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Towards open skies for airlines in Canada

The federal Ministry of Transport appears prepared to take advantage of the current international trend toward open markets in aviation and to move ahead with the liberalization process that began in the early 1980s. In particular, it is considering the possibility of allowing foreign airlines to fly between Canadian cities – known as "cabotage" – and of raising the limit on foreign ownership of airlines in Canada, currently set at 25%. Both would be excellent news for consumers and for the Canadian economy generally.

The "Open Skies" agreement

In 1985, the Canadian government took its first steps toward deregulating air transport with the adoption of the Carriage by Air Act. In so doing, it built on initiatives which began in the United States in 1978 with the Airline Deregulation Act. Both laws abolished certain restrictions on the operating permits issued to airlines. However, it was not until 1995 that a major advance was achieved in opening the market to foreign competition with the signing of a bilateral "Open Skies" agreement with the United States.

This agreement authorized any Canadian or U.S. airline to offer transborder services without restriction in terms of fares, flight frequencies or aircraft types. It enabled airlines to meet their customers' needs more effectively. It greatly facilitated business and leisure travel, providing greater choice through a growing number of transborder routes. The capacity of scheduled airline services between the two countries experienced strong growth starting in 1995 – with a sharp increase of 25% in the first year alone.[1]

The number of trips by air taken by Canadian and U.S. residents between the two countries rose 41% in the five years following the signing of that agreement.[2] Figure 1 shows that the growth in transborder passenger traffic was far greater than the growth in economic activity during the period 1991-2000, following which the negative effects of recession and the bursting of the tech bubble in the U.S. were amplified by the terrorist attacks in New York and the SARS crisis.

Trade in merchandise shipped by air between the two countries nearly doubled during the second half of the 1990s, while that shipped by other modes of transport increased only half as much. Canadian air carriers increased their competitive position substantially in the transborder market during this period, with their market share rising from 43.3% in 1994 to over 50% in 1999.[3]

By allowing greater flexibility in fares, flight frequencies and aircraft size, the agreement greatly helped airlines to improve their efficiency, as demonstrated by the 10% rise in the load factors of the main carriers from 1994 to 2000.[4] Labour productivity during this period, as measured in passenger-kilometres per employee, grew 18%.[5]

1. Transport Canada, *Transportation in Canada 1996 Annual Report*, available at http://www.tc.gc.ca/pol/en/report/anre1996/tc96_chapter_4.htm.
2. Statistics on transportation in North America, Section 9: North American passenger traffic, available at http://nats.sct.gob.mx.
3. Transport Canada, *Transportation in Canada 2000 Annual Report,* Table 13-15, p. 168, available at http://www.tc.gc.ca/pol/en/Report/anre2000/tc2000en.pdf.
4. Transport Canada, T-Facts information system, Air transportation operating statistics.
5. Transport Canada, T-Facts information system, Air transportation, labour.

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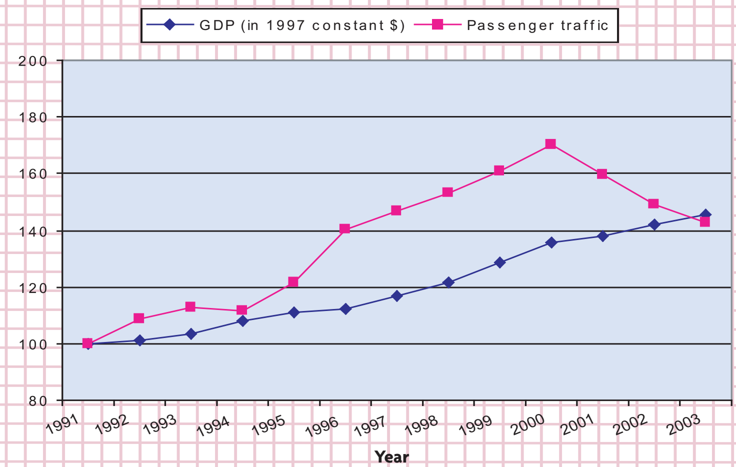
Figure 1

Changes in transborder air traffic and Canadian GDP, 1991-2003 (1991=100)



Source: Statistics Canada, CANSIM Table 379-0017; Transport Canada, *Transportation in Canada 1999 Annual Report*, available at http://www.tc.gc.ca/pol/en/Report/anre1999/tc9900ae.pdf and *Transportation in Canada 2003 Annual Report,* available at http://www.tc.gc.ca/pol/en/Report/anre2003/tc2003ae.pdf; calculations by the Montreal Economic Institute.

