American Airlines goes broke:

Can a "national" airline be allowed to fail?

As American Airlines becomes the last major US airline to seek Chapter 11 bankruptcy protection, the issue of airline reconstruction and the basic role of airlines in the national economic and social equation remains a very real one for policy makers. In this timely article, Chris Lyle of Air Transport Economics gives a Canadian perspective.

The vast majority of the world's airlines are today privately owned. This includes most former "national" carriers which have been turned over by their governments to private ownership. And yet, in an era of globalization and transnationalism, when it comes to economic regulation, the "flag" carriers are still mollycoddled with a lean towards jingoism.

There are two principal reasons why this happens. The first is provisions in national law and notably in the vast majority of bilateral air services agreements which preclude majority ownership and effective control of a carrier from one country by parties from another country.

There is a notable exception to this through the multilateral arrangements within the European Economic Area but even there many carriers are still unable to merge fully because of the retained provisions regarding services between European and other countries (thus AF-KL, BA-IB, LH-LX-OS).

There is widespread recognition that the ownership and control provisions put severe constraints on access to capital (in a capital-intensive industry) and on market access (in a transnational industry), leading to indirect and ultimately unsatisfactory means of obtaining market access such as alliances and code-sharing. However, various initiatives for reform all flounder through lack of political will. Thus, the concept of a "national" carrier continues to this day and when the "national" carrier has a dominant traffic share and holds, or is closely associated with, a country's name, then an emotional card often comes into play.

A second reason why flag carriers are effectively protected is that, apart from operations within Europe, the air transport regulatory process is driven by a network of bilateral agreements based on reciprocity of operations. This concept takes precedence in many countries over a more rational assessment of air services, one which goes beyond narrow sectoral interests of an air carrier and provides the optimum overall benefits from tourism, trade and investment for the economy, protection of consumer interests and enhancement of competition.

The global airline industry is undergoing a quantum shift

Of course, there are still a number of government-owned carriers, and some of them are already or are becoming powerhouses in their own right, notably the Gulf carriers Emirates, Etihad and Qatar Airways. Concerned at the increased competition and the geographic advantage of hubs in the Middle East, some major carriers in Europe and Canada argue that the Gulf carriers are the recipients of improper subsidy, although no substantive proof of this has been offered. The State-owned Gulf carriers do have access to sovereign wealth funds for financing aircraft purchase, but other carriers would themselves have much broadened access to capital should national ownership and control provisions be lifted. More fundamentally the host countries of the United Arab Emirates and Qatar offer seamless integration of trade, tourism, infrastructure and aviation policy. Such a holistic approach is not only sadly lacking in most western countries but many of these countries are compounding their shortcomings by imposing unsubstantiated taxes and charges on the air transport and tourism industries.

So, with a quantum shift in power to the Middle East and, also increasingly, China, the legacy carriers in the west are feeling the pinch and facing the prospect of being driven out of directly competitive markets and possibly, in the long term, out of business altogether. But at the same time, the economies of their home countries are generally benefitting from increased trade, tourism and investment flows generated by the Gulf carriers, as shown by economic impact studies in various markets.

The rising tide of western carrier concern over the expanding role of Gulf carriers (with Chinese airlines on the horizon) is natural from airlines which face increased competition - but should be viewed by regulators in a broader framework. If Emirates and its ilk can bring in the tourists more cheaply and more efficiently with net economic and social benefit to a country, even marketing your country overseas for you, why not let them? And if they can offer a cheaper fare via their hub why not let passengers have the option?

Also, if there is indeed a net benefit to your country ("net" taking into account any negative impact on a "national" carrier) why be concerned if a foreign entity is willing to provide a subsidy? In the past there has been a legitimate concern that a "foreign" carrier may suddenly withdraw its services, but many other traded critical goods and services today face the same situation, and many small countries, which are far more vulnerable than western ones with major economies, live daily with the risk of foreign carrier withdrawal. Perhaps the diktat for the large western carriers should be "If you can't stand the heat get out of the kitchen".

Can a national airline be allowed to fail?: the multi-billion dollar question

So, we come to the crunch question. Should and would a government be prepared to let a struggling legacy "flag" carrier go down the tube? The number of defunct international airlines is large (in the order of 200 worldwide – large and small – over the past 20 years, excluding merger or rebranding). But only a handful of "flag" carriers have been allowed to disappear (although even they have occasionally been amalgamated into successor carriers) and the vast majority of these has been from small market, developing countries. Airlines such as Air Canada, Alitalia, Austrian, Delta, Japan Airlines, Olympic, Northwest, Swissair, TWA, United and US Airways were all given substantial lifelines against potential collapse by their respective governments.

