STRATEGIC KNOWLEDGE CLUSTER | RÉSEAU STRATÉGIQUE DE CONNAISSANCES
Canada-Europe Transatlantic Dialogue | Dialogue transatlantique Canada-Europe

CANADA-EUROPE TRANSATLANTIC DIALOGUE:
SEEKING TRANSNATIONAL SOLUTIONS TO 21ST CENTURY PROBLEMS
http://www.carleton.ca/europecluster

Policy Brief December 2008

Policy considerations in the negotiation of a new air services agreement between Canada and the European Union[1]

Mark Glynn under the direction of Professor Armand de Mestral
McGill University*

Background

Canada and the European Union are in the process of negotiating a new air services agreement. This represents the first time in history that Canada has exited the post-Chicago Convention paradigm of binational negotiation and follows on from the conclusion and entry into force of a single text between E.U. Member States and the U.S.[2]

In 2002 the European Court of Justice in its "Open Skies" judgment specifically held that the bilateral air service agreements between eight Member States and the United States violated the freedom of establishment under the European Community Treaty, since the agreements restricted air traffic rights into the United States from the European Union Member States to airlines substantially owned and effectively controlled by nationals of that particular Member State.[3]

Whereas the Open Skies judgment was prima facie limited in scope to the eight complained of bilateral agreements, all other bilateral agreements between Member States and a non-Member State which contained restrictions based on national ownership and control found themselves in a legal grey area. The European Commission undertook different corrective actions to bring such agreements into line with European Union law. Member States were encouraged to negotiate with their bilateral partners to replace restrictive nationality clauses with Community clauses thus ensuring that no distinction could be made on the grounds of nationality provided that ownership was majority vested in nationals of any Member State(s). Secondly the Commission undertook to negotiate horizontally with third countries to replace national clauses with Community clauses in all bilateral agreements with European Union Member States.[4] Canada has agreed to bring all of its bilateral agreements into line with Community law by relaxing national ownership restrictions in bilateral agreements with Member States.[5]

The third initiative of the Commission has been to seek mandates from the Council to negotiate new agreements with third countries on behalf of all Member States. Market access rights

* *Mark Glynn is a PhD candidate, Institute of Air and Space Law, McGill University. Armand de Mestral is Jean Monnet Professor of Law at McGill University. The views expressed are attributable only to the authors in a personal capacity and not to any institution with which they are associated.*

conferred by agreements concluded by the Commission would be granted to any Community enterprise irrespective of state of origin. After a first strategic agreement with Morocco,[6] the Commission turned to negotiating with the U.S. Since eight bilateral agreements binding Member States and the U.S. had already been specifically declared illegal by the Court of Justice and as the chief trading and aviation partner of the E.U., the United States was a natural early and key partner for the E.U. After extended and difficult negotiations, those two parties finally agreed upon an Open Skies agreement in March 2007, which provisionally came into force on 30 March 2008.

The Commission has since sought mandates to negotiate further air services agreements with strategic global partners. Canada was a natural next State with which to undertake negotiations. Canada is the second largest extra-European destination of E.U. air traffic after the United States,[7] and its aviation sector is closely related to the U.S. market due to the geographical and economic proximity of the two countries. On 2 October 2007, the Council granted the Commission the mandate to engage in negotiations with the government of Canada with a view to concluding an air services agreement.[8]

The importance for Canada of reaching an agreement

The Canada-E.U. market is presently lacking capacity after the August 2008 liquidation of a significant year-round carrier, Zoom Airlines.[9] Despite the fall of oil prices from their crippling zenith, airlines continue to struggle due to reduced demand resulting from economic turmoil, currency fluctuations, and what may have since proven to be overly-cautious fuel hedges implemented when oil prices were spiralling.[10] The capacity lost from bankruptcies and commercial decisions to scale back service should be easily replaced whenever deemed feasible by incumbents and entrants. Consolidation amongst European network carriers is also presently accelerating thus reducing competition on E.U.-Canada services. It is anticipated that the Open Skies agreement between the United States and the European Union will foster the emergence of transatlantic low cost carriers. If regulatory restrictions prevented Canada from benefiting from the revolution of transatlantic air services, investment and tourist euros may be diverted southward to the United States due to better and cheaper connectivity. Canada-bound leisure passengers may also find themselves presented with significantly cheaper transportation options by flying directly with a low cost carrier to a United States border airport offering onward entry to Canada. In the same way Globespan offers service to Toronto by flying to Hamilton airport with shuttle service to downtown Toronto,[11] it is conceivable that Ryanatlantic - the proposed new subsidiary transatlantic arm of the E.U.'s largest low cost carrier Ryanair[12] - could serve Plattsburgh and Buffalo airports yet market the destinations as Montreal and Toronto by providing onward ground transportation thereto.

