by partnering with local investors. AirAsia, a Malaysia-based carrier, owns a 49% minority stake in what are essentially subsidiary carriers in other states in the region that now operate under a similar generic brand name (AirAsia India, Thai AirAsia, AirAsia Indonesia and so on). The business model used in these contexts is that minority stakeholdings and the use of local managerial personnel ensure that the branding complies with national laws (the internal bolt) and ASA rules (the external bolt). But whether "effective control" of these various carriers truly rests with local management or (for example) with the Malaysian parent is a more contestable question and indeed is one that has prevented AirAsia from opening up affiliates in some states.

While both the alliance and the airline group business models represent smart thinking by the airline industry to work around the nationality rule, both are inferior to normal models for corporate integration. Significant redundancies cannot be eliminated while separate corporate structures must be maintained, leading to additional transaction costs; and cooperation and joint planning remain heavily circumscribed compared with operating within a single organization. Moreover, as noted above, regulatory uncertainty looms large. Airline groups, for example, are beholden to subjective evaluation of the "effective control" test by national regulators. And, apart from the sheer conditionality of antitrust immunity, US legacy carriers also find that immunity is often made contingent on satisfying tangential aeropolitical goals, such as the signing of an open skies agreement with the United States by the states of its proposed partner airlines.

b. Progress on unlocking the internal bolt

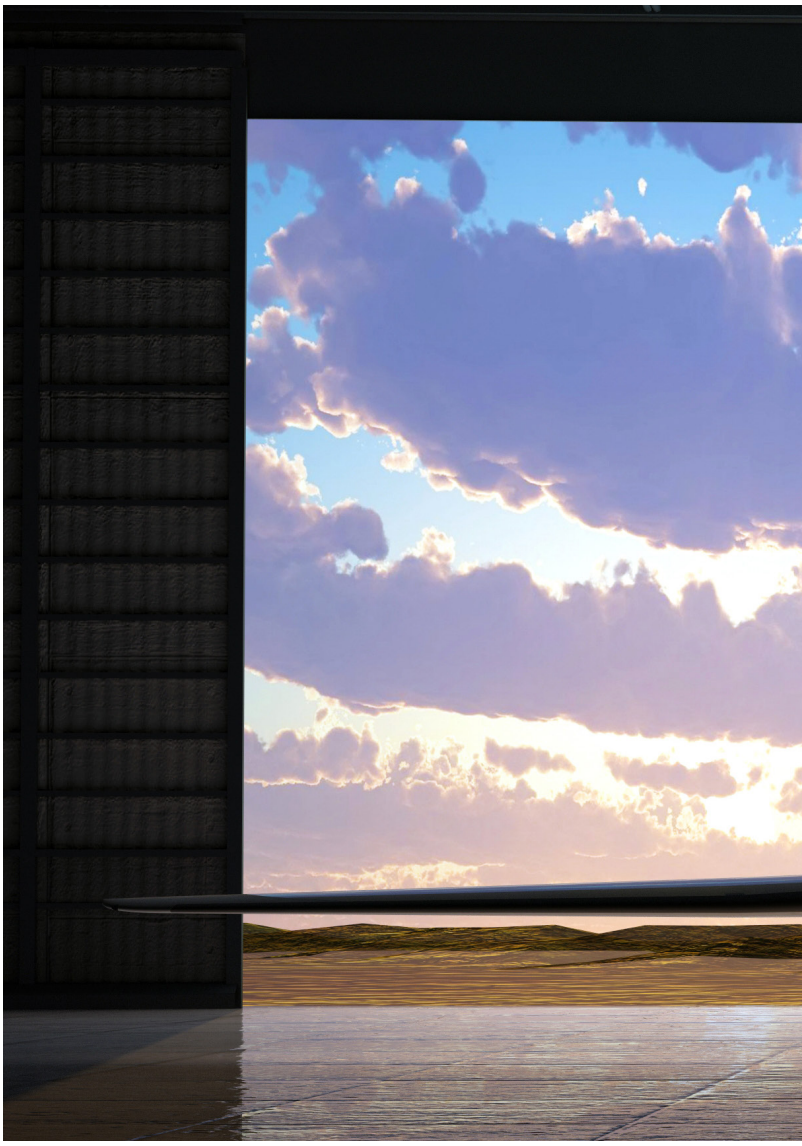
Some states have made significant moves to relax or even abolish statutory restrictions on foreign investment in or ownership of their domestic airlines. A modest adjustment of the traditional nationality clause that has won some favour, and that can possibly substitute for either the internal or external bolt, is to require airlines to have their principal place of business in the designating state instead of imposing a strict quota on the percentage of nationals owning equity or serving on the board of directors. This trend has been most pronounced in Latin America. Chile, Costa Rica and El Salvador have all moved to a principal place of business test instead of using hard numerical caps on ownership.[13] This progressive thinking has enabled creative cross-border mergers such as LATAM, a combination of Chile's LAN and Brazil's TAM (which merged under a joint holding company but operate separately in order to avoid jeopardizing their international traffic rights under the external bolt).