The best example of international liberalization is the integration of the airline market within the European Union. Since 1997, any carrier from an EU member country can operate domestic flights within any other EU country as though it possessed the nationality of the country in question. The reduction in obstacles to entry by new air carriers has led to the emergence of "low-cost" airlines such as RyanAir and EasyJet. Most of these companies specialize in routes linking regional centres, and about 50% of their traffic is new growth.[8]

Thus, the choice of routes, flight frequencies and available seats offered have all increased considerably following liberalization. From 1992 to 2000, the total number of routes within the European Union rose by 74%. Domestic and international flights within the EU rose by 49% and 88% respectively. During this period, the impact of competition was also reflected in fares. In real terms, taking into account the 19% inflation rate from 1992 to 2000, economy class fares went down by 29% and promotional fares by 4%. Only business class fares went up in real terms, by approximately 22% (see Table 1)[9].

This increased activity in the airline industry can be expected to raise demand for related products and services, especially in the aeronautical sector. Given the importance of this industry in Quebec, the increased liberalization of air transport becomes all the more pertinent.

Additional benefits

Eliminating restrictions on cabotage and foreign ownership could produce major additional benefits to the Canadian airline industry and to travellers. Raising the foreign ownership limit would give Canadian carriers access to a broader capital market, which would have a major stabilizing effect given the industry's rather volatile nature. It would make it easier for new competitors to enter the sector, and also help smaller carriers seeking to expand or improve their fleets to attract the capital they require to finance their growth. At the same time, Canadian investors could increase their stake in foreign airlines and Canadian carriers could extend their operations to other markets.

As in any sector of the economy, increased competition would exert downward pressure on prices.[6] It would also lead to a greater number of flights and a more varied choice of destinations. A U.S. study indicates that greater competition is associated with a reduction in flight delays.[7] New direct links and greater frequencies would be of particular benefit to time-pressed business travellers, who would no longer have to make intermediate stops before reaching their destination.

The number of trips by air taken by Canadian and U.S. residents between the two countries rose 41% in the five years following the signing of the agreement.

6. See in particular Rauf Gönenç and Giuseppe Nicoletti, "Regulation, market structure and performance in air passenger transportation," *OECD Economic Studies* No. 32, 2001, pp. 183-227.
7. Michael Mazzeo, "Competition and service quality in the U.S. airline industry," *Review of Industrial Organization* Vol. 22, 2003, pp. 275-296.
8. International Civil Aviation Organisation (ICAO), "The impact of low cost carriers in Europe," Case studies on liberalization, political economy section, February 2003, available at http://www.icao.int/icao/en/atb/ecp/CaseStudies/Europe_LowCost_En.pdf.
9. ICAO, "European experience of air transport liberalization," Case studies on liberalization, political economy section, February 2003, p. 8, available at http://www.icao.int/icao/en/atb/ecp/CaseStudies/EuropeLiberalization_En.pdf.

Table 1

Main indicators of air transport European Union

	1992	2000	Variation 1992-2000
Number of domestic routes served by more than one carrier	106	199	88%
Number of seats weekly on EU domestic routes (thousands)	2891	4084	41%
Number of flights annually on EU domestic routes (thousands)	1436	2220	49%
Number of international routes (intra-EU) between city-pairs	692	1202	74%
Number of international routes (intra-EU) served by more than two carriers	61	217	256%
Number of seats weekly on international routes (intra-EU)	2231	4571	105%
Number of flights annually on international routes (intra-EU) (thousands)	1109	2080	88%
Change in business class fares (real terms) on routes within the European Economic Area (EEA)			22%
Change in promotional fares (real terms) on intra-EEA routes			- 4%
Change in economy class fares (real terms) on intra-EEA routes			- 29%

Source: ICAO, "European experience of air transport liberalization," Case studies on liberalization, political economy section, February 2003, p. 8, available at http://www.icao.int/icao/en/atb/ecp/CaseStudies/EuropeLiberalization_En.pdf.

