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Introduction

It seems that every day now, new initiatives and developments are announced building on the new (yet to be implemented) EU-US bilateral agreement. Some of these announcements are additional capacity, capitalising on the new regulatory framework in a completely conventional, and foreseeable way; others are new service offerings that are apparently opening up as a result of the new arrangements. Geoff Dixon, CEO of Qantas has been quoted saying that he believes that the entire aviation world will be liberalised by 2015. That is starting to look possible. Furthermore, this trend is spreading. This month Japan announced a substantial liberalisation of its air services approach, Singapore continued to open new routes (it signed an open skies deal with Belgium) and China and the US significantly opened the cargo capacity between their two countries.

All this movement almost starts to smell of panic. At the same time, whenever airlines want to find a way to bring about neutral and measured developments (such as in the areas of emission trading, or ATC reform) there continues to be a tendency to look to ICAO. As noted last month, that makes the next tri-annual Assembly in September rich with meaning.

Emissions Trading for Aviation – starting to generate heat

- Airlines in Europe continue to discuss emissions trading schemes with the European Council and the European Parliament
- The airlines have released a study (by E&Y) that suggest the current proposals will be costly and unfair
- One argument is that the scheme will disproportionately disadvantage European carriers
- That makes for an interesting legal debate on the EU's scheme
- IATA at its AGM suggested a global scheme, details of which will be released in September
- In the meantime, there is a growing risk that some sort of tax will be introduced

The European Union (both the Commission and the Parliament) has been lobbied very heavily in the last month by European airlines and other aviation interests (which have coalesced to form a coalition on this point – the Coalition for Environmentally Friendly Aviation – CFEA) opposed to the EU's proposed inclusion of airlines in the European emissions trading scheme (ETS). Hardly a day goes by without some further meeting on the subject. Part of the CFEA's campaign has been a study by Ernst & Young showing that the proposed scheme would harm growth and disproportionately harm European airlines. There is also a concern that there has been insufficient allowance for growth, thus requiring airlines to buy credits to be able to grow their business.

The consultants found that barely one third of the expected cost of the proposed scheme would be recoverable from passengers and shippers, as the ability of airlines to pass costs onto their customers will vary according to the operator's business model and its exposure to competition. This is in direct contradiction to the Commission's claims that the cost of its ETS proposal can be passed on to customers, largely or even in full.

Furthermore, according to E&Y, demand for air travel is highly price-sensitive, contrary to the Commission's statements; therefore any price increase will result in a loss of customers for European airlines.

Furthermore, to allow for its predicted growth, the according to the CFEA, the European aviation sector will have to purchase carbon allowances for up to 45% of its total emissions by 2022. As aviation is both a driver and a consequence of overall economic growth, the CFEA believes the need to pay for growth will have a perverse effect on the environment, as it severely reduces the ability of aviation to invest in cleaner and quieter modern technology. Exactly how the CFEA thought that targeted reductions might otherwise be deployed is not clear.

According to the CFEA, the cost to airlines of purchasing allowances will be substantial, with an 'optimistic' estimate of over €45 billion from 2011 to 2022. Aircraft operators' overall profits will be reduced by over €40 billion during the same period, weakening the financial stability of the sector. Such a good job did the CFEA do at talking up the problems of ETS was a 3.7 percent drop in the share price of the Air France KLM group when the market reacted within hours to the possible consequences of the proposal.

The veracity of the claims that airlines will suffer a competitive disadvantage will be more likely true if not all airlines are exposed to the cost. But the scheme, at least in the first place, applies to *all* European airlines from 2011 and then all non European airlines flying into and out of Europe in 2012. So the argument is only valid for the one year between 2011 and 2012. Furthermore, article 15 of the new EU-US bilateral recognises the importance of the environment and allows for the introduction of environmental measures assessed against the benefits of the agreed rights. In case of doubt, there can be a request to meet the Joint Committee set up by the agreement. However the Joint Committee has no decision making power. Consequently, intra-EU flights which are operated by US airlines would be covered. Unfortunately, we understand that these flights have already been exempted from the introduction of ETS in aviation.