Even where abolition has not been complete, there have been some promising signs of progress toward liberalization. Australia, for example, has a bifurcated policy treating airlines differently depending on whether they operate domestic or international routes. Australia places no legal limitation on foreign ownership and control of airlines that operate exclusively and entirely within its airspace jurisdiction. This regime allows Virgin Domestic (part of the Virgin Australia Group), for example, to serve routes connecting Australian cities despite being 80% foreign-owned, including major stakes that belong to foreign airlines such as Singapore Airlines and Etihad Airways. Foreign investors, however, continue to be restricted to a maximum of 49% ownership of any Australia-based carriers that fly internationally between Australia and other countries. India, meanwhile, embarked on a significant relaxation of its foreign ownership rules in 2012, scrapping a unique restriction that prohibited foreign airlines from owning any stake in Indian carriers. Foreign airlines are now aligned with non-airline foreign investors in being permitted to invest up to a 49% equity ownership cap.

c. Progress on unlocking the external bolt

Convincing states to take unilateral action to reform the external bolt of the nationality rule is difficult because states view relaxation of bilateral restrictions in ASAs as concessions that need to be reciprocated by their partner states. A few states have had the foresight to recognize that even unilateral liberalization helps their citizens by creating additional competition and by lowering prices. Chile's policy is to use principal place of business rather than ownership and control in the designation clauses of its ASAs. Brazil, despite strict national limits on foreign ownership of Brazilian airlines, has taken a more relaxed approach to the ownership and control character of foreign airlines. In almost half of its bilateral ASAs, Brazil permits its partner states to designate airlines so long as they are legally established in a partner state and subject to that state's full regulatory control.

Setting aside the European Union's (EU) single aviation market (discussed in the next section), other multilateral liberalization efforts do exist on paper but have in reality achieved less impressive degrees of implementation. Under the 2001 Multilateral Agreement on the Liberalization of International Air Transport (MALIAT), a multi-state air services agreement among the United States, Brunei, Chile, Singapore, New Zealand and others, the United States agreed not to object if any of the MALIAT contracting states designated an airline that was not domestically owned to serve routes under the agreement, so long as that airline had its principal place of business in the designating state and was effectively controlled by that state or its nationals. But MALIAT has functioned more as a multi-party open skies agreement and its modest adjustments to the nationality rule have not had any practical consequences. The 2009 EU-Canada air services agreement plans for the eventual abolition of foreign ownership and control restrictions on airlines operating between the EU and Canada, but progress will be solely in accordance with a step-by-step schedule that requires significant liberalization in conjunction with the concurrent action of both sides.



The Association of Southeast Asian Nations (ASEAN) plan for a single aviation market entails the eventual abolition of ownership and control limits among ASEAN member states; but as with its plans for the increased liberalization of traffic rights, ASEAN's efforts to reform the nationality rule are proceeding at a glacial pace.