There would no longer be separate Canadian, U.S. or Mexican policies. Each air carrier would be regarded as a NAFTA carrier. Of course it would be necessary, at least from a commercial standpoint, to harmonize regulations among these countries, and this could eventually include the awarding of licences, air navigation, and so on. There would no longer be restrictions on foreign ownership as long as the air carrier was registered in a NAFTA country.

This may be a lot to expect from a single agreement, especially for the U.S. However, if the countries were to agree to move gradually towards such a defined objective, a program to achieve integration and harmonization could move ahead in stages over a period of several years.

Canada's options

Various agreements have been reached, or are presently under negotiation, between Europe, the United States and emerging markets such as India, China and Russia. On April 19, Canada and China announced a major broadening of their bilateral agreement. Negotiations are expected to begin shortly with India.

Should the next stage be to seek total integration of aviation markets in North America as part of the North American Free Trade Agreement (NAFTA)? Or should Canada start by negotiating with the EU to develop an agreement similar to what Europe has attempted, unsuccessfully up to now, to obtain with the United States?

1) Creation of an integrated aviation market within NAFTA

Under this scenario, Canada's efforts would essentially be channelled towards integration of North American markets similar to that which presently exists within the European Union. The final result would be that carriers in the three countries would have the same rights in each of these countries, giving them total freedom of "domestic" operation.

In the initial phase, for example, each country could agree to raise foreign ownership levels from 25% to 49%. Limited cabotage could then be introduced as an extension of existing services. For example, an Air Canada flight from Montreal to Chicago could carry American passengers between Chicago and Los Angeles, while an American Airlines flight between Chicago and Toronto could carry passengers between Toronto and Halifax.

In a further step towards this gradual integration, carriers from any one of the three countries could be allowed to serve a neighbour's domestic market through transborder links. For example, WestJet could sell Boston–Seattle seats through Boston–Toronto and Toronto–Seattle flights. Similarly, United Airlines could connect Montreal and Vancouver via Chicago.

Since 1997, any carrier from an EU member country can operate domestic flights within any other EU country as though it possessed the nationality of the country in question.

One area likely to be less controversial would be to serve multiple points in another NAFTA country on transborder flights of all-cargo carriers. Freight is a very different market which could move more quickly toward complete liberalization. The distinction between regular and charter flights should also be eliminated, subject only to the need for carriers to submit operating plans and to be held responsible for meeting their obligations to the public.

2) Negotiations with the European Union

Canada could take the initiative and propose to the European Union the start of negotiations similar to the talks proposed by the EU to the U.S. dealing with the transatlantic air travel market. Here again, it would be important to consider whether an overall agreement should be introduced all at once or step-by-step.

There could well be fewer objections in Canada to granting cabotage rights to European carriers in exchange for reciprocity. Canadian carriers would have more to gain from this right than their European competitors, given that they would obtain access to much larger markets. If Canada obtained reciprocity, it should be willing to establish a schedule whereby foreign ownership of Canadian carriers would rise initially from 25% to 49% and eventually to 100%.

In negotiating such an agreement with the European Union, Canada would enjoy a head-start advantage in the entire liberalization process. The U.S. may well prefer this path which, by entering in the first instance into a bilateral arrangement with Canada, would provide an opportunity to "test" an eventual integrated Europe–North America aviation market.

Canada should take every opportunity that comes up to negotiate "Open Skies" agreements with any country that already has a comparable agreement with the United States.

Conclusion

It is worth pointing out that a strong, pro-active effort by Canada to widely open up airline markets would have yet another advantage. The Canadian government would no longer be required to reconcile the often conflicting interests of Canadian airports and local authorities on the one hand and airlines on the other: market forces would dictate the future direction. In any case, government would maintain the right to intervene if the results were prejudicial to the public interest.

Canada should take every opportunity that comes up to negotiate "Open Skies" agreements with any country that already has a comparable agreement with the United States. It should also offer similar reciprocity agreements to other "liberalized" parts of the world at an opportune time.

By showing leadership in this area, Canada would position itself strategically to take maximum advantage of the social and economic benefits arising from the current trends toward globalization of aviation markets.

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