In the case of small markets, the perceived need to maintain a national carrier varies according to circumstances. Some tourism-dependent countries manage without any jet carrier (for example Maldives). Others have maintained a national long-haul carrier as a lifeline while taking a fairly liberal approach to giving access to foreign carriers (for example Seychelles, where major carriers such as Air France and British Airways withdrew because the market was "too small". 36 per cent of seat capacity there is now provided by Emirates and Qatar; developing the successful contribution by the Gulf carriers in terms of economic benefits from tourism, with an increase in frequency by Emirates plus Etihad coming in twice-daily, by the end of 2011 the Gulf carriers' share will rise to 44 per cent – or nearly as much as Air Seychelles). There are hybrid approaches in a number of Caribbean countries, even including financial incentives for the foreign carriers concerned. The risk of foreign carrier withdrawal and the consequent impact on the economy in these markets cannot be underestimated. There is no one-size-fits-all.

But in major markets, where the local airlines should arguably be more robust, particularly when they have significant domestic traffic and where they are associated with alliances, there is another and very important consideration. That is that there are almost always new and rising airlines, ***both nationally and externally***, which would be ready to fill at least part of the gap created by retrenchment or failure of a particular carrier.

Some of the questions which might be envisaged in a scenario for a failing airline in such a market:

- to what extent are other carriers (both domestic and foreign) able and willing to take up the slack?
- if the airline is a member of an alliance, would there be support from the alliance?
- could additional code-sharing fill some of the gap (especially by alliance carriers)?
- could the airline be sold off, in sum or in parts?
- how could essential services be maintained?
- would the government be prepared to open the domestic market to cabotage?
- would the government be prepared to raise air carrier ownership and control limits or offer other opportunities for joint venture with foreign entities?

Rationally such questions should be placed under the umbrella of ones in broader strategic context, for example: To what extent is air transport considered an essential service/public utility? Is tourism a human right and/or an economic necessity? But in practice the situation would be driven by business interests and *realpolitik* rather than by what many would consider to be academic premise. Last year the economic ramifications of the volcanic ash cloud in Europe induced IATA and others to state that this was an illustration of the fundamental contribution of aviation to the world economy.

This is somewhat specious since the main problems were caused by the unexpected and unplanned nature of the events. However, failure of a carrier would also be likely to require urgent short-term decisions to be taken which, if not placed in a broad context of responses to questions such as those above, may well not be the optimum for the mid- to long-term health of the economy and benefit of users. Brief address of the questions in a hypothetical but nevertheless possible real-life situation will be given below.

Airlines which may need support

In 2009 or 2010 negative operating results were shown by such western icons (in order of size) as United-Continental, Delta, Air France-KLM, American Airlines, British Airways-Iberia, Air Canada, SAS, Alitalia and Finnair. In some cases restructuring has turned things around but others show continuing vulnerability. Just last month, American took its long-expected move to restructure within the confines of Chapter 11 bankruptcy provisions, the last major US carrier to take this route. This measure is often seen by foreign competitors as a form of “subsidy”, allowing US airlines to “unfairly” slash costs.

Air France-KLM also remains in trouble. AF-KL is of course a European entity and as such there is a wide variety of options for maintaining air transport service in the event of severe financial difficulties, including scaling back where the slack would readily be taken up by other carriers. As it goes into bankruptcy, American has a US market share of 19 per cent domestically and 16 per cent internationally (in terms of scheduled tonne-kilometres performed) and is thus not dominant. Several competitors are ready and able to take up the slack from a retrenchment or to participate in a merger, as is currently speculated with US Airways. Internationally however, the impact on oneworld of losing American would be pronounced.

Air Canada is a different case entirely. Despite having a 40 per cent share of Canada's large domestic market over 80 per cent of Canadian carriage on international routes, and being highly protected by its government, the airline went through the Canadian equivalent of Chapter 11 in 2003/4 (and flirted with this again in 2009, before being given a helping hand by the government) but it still carries legacy baggage and continues to struggle. Canadians may welcome a more competitive air transport environment but severe retrenchment by or collapse of such a dominant carrier would pose particular challenges, ways of overcoming which are worth exploring. Would the Canadian government be prepared to accept another visit to bankruptcy protection or should it look at other options?

Is Canada the last bastion of economic regulation?