Finally, the most direct method to work around the external bolt is to have states simply decline to enforce the nationality clause in their ASAs with partner states. The United States has adopted such a pattern of restraint, applied on the condition that the foreign ownership structure not be inimical to US interests, particularly any concerns over the rule of origin problem discussed in section 3. In practice, this approach has meant that the United States will not accept a state's designation of a foreign-owned airline if doing so would allow an airline from a state with which the United States has a more restrictive ASA to gain enhanced access to the US market. Past examples of US restraint have included waivers for Aerolineas Argentinas when it was under Spanish ownership and control and for Cargo Lion, a now-defunct Luxembourg-based cargo carrier that was entirely owned by foreign nationals. As recently as five years ago, the United States even made a push at ICAO for the adoption of a multilateral convention on foreign investment in airlines under which contracting ICAO member states would essentially pledge not to enforce their nationality clauses against each other. This convention does not currently have US support, however.

The difficulty with relying on waivers is that, once again, they represent a contingent system that is open to abuse and favouritism. As observed in US practice, the willingness to overlook a technical violation of the ASA can be used to incentivize certain behaviour on the part of the state benefiting from the waiver; relatedly, the threat of a possible revocation of the waiver may adversely influence the negotiating positions and aeropolitical relationship of the two states going forward. Such a system also undermines the predictability that airlines need to operate and to undertake long-term planning. What would happen to an airline that succumbed to foreign control on the understanding that its access to US markets would not be jeopardized, only to find that a new US administration – lobbied by a US carrier that suddenly found itself exposed to heightened competition from a strengthened foreign competitor – was now less favourably disposed to the waiver?

d. Regional liberalization

The most striking departure from the traditional nationality rule has taken place within the European Union. Airline ownership and control have been multilateralized within the Union such that any EU-licensed airline can be in the hands of any EU nationals (or of any EU member states). Thus, a Polish carrier can be 100% owned and controlled by UK nationals, but there is a 49.9% cap on ownership of that carrier by non-EU citizens (as well as the control restriction). The EU's abolition of the internal bolt would be relatively meaningless, of course, without also mandating that all EU member states must accept flights by airlines from any other EU member state, even if an airline is not owned by that state or its nationals, so long as the airline is substantially owned and effectively controlled by any EU member state or by the nationals of **any** EU member state. Thus, as well as deactivating the internal bolt, the external bolt has also been abolished on a region-wide basis. The impact of these changes on intra-EU air transport, in terms of both services and prices, has been significant: Ryanair and EasyJet, for example, would not exist without them. The EU experiment offers a glimpse into the potential traveller welfare benefits if the nationality rule were to be abolished globally.

Restrictions on flights connecting EU member states to countries outside the Union have presented a greater challenge. The EU's regional air transport integration **by itself** does not alter the terms of each member state's bundle of existing ASAs with third countries. With the external bolt still in place for those countries, they remain within their legal rights to deny access to, for example, an Italian carrier owned by French nationals, regardless of what the EU permits internally. To resolve the inconsistency, the Union has been diligently working to amend all ASAs between member states and non-EU countries to include a "Union carrier" designation. Using this device, the nationality clause is altered to require that any EU airlines providing services under an ASA between an EU member state and a non-EU member state must be substantially owned and in effect controlled by nationals of any EU member state (or by any EU member state) but not necessarily the EU member state that is a party to that specific ASA. While the EU has made significant progress, many ASAs have yet to be amended, restricting the ability of EU carriers to take full advantage of the regional abolition of the nationality rule.