Conversely, the introduction of ETS on intra-EU flights for EU carriers is not problematic as positive discrimination is being allowed. But the application to ETS to other flights would be subject to an international agreement yet to be reached. However, intra-European flights operated pursuant to the EU-US agreement are exempt from the ETS scheme. So if the new EU-US open skies agreement delivers all that it is possible of delivering, it will be true that US carriers will get a price break for operating European flights. That is, of course, unless the EC is able to negotiate something in the meantime.

The legal basis for the introduction of ETS in aviation is found in the United Nations Framework Convention on Climate Change, the Kyoto Protocol and EC law that brings those treaties into effect within Europe. In particular, protection of the environment under Article 174 and the "polluter pays principle" under Article 172.

In February 2007, the CAEP meeting provided guidance to the 190 ICAO states which was consistent with the UNFCCC process. It highlighted the responsibility of aircraft operators for emissions trading, based on total emissions from all covered flights. The criteria would be CO₂ emissions and/or aircraft weight. A separate accounting

management for aviation was to be made by the states. Last but not least, the guidance agreed with the inclusion of foreign operators on a *mutually agreed basis*.

There are indeed arguments in aviation law which would support the introduction of ETS in aviation. International air services must be operated “soundly” and developed in an “orderly manner”, as stated in the Preamble to the Chicago Convention.

The environment is covered in Annex 16 of the Chicago Convention, but not ETS per say. ETS is unknown as a concept. Therefore it is neither forbidden nor allowed. Is an international agreement needed or is unilateral introduction feasible? And enforcement of ICAO agreed standards are made through bilateral agreements. Article 6 of the Chicago Convention does allow the operation of international air services “with special permission, and in accordance with the terms of such special permission”. But there is a strict approach toward the operation of international air services. ETS would only be permissible if expressly allowed.

So we are back to the traditional bi-lateral process of mutual agreement for the introduction of ETS, if that is what Europe wants. Remembering that Europe is the largest single market in the world, Europe can drive a hard bargain – ETS for enlarged capacity rights – but it is a risky strategy. For a start, it calls for the retention of the bilateral system, in the face of Europe calling for an increasingly ‘open sky’ framework. Secondly, in relation to the US, the EU folded, exempting US flights. Other countries will no doubt negotiate with that precedent in mind.

So there are obstacles for ETS on ex-EU air services. To date, the ultimate reaction of the EC and the Parliament to the CEFA orchestrated prediction of the end of the world as we know it, and other gloom and doom is not known, but it is fair to say that the airlines (and their associations) don’t seem to be getting significant support from any of the usual sources. What that seems to show is that emission trading, and the environment is too big and too important for aviation to be able to argue that it is ‘special’.

Furthermore, there is some pent up frustration at the way that airlines have reacted in the past to this issue. It is arguable that IATA’s initiative, announced at the AGM in Vancouver, will be treated in a similar way: that is it will not be considered credible or fast enough to satisfy the European parliament and European public. It is difficult to over-estimate the urgency with which this issue is being addressed within Europe. This week, for example, the German Minister for Transport suggested that all trading certificates be acquired through auction, right from certificate one. This is in line with the original view in the Lucas report, dismissed at the time as too radical. Now it is the view of a Minister of State responsible for transport. Simply playing for time is not going to work for the European carriers.

It is our assessment that, at least in Europe, there is a real risk of additional taxes on air transport, or perhaps on aviation fuel. The legality of such a move under the Chicago Convention is not clear. That will make the ICAO General Assembly all the more interesting.

Article 15 of the Chicago Convention allows only charges, no taxes. The question is: is ETS a charge? Bilateral air agreements are the exclusive basis for trade in international air services. The agreements must provide a level playing field via “fair and equal opportunity to compete”, a clause which applies to carriers on both sides of the agreement.

So the question must be: is the level playing field affected by the introduction of ETS? And if ETS is introduced on airspace above the high seas, is it to be achieved only under the auspices of ICAO (Article 12 of the Chicago Convention)? If ETS is introduced on flights started in a third state, is there a risk of affecting the sovereignty of that third state protected by Articles 1 and 2 of the Chicago Convention? It is clear that enforcement in relation to third country carriers has been underestimated by the European Commission.