The Canada-E.U. market is significantly less competitive and more expensive than the U.S-E.U. market. For the winter season 2008/2009 there are 24 city-pair connection between the E.U. and Canada with only six routes being contested by two network carriers. Canadian self-styled "vacation" airline Air Transat adds non-daily service to four already contested routes.[13] Air Transat also serves additional European points during peak summer however infrequent service and absence of network dictate that the airline serves niche leisure markets. Nine E.U. Member States now have direct scheduled service to Canada from 10 E.U. airports. Service is provided by eight E.U. airlines, Air Canada and the Toronto-Brussels service is a traffic stopping point on Jet Airways' Toronto-Delhi flight.

Although the value of comparisons with the U.S. market is limited, the following data gives a point of reference. British Airways alone offers service between London and 18 U.S. airports.

Network carriers offer another 17 direct U.S.-U.K. city-pair connections. The 35 direct network airline city-pairs serve seven U.K. cities and 24 cities in the U.S. This compares to 23 pan E.U.-Canada scheduled services which serve six Canadian cities and 10 E.U. cities. In the New York-London market six U.S. airlines offer service, plus two U.K. airlines, and two foreign fifth freedom carriers. The 10 scheduled carriers on that one route equal the total number of network airlines operating between Canada and the E.U.[14]

The table below highlights the cost of lesser competition in the Canada-E.U. market. It shows the lowest seven day return economy direct fares to four major European cities from the three largest Canadian gateways and from three leading transatlantic U.S. gateway cities.

	AMSTERDAM	FRANKFURT	LONDON	PARIS
MONTREAL	$881 (3420 m)	$732 (3779 m)	$708 (3248 m)	$720 (3424 m)
TORONTO	$879 (3722 m)	$731 (4075 m)	$715 (3554 m)	$705 (3733 m)
VANCOUVER	$1004 (4790 m)	857 (4996 m)	$965 (4716 m)	NO SERVICE
NEW YORK	$668 (3645 m)	$532 (4017 m)	$531 (3463 m)	$665 (3628 m)
CHICAGO	$658 (4114 m)	$646 (4454 m)	$575 (3954 m)	$717 (4138 m)
L.A.	$799 (5563 m)	$622 (5831 m)	$731 (5448 m)	$739 (5653 m)

AVERAGE PRICE PER MILE CANADA-E.U. $USD 0.205
AVERAGE PRICE PER MILE U.S. – E.U. $USD 0.146
PRICE DIFFERENTIAL PER MILE EX-CANADA 40.4% [15]

Baseline - Open Skies

The starting point for negotiations will be Open Skies in the sense of allowing direct flight from the other country to the city of choice, rather than restricting destinations. (This is a more restrictive vision of Open Skies than that prevailing within the E.U.) The E.U. did not secure such as agreement with Morocco, however it was a point of agreement in negotiations between the Commission and the United States. This was not a surprise since expansion of Open Skies was the U.S.'s external aviation policy and 16 Member States already had open skies with the U.S. As comparably developed and industrialized areas with mature aviation sectors, airlines from both Canada and the E.U. will be able to flourish in a liberalized environment. Canada has adopted its Blue Sky policy favouring progressive global liberalization of air transportation[16] and the E.U. is in favour of removal of aviation market access barriers. Currently Canada has an open skies agreement only with the U.K., however the agreement was acclaimed on its entry into force as British Airways expanded its service and a new seasonal low cost service was incepted by Scotland-based airline Globespan.

An open skies agreement would allow any E.U. or Canadian certified airline to fly directly between any pair of European and Canadian points (unrestricted third and fourth freedom operations). Furthermore E.U. airlines could serve with traffic rights any behind, intermediary or beyond points as part of the flight to and from Canada except for points within Canada. Canadian airlines would be allowed to serve with traffic rights behind, intermediary and beyond points in their operations to/from the E.U. except with regard to domestic service within a single Member State (unrestricted fifth freedoms excluding cabotage). No indirect constraints would be placed on operations, thus an unlimited number of carriers could be designated to serve any and all routes, those carriers could freely determine capacity and frequency based on market principles, and pricing would be at the sole discretion of operating airlines bar antitrust review.