Additionally, the intra-EU rule changes have enabled numerous mergers among European airlines over the past 15 years. As with their Latin American counterparts, however, these intra-EU mergers have had to adopt suboptimal organization structures and to sacrifice efficiencies in order to avoid violating nationality clauses with third countries and, in that way, to preserve international operating rights that might otherwise be put at risk. This approach typically means that merging airlines such as Air France and KLM are joined through a separate holding company (in the case of British Airways and Iberia, this company was given a new name, IAG). Each airline in these quasi-merger situations continues to retain its distinct national brand, board of directors and other ties to its home state in order to appease any external concerns about nationality.

e. Recent enforcement actions

A recent reversal illustrates how ultimately untenable it is to expect airlines to construct their business plans around creative corporate structures and the hope of lax regulatory enforcement. In mid-2015, the Hong Kong Air Transport Licensing Authority (ATLA) rejected an application by Jetstar Airways to establish a Hong Kong-based affiliate, Jetstar Hong Kong Airways. The Jetstar group, with subsidiaries in Australia, Vietnam, Singapore and Japan, has been put together by Australia's Qantas as a competitor to the AirAsia group.

While Hong Kong lacks specific requirements about ownership and control, it does apply the condition that airlines must have their principal place of business in Hong Kong in order to obtain an operating license from the ATLA. A principal place of business had never previously been defined for air carriers in Hong Kong, making it difficult for airlines to predict what might be needed to satisfy this requirement. Jetstar Hong Kong's majority shareholder (in voting rights), chief executive officer and business operations are all located in Hong Kong. ATLA chose not to follow the guidelines on identifying an airline's principal place of business established by ICAO, which Jetstar likely would have satisfied. Instead, the agency ruled that Hong Kong was not Jetstar Hong Kong's principal place of business because of the likely external influence of the parent corporation on Jetstar Hong Kong's route network and pricing, and the affiliate's perceived inability to operate completely independently from the larger Jetstar brand. This example is made all the more worrisome by the widespread belief that the decision was influenced (at least partially) by a desire to protect Hong Kong-based Cathay Pacific from the prospect of new competition.

Indeed, Hong Kong's rejection of Jetstar may not be an isolated case. In 2014, the European Commission opened a probe into a handful of carriers in which foreign shareholders had acquired large minority stakes. These included Virgin Atlantic (49% owned by Delta), Air Berlin (29.2% owned by Etihad) and Czech Airlines (44% owned by Korean Air Lines).[14] Etihad's 49% purchase in Alitalia was added to the list later in the year. While all of these airlines comply with the requirement that they must be majority-owned by nationals of EU member states, the Commission is investigating whether "effective control" of the carriers resides outside the European Union. This investigation is also problematic because of a sense that protectionist impulses, particularly complaints by European airlines about losing market share to Gulf operators like Etihad, may be playing a role. Until these investigations are final, it is too soon to declare that the industry is seeing an uptick in regulatory enforcement of ownership and control restrictions. But the mere prospect of increased scrutiny, especially from a region that has been a leader in relaxing these rules, warrants concern.

5. Proposal for Reform: A Dual-Track Solution

Even if states are slowly recognizing that foreign ownership rules are outmoded and are engaging in mild reforms, as long as these rules remain in place they are loaded weapons that can be used at any time by a national aviation authority – abetted, in some cases, by a whistleblowing competitor – seeking to block competition. As a result, even when the rules are not being strictly enforced, they inhibit the expansion and efficiency of air travel by significantly increasing the uncertainty surrounding new ventures. At the same time, the continued existence of these rules and the lack of a significant lobbying push on the part of airlines suggest that complete abolition is perhaps too ambitious a goal. Nationalistic public sentiment and entrenched interests together make the elimination of nationality requirements a heavy political lift. Instead, the objective should be intelligent reform that addresses the most substantive arguments against liberalization, while still permitting a superior business and investment environment for airlines going forward.

Principles of smart regulation dictate that regulation should be as narrowly tailored as possible to the fulfilment of the intended policy objectives. Regulation that is overbroad, meaning that it unnecessarily prohibits or requires behaviour that is tangential to the social problems directly targeted by the regulation, causes unjustifiable market distortions and should be revised.