Before looking into this question, some background. Air Canada has continually been protected by the federal government. On the domestic front, the flag carrier now incorporates a merger of a series of former competitor airlines: Wardair, Canadian Pacific Airlines, Eastern Provincial Airways, Nordair, Pacific Western Airlines, Canadian Airlines…….. Canada's regulatory policy restricted competition and allowed Air Canada to become a monopoly Canada-wide until the no-frills, single class, single aircraft type (B737NG) Westjet was founded in Calgary in 1996 with oil business funding and later expanded towards eastern Canada and into the US.

Another independent startup, from 2006, Porter Airlines, based at downtown Billy Bishop Toronto City Airport, using turboprop aircraft (Bombardier Q400) domestically and transborder into the US, is now also nibbling at Air Canada's edges. Despite competition from these dynamic innovators, AC continues to demonstrate many of the negative characteristics of a legacy carrier in terms of both price and quality of service. Air Canada's revenue yields and unit costs are significantly higher than those of almost every other North American carrier (United being a notable, if temporary, exception), with unit costs substantially higher than Westjet. The airline has an ageing short-haul fleet and is cash strapped.

Internationally, Canada's international regulatory policy is amongst the most conservative (and hence restrictive) in the world, founded not only on third and fourth freedom traffic rights but also reciprocity within this limited scope. In 1988 Canada even withdrew from the multilateral *International Air Services Transit Agreement* regarding overflight and technical stop rights during a bilateral dispute with the UK. By withdrawing from the multilateral treaty (which has 129 parties) Canada could thus use authorisation of overflights between the UK and the US (notably Chicago, San Francisco and Los Angeles) as a lever for restricting UK-Canada operations.

This protective policy has been even more clearly illustrated over the past couple of years following requests for increased access by Emirates and Etihad to Canada. Air Canada does not fly to the Gulf. And yet it opposes addition to the limited access by Gulf carriers to Canada, primarily on the grounds that the traffic would be sixth freedom, notably from India, a large end-to-end market for Canada.

Air Canada, paradoxically, has an avowed policy of exploiting sixth freedom by developing Toronto and Vancouver as hubs for traffic between the US and Asia. Air Canada also has a Star Alliance partner in Lufthansa, whose hub is Frankfurt (and Air India's application to join the Star Alliance has recently been suspended).....And yet Air Canada stridently opposes a requested increase in the thrice weekly (and regularly full) services of each of Emirates and Etihad to Toronto, or any service by these carriers to Vancouver. Both Toronto and Vancouver have large South Asian populations, with substantial potential traffic which proposed service by the Gulf carriers would tap into. As shown by various economic studies, this would both generate new traffic and provide net national economic and social benefits to Canada (taking into account the – essentially minimal – impact on Air Canada). Air Canada has tried and failed more than once to provide a viable service of its own to India.

The position taken by Air Canada, concerned with increased competition, is perhaps understandable. But that of Canada's regulators in not accommodating the larger picture begs belief.

Not content with being unable to make a financial go of its clout, Air Canada's latest venture is aimed at squeezing out the much smaller Canadian leisure carriers which carry tourist traffic to Europe and sunspots in the US, Central America and the Caribbean, by establishing a discount carrier. The approach seems to be modelled on Qantas' highly successful establishment of Jetstar in Australia in 2004, which has however generated considerable union unrest.

The sheer scale and resources of AC would undoubtedly impact Canadian leisure carriers such as Air Transat (which is itself in trouble), Sunquest and Sunwing, as well as AC's main rival, Westjet. Canada's Competition Bureau appears to have been asleep at the joystick on this (although they do follow events, a Commissioner intervening recently when AC proposed to strengthen its joint venture with United Airlines). In contrast, the federal government has been so alert that when AC's cabin crew recently threatened a legal strike at concerns regarding the pay and conditions of service at the discount carrier, it immediately intervened. The second time around the government took the step of referring the issue to the Canada Industrial Relations Board, requesting the Board to determine whether there were any "health and safety" (*sic*) reasons why a strike should be denied (thus legally disallowing a strike while the Board deliberates). This doubtful action, if probably directed more at union bashing than at protecting the travelling public, is a symbol of just how far the government will go in support of Air Canada.

And yet ***despite - or perhaps because of - being cosseted, Air Canada remains in trouble***. Perhaps it should simply be allowed to fail this time around. There would undoubtedly be a major negative impact on the Canadian economy in the short term, and there is no doubt that transitional measures would be required, particularly as other Canadian carriers have not reached the critical mass necessary to fill the gaps in an all-inclusive way. It is ironic that the regulatory policy which has allowed Air Canada to have a dominant position creates a bigger problem when the lumbering behemoth can't seem to hang in.