Open skies would allow Canadian and E.U. airlines to enter and exit markets more easily, thus inciting existing service providers to at least seek to expand service, allow airlines not currently flying between the E.U. and Canada to test the market and facilitate entry by upstart and low cost carriers. The removal of an important barrier to entry should also provide greater competitive discipline to incumbent services. Air Canada is the dominant carrier in the market with 16 daily frequencies across 12 transatlantic routes. The next largest competitor, British Airways, operates five daily frequencies on four routes. However, Air Canada has in 2008 reduced its transatlantic capacity and the Canadian government cannot adopt policies to protect Air Canada's proportionate market share when the airline itself is reducing service. Furthermore, European carriers have also generally been withdrawing service to Canada rather than expanding. The Canadian government has solid social and economic interests in maximizing transatlantic connectivity and thus should not hesitate to ink an open skies agreement promoting market entry.

Beyond Open Skies

In the E.U.-U.S. agreement, several provisions were coined as "Open Skies Plus" underlining that the agreement went beyond a classic U.S. open skies relationship. Specifically the agreement provides for third country airline investment and control for U.S. and E.U. citizens, rights to franchise and brand in the territory of the other party, and increased regulatory cooperation.[17] The E.U. will likely be seeking similar concessions with Canada is order to maintain symmetry in its external aviation policy.

Third country airline investment and control rights allow the citizens of each party to invest in airlines of other countries without the other State party opposing service on grounds of foreign ownership. This poses little risk for Canada, particularly if the rights were restricted as in the U.S. agreement to named countries and the continent of Africa. Canada has only two connections with Africa, provided by Royal Air Maroc and Air Algérie. An increase of service, even if provided by a European owned and controlled airline, will not harm the Canadian aviation sector but could boost the domestic economy.

Given the low cost connections across Europe, and Air Canada's many alliance partners, it is unlikely that Air Canada would wish to implement franchise agreements in Europe. European carriers have been moving away from the franchise model and are unlikely to be inclined to establish Canadian franchises. Should a European carrier choose to do so this could damage Air Canada's transatlantic market share from regional airports given that it is presently the only airline offering online transatlantic connectivity without passing through the United States. However, Canadian consumers could make significant gains from the move to duopoly of online service options from regional airports.

With regard to integration of regulatory mechanisms, Canada should assess the efficiencies of a coordinated approach to aviation safety, security, and antitrust review against the transaction costs of ongoing transatlantic negotiations. Should Canada wish to pursue regulatory integration with the E.U. it may further consider whether this should be done bilaterally or if it would not make more sense to work concomitantly on a tripartite basis with the E.U. and the U.S., with the goal of establishing as far as possible a single transborder and transatlantic aviation area with commonality of rules and regulations. The E.U.-U.S. agreement envisages far-reaching cooperation and it may prove easier for Canada to assume a meaningful role within that association earlier rather than later.

Towards an Open Aviation Area

The E.U. compromised in its agreement with the United States since it had sought an Open Aviation Area within which no distinction would be drawn between E.U. and U.S. carriers. The three principal components of an open aviation area which go beyond open skies are; exchanging stand alone international traffic rights to third countries from the partner's territory (seventh freedom), the grant of cabotage rights, and reciprocal freedom of investment by physical and juridical persons of each party in the airlines of the other party. The U.S. and E.U. agreed to limit seventh freedom traffic rights to cargo, and the Department of Transportation's negotiators were bound to respect domestic U.S. laws which prevented the grant of cabotage rights or extending investment privileges in U.S. airlines. The Commission however made clear that its medium term vision was a fully liberalized market and thus a timeline and mandate for second stage negotiations was included in the agreement.[18] The E.U. is likely to seek an open aviation area with Canada because it would be in line with its ideology, it would create a precedent for negotiating with other countries, and it would act as leverage to coerce concessions from the U.S.

As Canada has already submitted to a horizontal agreement accepting the Community designation clause in all its existing bilateral arrangements with Member States, it has lost a key weapon in negotiating with the Commission. However Canada is also far less pressed than was the U.S. to enter into an agreement since the major interest of the U.S. in pursuing pan-E.U. open skies was to gain unrestricted access to the U.K. aviation market, whereas Canada has already gained that. Thus, Canada must establish from the outset whether it is willing to enter into an open aviation area and how to respond if this were to be set out as a condition precedent to conclusion of an agreement.