Liberalisation. Suddenly, it is in fashion

- Even before the EU-US bilateral comes into force airlines are announcing new routes and services
- Interestingly, that is also putting pressure on airports and on slot regulations
- Other regions of the world are also announcing liberalising changes
- Full liberalisation by 2015?

The CEO of Qantas, Geoff Dixon has predicted that all the existing bi-lateral regulation of air service agreements would be liberalised by 2015, eight years from now. Dixon is an astute man and not prone to wild statements. If the first month after the signing of the EU-US bilateral open skies agreement (but before it comes into effect) is any guide, this is looking like a sure bet.

Suddenly, liberalisation is everywhere. Japan has announced a major review of its policy (which has been notoriously protective of JAL); China opens considerable amounts of capacity to the US and its carriers; Singapore signs a cargo open skies agreement with Belgium. This last one is very interesting, given that neither country has any significant domestic traffic. Clearly each is trying to improve the position of their carriers and airports to transfer and joining traffic. For Singapore, it is a tried and tested strategy. For Belgium it is a new strategy.

At the same time, a number of European carriers have announced a number of changes and developments. In isolation, any one move would merely be of interest. It is when the announcements are put into the context of the broader picture that they start to take on some more strategic significance.

First and foremost, we have seen a number of carriers look to reorganising their London Heathrow strategy, in conjunction with their alliance partners. Short haul flights to Paris, Amsterdam, Brussels and so on are being traded and swapped so that alliances such as Star and SkyTeam can ensure that there are long haul services operating out of Heathrow. This is seeing a remarkable amount of goodwill amongst alliance partners, as well as considerable amounts of money changing hands. Carriers in alliances such as Star, for example bmi, with a considerable portfolio of LHR slots are selling them to long haul members of their alliance, (currently the asking price is approximately £20-40M a

pair depending on timing) or otherwise rearranging services so that they can themselves offer trans-Atlantic services.

At the same time, new service offerings are in the pipeline. Both British Airlines and Virgin have announced that they will be offering 'business only' services from various European locations. These are likely to be B737-800 or similar aircraft with perhaps as few as 40 or so seats. Lufthansa, Swiss and KLM have been offering similar services for a few years now, all using the services of PrivatAir to offer neutrally branded services on sectors that have considerable business traffic due to the particular nature of the city pairs involved. Often the Business Class only service is operated as a supplemental service, as a further frequency, to maintain loyalty with business travellers. It is a defensive measure, as much as an active market share and yield winner. With BA and Virgin coming into the field it might be clear that there has been a need for defence of these routes all along.

Business markets have been under attack for some time. A number of 'business only' carriers have started up and there is a huge boom underway in the business aviation area, even before the introduction of the new generation Very Light Jets (VLJs). Perhaps we are seeing the bifurcation of airlines into all economy (low cost/service) carriers on the one hand, and carriers that cater for the full service business model.

An interesting question that arises out of that is whether this will also happen to airports? In other words, will we start to see business airports, with full service facilities, including interline facilities and low cost airports with a focus on cost containment? For airport operators of course, they have attempted to make this distinction by terminal, with a low cost terminal and traditional full service terminal. In Europe, the recent discussion paper from the EC, with a revision of the airport charging regime, makes this harder to achieve, as there is a strong prohibition on discriminatory pricing. Whilst one could argue that the services at a low cost terminal are not the same as the services at a full service terminal, this argument is not going down well in Brussels at the moment. Perhaps Brussels needs to understand better that it is possible for airports to compete against themselves.

The new regulatory framework represented by the EU-US bilateral is already seeing new products as well as a fundamental rethink of routes and services. Over time, this will push reform of other parts of aviation including airports. Furthermore, other regions of the world are not merely sitting up and taking notice, they are starting to liberalise their regions too. It is more than likely that as Dixon predicted, by 2015 the situation will be unrecognizable.

Slot Regulation

- The European Parliament has foreshadowed that it intends getting involved in a new round of discussion on slot regulation.
- Positioning is now taking place within the Parliament as to who is going to take the lead
- The Commission is looking at ways to avoid this

All this activity at Heathrow has again put slots and slot regulation in the spotlight. For some years, following the Jersey Island challenge to a slot sale by KLM in the UK Courts of Justice, which held that the sale of slots was not a priori in breach of the European Slot Directive (modelled in large part on the IATA slot procedures) slot regulation has been a sleeping dog. Not for much longer, apparently.