The impact on business and trade of the sudden disappearance of Air Canada would of course be huge in the absence of transitional measures. Tourism provides a more interesting scenario from a purely economic perspective. In 2010 Canada received 16.1 million international tourist arrivals, with expenditure of US$15.7 billion. However, Canadian residents spent almost double this amount abroad, US$29.6 billion. Thus a reduction in air service might actually reduce the imbalance in tourism trade (a feature exploited last year by Germany's eco-tax, if no doubt protectionist).

Policy options: Tempering the storm and moving forward

Hands off? - For of the vast majority of industries, governments will simply let the market take its course when a company folds, the exception being strategic or dominant businesses (think Chrysler in the US, initially saved by the government and more recently merged with Fiat). But as indicated above, airlines seem to benefit from an emotional mindset. Air Canada has been allowed to become unduly powerful, and ownership and control provisions prevent merger with non-Canadian entities. One option would of course to break the company down further, perhaps dividing it into competitive operators based on its three hubs of Toronto, Montreal and Vancouver and separating out Air Canada Express and related Thomas Cook operations. But, given the size and reach of the airline, a stringently hands-off approach would undoubtedly face substantial short-term disruption of service, instability and the prospect of an uncertain outcome.

Help from the Alliance? - If Air Canada were failing, would other Star members step in to protect their interests? This situation is a bit like the Euro and Greece, but without the imperative of a truly binding relationship in which a damaged wall could bring the whole house down. Star members may provide moral and political support for AC, and may well expand code-sharing and possible other joint ventures because that could well be in their own interest, but ultimately contributing financially to save AC's bottom line would only be detrimental to their own (in 1999 United and Lufthansa did provide financial support to Air Canada but this was to prevent a hostile takeover bid which would have placed the airline in the oneworld camp).

Additional code-sharing? - This is one area where support could be forthcoming, with "metal neutral" services filling in for Air Canada operations *per se* and reducing AC's operating cost. But there is already substantial code-sharing with Star Alliance members and limited additional benefits are available, sharing with other airlines may be conditioned by the Alliance agreements, and there would inevitably be a lower revenue share for AC itself.

Opening up cabotage? - There are two concepts of cabotage, "consecutive" and "stand alone". Enabling consecutive cabotage, that is a domestic operation tacked on to an international route, would mean, for example, that United Airlines could extend its existing (United Express/Skywest) flights to Winnipeg beyond to Edmonton and be allowed to pick up domestic passengers between these two Canadian cities, or that Lufthansa could similarly extend flights to Toronto onwards to Vancouver. Application of such a concept would be very limited in effect, especially as carriers tend increasingly to serve major destinations with non-stop service (as do United and Lufthansa to Edmonton and Vancouver respectively).

Stand alone cabotage, on the other hand, would mean that United or Lufthansa could carry traffic between any two cities in Canada, including establishing a hub in Canada should they wish, without the flights touching a US or a German city. Clearly stand alone cabotage could produce more significant results, but it may be difficult to control since conditioning to encompass only certain foreign airlines (for example Air Canada's Star Alliance partners) operating within Canada might fall foul of international law; the principle of "Most Favoured Nation" effectively appears in both World Trade Organization and Chicago Convention provisions and, while its application has not been substantively tested legally, implies that opening up to carriers of one country would mean having to open to all. The impact would nevertheless still be limited and in any event there is a much better way of allowing foreign carriers to operate within the country which is more secure and robust because it involves financial commitment - that is opening up national air carrier ownership and control restrictions. (Note: aside from the wider trade MFN principles, the non-discriminatory provisions of the Chicago Convention relating to cabotage have in the past been read to mean that one country's airlines may be granted the privilege – provided others are not *specifically* excluded. As bilateral agreements are necessary to allow access, this allows the granting country simply to refuse to grant additional rights)

Raising ownership and control limits? - Like most other countries, Canada does not permit foreign majority ownership of carriers with their principal place of business in the country (indeed Canada only allows 25 % of the voting equity to be held by foreign interests, with the maximum single holding in Air Canada by any investor limited to 10 %). This both limits access to finance by the Canadian air transport industry and access to Canadian markets by foreign carriers, to the detriment of the Canadian economy. In today's era of globalisation, this is a unique sectoral restriction which is denying maturity to the air transport industry worldwide.

If Canada were to allow majority, or even perhaps substantially increased minority, ownership, and increase the single investor limit, what would happen? Air Canada's Star Alliance partners, and notably Lufthansa and United Airlines, each more healthy than it, would probably wish to protect and develop their market and would consider taking a greater interest and playing a greater role in AC's strategy, even if the focus were to be on international routes. There may well also be interest from other carriers, on the basis both of commercial viability and of being competitive with Star.