The most compelling arguments for restricting foreign ownership of airlines, described in section 3, are twofold: to prevent airlines from congregating in a state with poor regulatory oversight and sparking a race-to-the-bottom mentality with regard to taxation, labour and environmental policies (the "flags of convenience" problem), and to prevent airlines from third states from gaining access to traffic rights for which those states have not bargained (the "rule of origin" problem). Both of these arguments can be satisfactorily addressed without placing any restriction on the nationality of an airline's investors. Thus achieving this reform could be done by reframing the nationality rule to reflect that governments' primary concern should be with **regulatory** nationality rather than with traditional notions of citizenship.

Regulatory nationality derives from an airline's association with the state that oversees that airline's compliance with international safety standards. It will presumptively be the state in which all or the majority of the airline's aircraft are registered (apart only from some leasing scenarios). To avoid flags of convenience, the state of regulatory nationality should also be the state to which the airline pays taxes and which provides the governing labour and environmental laws by which the airline abides. This construct differs from the substantial ownership and effective control requirement in that the nationality of the persons or corporations owning stock in the airline or of the persons making major operational decisions (which may, and often will, include the executives of a foreign parent company) will no longer be legally relevant.

There have been serial attempts to accomplish this reform through the replacement of ownership and control with the concept of a principal place of business. The recent Jetstar Hong Kong ruling is a reminder that principal place of business can cause confusion with respect to subsidiary corporations, which would themselves claim recognition for principal places of business distinct from a foreign parent company. Principal place of business is also a longstanding legal term of art which carries the baggage of numerous court interpretations in disparate contexts that reach far beyond the aviation sector. It includes multi-factor tests that exceed what is necessary to create a practical test for a "regulatory" nationality that addresses the specific circumstances of the global airline industry.

For the foregoing reasons, therefore, regulatory nationality is advocated as a replacement concept as it is commonly defined and simply understood. The phrase retains the association with nationality that states have found appealing and that underlies the operation of the international system of aviation regulation. ICAO could adopt and promote model clauses to be used by regulators, courts and administrative agencies to give effect to this recast idea of national affiliation. Assuming the continued vitality of a bilateral system for the exchange of air traffic rights, governments could use a dual-track approach to concurrently replace both the internal and external locks of the existing nationality rule.

Creating and defining a new test is only the starting point for reform and would be insufficient in the absence of a strategy for adoption and implementation. The proposal is a replacement of the ownership-and-control-driven nationality rule with a superior regulatory nationality test that would be pursued concurrently along two tracks.

Track 1: Replacing the internal bolt with regulatory nationality

Track I would focus on eliminating domestic restrictions on foreign ownership and control of national airlines. Although this effort would require dealing with significant political challenges, the new "regulatory nationality" test is intended to meet the objections of national constituencies that are invested in maintenance of the current citizenship-based rule.

States would, of course, still retain the ability to screen investors and to prohibit operating licenses when doing so is required by the national interest, authority that they currently possess when approving operating certificates for domestically owned carriers. The potential would remain for states to take a protectionist view when making these determinations; recurrences of the Jetstar Hong Kong case could not be entirely eliminated. The objective should be to make denials of operating certificates on the basis of foreign ownership and control the exception, instead of the default rule. The Committee on Foreign Investment in the United States (CFIUS) (see sidebar) could provide a potential model.

Track 2: Replacing the external bolt with the same test

Concurrent with efforts to unlock the internal bolt, reform should proceed along a second track to amend the designation clauses of existing bilateral agreements, replacing the substantial ownership and effective control requirement of the external bolt with the same test that replaces the internal bolt, namely, the regulatory nationality test. Using the identical formula to replace the internal and external bolts would represent a major reform of the foreign investment rules for airlines while adhering to the exceptional circumstances of an industry that cannot diminish its commitment to zero-tolerance regulatory oversight. States would be able to reject designations of airlines for which the designating state is not the primary regulator.