Entering into an open aviation area with the E.U. would allow Canada to take a lead in establishing transatlantic policy and would cement strong relations with the Commission. The granting of seventh freedom operations would open up Canadian dominated transborder routes and lucrative Latin American and transpacific markets to competition from stand alone service from European airlines. The exercise of the rights would however be subordinate to the E.U. or its Member States securing reciprocal rights from third States. Furthermore, it is unlikely that a European airline would find it lucrative to operate stand-alone international services from Canada with no domestic or international network to plug into at either end. Therefore, fear of lucrative international routes being cherry picked by European airlines should be rationalized, and even if successful, can be outweighed by the benefits to the Canadian economy from improved international connectivity, and to Canadian consumers from having a new competitor driving all airlines to improve efficiency. European carriers expressed their lack of interest and the commercial non-viability of providing intra U.S. service[19] and there is no reason to believe that this would be different within the Canadian market. Thus, there is little evidence that an open aviation area would be harmful to Canadian airline interests and Canada may deem that the political benefits of transatlantic open skies outweigh lingering concerns of the impact on its privately owned flag-bearing airline.

---

[1] The authors are aware that between the time of submission of this article and its publication, press releases have indicated that a new air services agreement was agreed upon by the Commission and Canada on 9 December 2008. As the text of the agreement is as yet not in the public domain, a commentary on the content of the agreement will be issued subsequently by the authors upon the availability of the agreement. For the press releases to date see online:

Transport Canada <http://www.tc.gc.ca/mediaroom/releases/nat/2008/08-h237e.htm> and European Union <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/08/1914&format=HTML&aged=0&language=EN&guiLanguage=en>.

[2] EC, Air Transport Agreement, [2007] O.J. L 134/4 (US-EU Open Skies Agreement).

[3] Court cases C-466-469/98, C-467/98, C468/98, C-469/98, C-472/98, C-475/98, C-476/98 of 5 November 2002

[4] European Commission, A policy built on three key pillars: horizontal agreements, online: EU Air Transport Portal <http://ec.europa.eu/transport/air_portal/international/pillars/horizontal_agreements_en.htm>.

[5] European Commission, Bilateral ASA brought into legal conformity since ECJ judgments on 5 November 2002, updated 01.08.2008, online: EU Air Transport Portal <http://ec.europa.eu/transport/air_portal/international/pillars/doc/asa_table.pdf>.

[6] Euro Mediterranean Aviation Agreement, [2006] O.J. L386/57.

[7] Directorate General for Energy and Transport, *Flying Together: EU Air Transport Policy* (Luxembourg: Office for official publications of the European Communities, 2007) at 9.

[8] General Report of activities of the European Union: Transport, online: EU Air Transport Portal <http://europa.eu/generalreport/en/2007/rg37.htm#fn38>. The mandate was handed pursuant to a Communication adopted by the Commission on 9 January 2007 COM(2006) 871, (OJ C 126, 7.6.2007).

[9] David Robertson, Zoom Airlines collapses and halts all flights, *Times of London* (28 August 2008).

[10] Brent Jang, Air Canada fuel hedges backfire as oil drops, *Globe and Mail Report on Business* (3 December 2008.).

[11] See Flyglobespan website, online: <http://www.flyglobespan.com/>.

[12] BBC News, Ryanair set for £8 flights to US, online: BBC News <http://news.bbc.co.uk/2/hi/business/7705169.stm>.

[13] All data taken from published timetables of international airlines operating between Canada and United States as available through carriers' websites on 13 November 2008.

[14] *Ibid*.

[15] Search operated to locate lowest direct fares for 7 night stay 13-20 January 2009 through Sidestep metacrawler internet platform which scans tariffs from all major airlines as well as consolidators and agencies. Fares are all expressed in US$ and represent lowest price economy tickets and are inclusive of all taxes and charges.

[16] Transport Canada, News Release, "Blue Sky: Canada takes its international air policy to new heights" (27 November 2006).

[17] Daniel Cellja-Crespo, "EU-US Aviation Agreement: Promoting a competitive industry" (Paper presented to Airneth Annual Conference, The Hague 17 April 2008).

[18] EU-US Open Skies Agreement Art. 21

[19] Booz Allen Hamilton, *The Economic Impacts of an Open Skies Aviation Area between the EU and the US*, available online: EU Air Transport Portal <http://ec.europa.eu/transport/air_portal/international/pillars/global_partners/doc/us/final_report_bah.pdf> at 199.