And what if Emirates, for example, were to move in and establish a base in Canada and/or to buy into Air Canada? Would this be such a bad thing? In recent years there have been forays by "foreign" carriers across borders in Latin America and Asia which have benefitted the carrier, the market and the consumer (eg LAN-TAM, TACA, Virgin). Emirates is in the business of making money and with its focus on low costs and high quality of service might inject a much-needed dose of competition into Canadian markets.

Of course, the foreign ownership may not be by a carrier at all and there could be fear of stripping the business and taking it abroad, but why would someone walk away from a market in which there is money to be made? In any event, as with any industry, national controls could be built in to limit such depredation.

In sum, there is a strong case, not just in Canada but worldwide, for raising or even eliminating the national ownership and control limits, accepting that a radical change too quickly might well produce some turbulence in the early stages. And Canada is by no means alone as regards the latent xenophobia exploited by policy makers and unions to counter foreign investment, especially when it comes to the iconic aviation industry.

Essential services? - One legitimate concern of allowing a purely commercial-focused basis for air transport operations within Canada would be the maintenance of service to small and far flung destinations in a country with such a large territory. Historically Canada provided subsidies for services to northern communities, but today most routes have become viable without federal subsidy, operated by such independent carriers as Air Inuit, Air North, Canadian North, First Air and Pacific Coastal, with Air Canada and Westjet also now providing service to a few points.

In practice this should not be a problem. At present carriers may receive financial support through contribution agreements with Inuit and First Nations organizations that are matched to specific shipment and medical requirements, and there is no air transport regulatory reason why this should not continue. And, should actual or potential withdrawal by Air Canada (or its subsidiaries of the Air Canada Express group) occur in any market, Canada could decide to apply essential air services provisions similar to those existing in Australia, Europe, and the US. The concept is focused on the provision of a specified level of air service (defined in terms of capacity, periodicity and price) between specified points, where such a level of service is not (fully) supplied, or is at risk, under existing market and regulatory arrangements. It is premised upon external support to air carriers for achievement of the specified level of service.

Such support would normally be in terms of supplemental funding by government or business at federal, provincial, territorial and/or municipal level. To minimise subsidy, operation of the prescribed service would be put out to tender with the carrier requiring the least subvention obviously being a prime candidate. The concept of an essential service programme enables the true cost of operating a route to be determined while avoiding cross-subsidy and diversion of focus by a carrier primarily operating major routes. If required, the concept could apply equally to international routes (where ICAO and the World Tourism Organization have jointly carried out feasibility studies and developed guidance on *Essential Service and Tourism Development Routes*).

A *realpolitik* way forward for aviation policy

So, *quo vadis*? There is clearly a need to develop a more robust yet more competitive air transport industry in Canada, removing Air Canada from its silo and providing light-handed economic regulation on the basis of the larger picture of air transport services, consumer benefits and the economy at large. As illustrated above, there are a number of tools available for doing this, some of which are more powerful than others and some of which would be more disruptive than others, at least in the short-term, if providing long-term benefit. In order to achieve a balance, a progressive package of elements could be developed along the following lines:

- Let Air Canada enter bankruptcy protection again, or otherwise encourage restructuring, but with this conditioned on slimming down, spinning-off non-core operations, perhaps even breaking core operations into separate saleable assets, and with an emergence deadline; AC would not simply evaporate, there would be available aircraft (if ageing), infrastructure and a skilled staff for others to pick up.
- Raise the ownership and control limits by foreign interests, for all carriers with their principal place of business in Canada, to say 49 % (to increase both potential capital investment and competition) and maximum single holding in all Canadian carriers to a similar level, with conditions assuring that control (Board membership, voting shares, etc) remains in Canadian hands; one possibility could be to distinguish between limits for domestic and for international Canadian carriers, as is the case in Australia (where domestic airlines may be 100% foreign owned), although this would probably require special treatment of US transborder operations.
- Limit investment, joint ventures and code-sharing by any foreign member of one of the major alliances (oneworld, Skyteam and Star) and of any other predefined major foreign carrier to only a single Canadian carrier (ie a Star member could enter into an expanded joint venture with Air Canada but then not with any other Canadian carrier); this should encourage both domestic and international competition.

- Develop and apply essential services provisions, including subsidies, as may be required.

So, as American Airlines takes the US airline industry a step further towards a more rational and cost effective entity, many other countries' airlines – and their governments – are watching with interest and perhaps even envy.

And, with the sort of measured approach outlined above, who knows, Canada might not only get its own house in order but become a model to the world for progressive liberalisation of air transport!

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