For its part, the EC admits that they will be looking again at the slot regime, but then again that has been true for the last several years. Economists will argue that the best solution is to make slots fully tradable on an open market. Airports, on the other hand, take a view that given that it is their investment on infrastructure that creates slots in the first place, they should be involved. Politicians see a number of policy issues that also need addressing, including ensuring that there are no infrastructural reasons to stop new entrants to actually enter the market and that remote locations are served. The question is whether the current Directive allows secondary trading. The airlines say that it does not prohibit it, and thus it is legal. That is supported by the UK case referred to above. The Commission is looking to clarify the point.

The European Parliament is determined to be involved in any review and revision of the existing slot rules. The first shot has been fired by Ulrich Stockmann MEP of the Socialist Group in the European Parliament. He has released a white paper reviewing the current procedures and setting out what he sees as a range of possible replacements. Stockman finds the grey market in London Heathrow slots unacceptable. He said it could be eliminated by means of a 'transparent mechanism'. What that mechanism might be is, however, somewhat opaque. Stockman is against the introduction of a primary trading scheme as the consequences are not sufficiently foreseeable. This would pose a disproportionate threat to the air traffic market.

Conversely, Stockman said secondary trading is an appropriate means of increasing the efficiency of the slot system. However, including third parties in secondary trading must be strictly prohibited. From the viewpoint of the European legislator, slot trading is a tool for optimising the air traffic system, not a means to profit maximisation for third parties.

The Commission has started a consultation with the airlines on this matter. One option might be to provide clarity by way of issuing guidance, rather than an amendment to the Directive. This might avoid going through the Parliament at all.

Spectrum Issues – Still in the news

- There is continuing pressure to sell spectrum that aviation has used for free hitherto
- A number of big players are now getting involved
- At the same time, ICAO has endorsed a paper aimed at slowing down the introduction of mobiles on-board aircraft

i The commercialisation of spectrum

Spectrum continues to be an aeronautical issue. Last month we reported on moves by the UK spectrum regulator, Ofcom, to commercialise the spectrum that aviation uses. That process is now picking up pace. Reviewing what it calls the 'digital dividend' it has

looked critically at usage in a large spectrum block. Part of the block is Channel 36 (590-598MHz) where one of the current users is aeronautical ground radar.

Having identified the band, Ofcom has had a public consultation on what it might do with it. Over 700 responses were received, something of a record for an Ofcom enquiry, but curiously, none were from the aviation industry at all. The majority of responses called for an acceleration of the timetable Ofcom had set for the release of this spectrum band, allowing for a reallocation of its usage.

Ironically, due to the large number of responses calling for the rapid and ahead of schedule release of the spectrum, Ofcom has advised that it will need to delay its proceedings. Nevertheless, at some point this spectrum, currently available for ground radar will be reallocated. Calling for its immediate release were such lightweight players as Nokia, Orange, the BBC and BSkyB.

One thing is clear, once this sort of player is involved, the price that they are prepared to pay for the spectrum that they want to use will go up from the price that aviation paid for access to it (which was nothing). With the work Ofcom is doing in the AIP process (reported in last month's report) this sort of pressure will see the market value this spectrum at a commercially aggressive price.

ii A set back for on-board mobiles

Just when you thought that it was safe to leave your phone on on-board, the UK CAA has swept in to put such thoughts on hold. At a recent meeting of the ICAO Air Navigation Services bureau in Montreal, the UK CAA won support for a paper that called for continued study, a universal approach (as opposed to the regional approach suggested by the service providers) and if possible uniform spectrum allocations for the service. At the same time, the paper raised a number of concerns for what it called 'social issues' such as unruly passengers. This outcome raises as many questions as it answers, including what jurisdiction the ANS might have had to agree such a paper and the approach the service providers have recently taken.

In the meantime, a survey of 25 European regulators on the application of ECC Decision 07/06 (which provides for a regional, harmonised licensing approach for Europe, based on the recognition of licences issued by the state of registration of the aircraft) shows that whilst there are varying degrees of understanding of the process, there has been considerable acceptance of the framework that the ECC Decision represents.