States have already accepted this logic to some degree. For example, Chile has had success in convincing partners to use a principal place of business in its ASAs; ICAO uses the same phrase for its model bilateral designation clause. For regulatory nationality to become the new global standard, concerns about the rule of origin problem will need to be alleviated. Therefore, it is proposed to add a further qualification to the regulatory nationality standard that permits states to refuse the designation of any airline that would otherwise (because of the state of citizenship of its owners) lack the traffic rights it is seeking to enjoy and is now taking advantage of the greater market access rights of the designating state. This is actually a formalization of the policy the United States already applies, whereby it selectively waives objections to designations for countries with which it has "open skies" aviation relationships. Having put this further contingency in place, states could protect their negotiating power over market access.

The market access provision is superior to a general right to refuse a designation on grounds of public policy because it ties the reservation to the specific policy objective of reliable regulatory oversight that states seek to protect. Broader language justifying rejection could be abused for protectionist reasons (as has been evident in the Jetstar Hong Kong and Norwegian Air Shuttle cases).

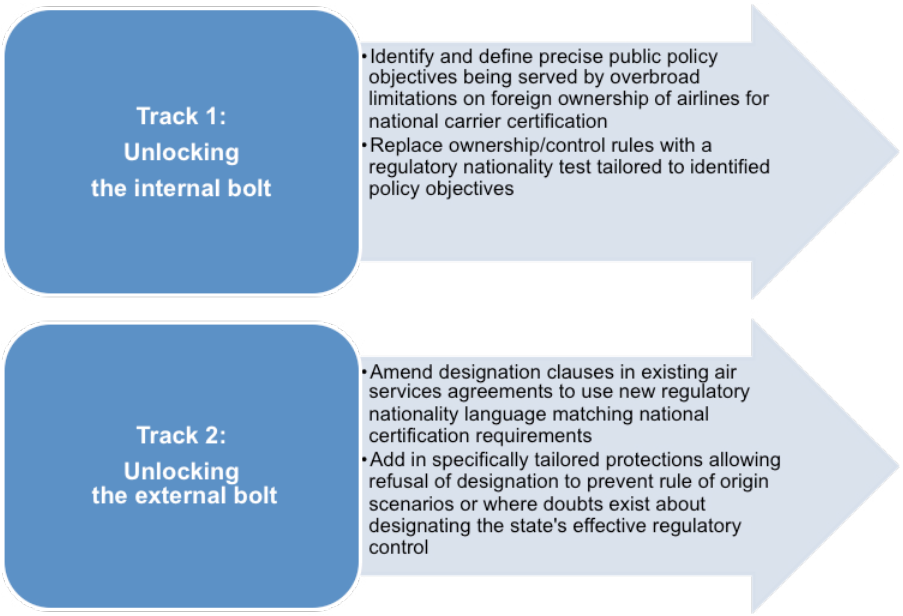
CFIUS

The Committee on Foreign Investment in the United States (CFIUS) is an inter-agency committee of the US Government entrusted with reviewing any foreign investments in a US company or asset with potential implications for national security or critical infrastructure. The investment targets can include any sector, ranging from energy (including oil) to communications and transport networks.

CFIUS attempts to judiciously review any proposed investments that fall under its purview. It begins with a 30-day routine review, followed by a 45-day investigation only if concerns are raised.

The purpose of relying on a specialized committee such as CFIUS is to protect against foreign investments becoming victims of political passions – as was seen in the 2005 Dubai Port World controversy, a transaction CFIUS initially approved before media and congressional attention forced the would-be purchasers to withdraw.

Ideally, foreign investment in airlines would be scrutinized by states on a case-by-case basis, protecting specific public policy interests that are sufficiently well-defined to exclude purely protectionist actions.



6. Benefits and Risks of Liberalization

Liberalizing airline ownership and control would provide carriers with greater access to capital markets, creating the following **benefits**:

- → Lower cost of capital, leading to reduced fares for air travellers
- → Reduced reliance on government support, producing benefits for taxpayers
- → Diversified financing options for airlines, increasing chances of avoiding insolvency during national recessions and providing greater overall stability to airlines
- → Increased financial stability for carriers correlating with enhanced safety
- → Potential to use mergers to achieve efficiencies of size and scope, with savings passed on through lower prices for travellers
- → Greater network scope and offerings through merged networks, again benefiting travellers
- → Protection and creation of jobs

The primary **risks** of reform include the potential for illicit freeriding on other states' "open skies" agreements, and the emergence of flags of convenience in which the connection between airlines and their states of regulatory oversight is compromised or even severed, raising concerns about safety and security and the potential for labour arbitrage.

The proposal of regulatory nationality as outlined in section 5 mitigates the risks of reform as much as possible, while still retaining the benefits to the greatest degree feasible. The nationality rule should be treated as a first-order, or historically contingent, rule of international air transport regulation and its replacement in a new global context should now be expedited.

Endnotes

[1] World Travel and Tourism Council (WTTC) (2015). *Global Talent Trends and Issues for the Travel & Tourism Sector.*

[2] The aviation sector contributes as much to global GDP as Switzerland or Poland. See http://www3.weforum.org/docs/TTCR/2013/TTCR_Chapter1.4_2013.pdf (citing various studies).

[3] Note that in the aviation value chain, only airlines are subject to the nationality rule. For example, as reflected in the sidebar case study on global airport management, airports are not typically subject to equity and control restrictions that prevent majority foreign investment.

[4] The slogan has appeared in a number of settings. See, e.g. INT'L AIR TRANP. ASSOC., Agenda for Freedom, http://www.agenda-for-freedom.aero/.

[5] See Havel, Brian F. (2009). Beyond Open Skies: A New Regime for International Aviation.

[6] 49 U.S. Code § 41101 – Requirement for a certificate.

[7] 49 U.S. Code § 41102 – General, temporary, and charter air transportation certificates of air carriers.

[8] 49 U.S. Code § 40102(a)(15)(C) – "A corporation or association organized under the laws of the United States or a State, the District of Columbia, or a territory or possession of the United States, of which the president and at least two-thirds of the board of directors and other managing officers are citizens of the United States, which is under the actual control of citizens of the United States, and in which at least 75 percent of the voting interest is owned or controlled by persons that are citizens of the United States." Note that the US Department of Transportation has historically interpreted the phrase "owned or controlled" conjunctively rather than disjunctively. In 2003, the statute was amended to reflect this interpretive approach by adding an explicit requirement of "actual control".

[9] Adapted (with updating) from Chang, Y., G. Williams and C. Hsu (2004). "The Evolution of Airline Ownership and Control Provisions". *Journal of Air Transport Management*, vol. 10, issue 3, pp. 161, 162.

[10] The International Air Transport Agreement and International Air Services Transit Agreement.

[11] Norwegian Air Shuttle (NAS) has attempted to form a subsidiary in Ireland for the purposes of operating transatlantic flights to and from the United States under the European Union's common air carrier designation. The United States has so far delayed the application for the subsidiary to operate to the United States. Labour unions have argued that, because Irish labour laws are lax compared to those of Norway, NAS's use of an Irish subsidiary is a form of regulatory arbitrage that runs contrary to US public interests. The European Union has countered by arguing that the United States is required to accept the common air carrier designation under the open skies-style U.S.-EU Air Transport Agreement that came into effect in 2007.

[12] The nine freedoms of the air are an artificial construct by which air transport services are divided into various point-to-point segments on which traffic rights are based. A truly open market for air transport services would have no need for such classifications as airlines would simply serve whatever market demand existed for their services. Even most so-called "open skies" agreements disallow the widest of these so-called freedoms (the seventh, which cuts the required route connection to the homeland of the operating carrier, and the eighth and ninth, the "cabotage" freedoms), meaning that a truly open market is absent from international aviation.

[13] Hong Kong and Singapore also rely on a principal place of business standard. Chile has been the world leader, permitting foreign ownership as early as 1979. Similar to the ways in which the nationality rule is an anachronism left over from previous eras, Chile's unique position is a historical by-product of an earlier government's philosophical approach.

[14] The Air Berlin probe has now closed.

Acknowledgements

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