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**Rethinking Foreign Ownership:  
The Key to Opening Transatlantic Skies**

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Two years ago, the authors submitted to this policy series a review of the unique bilateral air services agreement concluded between Canada and the European Union on 8 December 2008. The authors applauded this initiative since it not only formalized relations between Canada and all twenty-seven Member States of the European Union, but also paved the way for a historic and seismic change in the manner of regulating – or more accurately deregulating – international air transportation.

The agreement foresaw the progressive implementation of a transatlantic open aviation market. Not only were the most evident and obstructive governmental regulatory restrictions – including tariff, capacity and frequency controls – removed, but moreover the agreement foresaw that nationals of the European Union and Canada would eventually be able to found airlines in the other Contracting Party’s territory, and the airlines of each Party would be invested with cabotage market rights to operate domestically within the other territory. These are commercial opportunities and freedoms rarely if ever fully exchanged on a bilateral basis, never mind amongst twenty-eight state parties.

Four stages of implementation are foreseen in the Agreement. Traffic rights are to be gradually liberalized when foreign ownership opportunities – as prescribed by domestic laws within the European Union and Canada – are increased for nationals of the other Party.<sup>1</sup> In 2009, on reviewing the agreement, the authors recommended that Canada should be proactive in promoting the implementation of the agreement to its full potential of creating an open aviation area. However, contrary to these pleas, implementation remains stuck at the first stage. As the EU and the United States in 2010 advanced their liberal framework through a second stage open skies

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agreement,<sup>2</sup> the Canadian market remains hampered by a more restrictive policy, despite the *prima facie* more liberal air services agreement.

In order to complete the Canada-EU transatlantic open aviation area, both sides must modify their foreign ownership restrictions.<sup>3</sup> However, Canada must shoulder a greater share of the fault in the current stalled *status quo*. The second stage of implementation arises once both Parties have national laws allowing the nationals of the other Party to own up to 49 per cent of their airlines.<sup>4</sup> This condition precedent was already met by the European Union upon signing the agreement; therefore only Canada needs to act to move the agreement on to the second stage. Moreover, Canada ought to be demonstrating particular interest in maximizing market access for its carriers into Europe, given that the Canada-Europe market is significantly more integral to the business model of Canadian international airlines than it is to any European carrier.<sup>5</sup>

This paper will reaffirm the importance for Canada of implementing the air services agreement with the European Union. The paper will demonstrate the progress made in the past two years towards establishing a deregulated open aviation area between Canada and the European Union. The paper will compare this progress to the changes enacted through the entry into force of a second stage agreement between the European Union and the United States. Finally we will underscore the traumas suffered by the international airline industry over the past two years owing to the double strains imposed by record high oil prices followed by deep recession. The industry moreover is on the brink of further hardship in 2011 and consumer demand may prove to be even less resilient with a still soft global economy and reduced disposable income due to austerity measures adopted particularly by European governments. Coupled with the effects of increased competition in lucrative long-haul markets from Middle East based airlines, European and United States airlines have responded swiftly by engaging in an unprecedented round of consolidation. Canadian airlines however are effectively precluded from gaining such economies of scale due to foreign ownership restrictions.

### **Status quo**

With the entry into force of the Canada-EU Air Services Agreement, the parties agreed to create open market access for third and fourth freedom services and sixth freedom operations. Thus, Canadian airlines are free to operate direct services to the European Union without restriction on frequency, capacity, aircraft in operation or the tariffs charged. Moreover, Canadian airlines may, without limitation, transfer passengers originating from and terminating in third countries through their Canadian hubs in connection with European destinations. EU airlines meanwhile gain the reciprocal rights. The sixth freedom “transit passenger” right is significantly more valuable for EU airlines since their geographic position and greater scale of operations offer greater opportunities to serve as a global connecting point. The agreement has created opportunities to create air links with the eight member states of the EU with which Canada did not previously have an air services agreement as well as facilitating market access with member states with which restrictive bilateral agreements were previously in place. Airlines have not greatly utilized the new commercial opportunities. This is likely related to the difficult operating conditions which the industry has faced. New direct scheduled transatlantic services inaugurated since the 2008 agreement are operated from Montreal to Brussels and from Toronto to Copenhagen. Air Canada may well be seeking to further exploit new market opportunities into Europe with the statement of intent to found a new vacation model subsidiary airline which would focus on seasonal services to the Caribbean and Europe.<sup>6</sup>

The Canadian Parliament has passed an amendment to the Canadian Transportation Act. The Act previously imposed a 25 per cent cap on foreign investment. The amendment continues to specify

a 25 per cent cap, however authority to increase this percentage to up to 49 per cent was delegated to the Governor in Council.<sup>7</sup> Thus unlike in the United States where Congress has ferociously opposed relaxation of foreign ownership restrictions on airlines, the Canadian restriction may now be reduced by a Regulation of the Governor General. This however has not been done to date. This is the sole obstacle to passage to the second stage of the EU-Canada air services agreement. The second stage of the agreement envisages the exchange of restricted fifth freedom rights. Both EU and Canadian airlines will be able to serve all intermediate points with fifth freedom traffic privileges, and Canadian airlines may operate fifth freedom beyond sectors to points in other member states, Morocco, Switzerland, the European Economic Area and other members of the European Common Aviation Area.

One school of thought believes that fifth freedom rights are largely redundant, inter-airline connections through alliance hubs having largely replaced the fifth freedom sectors which were previously a necessity for ensuring commercial viability. However there are recent instances which demonstrate that through aircraft service may be beneficial to carriers. Air Canada has been able to introduce service to Brussels (AC 832) and Geneva (AC 830) from Montreal by offering same aircraft stopping service originating in Toronto. United and American Airlines also launched fifth freedom London-Brussels operations in 2009 pursuant to the open skies agreement between the US and EU. North American-originating aircraft typically spend a lengthy period on the ground in Europe. Connection convenience dictates that aircraft should arrive early in the morning to make connections, but should depart mid-afternoon to consolidate maximum transit passengers. Fleet ground time is extremely inefficient and costly for airlines making large leasing or financing payments for the aircraft. Therefore it would be of particular benefit to Canadian airlines to have the opportunity to at least trial fifth freedom routes in Europe to ascertain whether these may prove economically beneficial.<sup>8</sup>

The United States and European Union have however moved beyond their first stage arrangement, further liberalizing traffic rights, and thereby leaving Canadian airlines in an even more disadvantaged position with less commercial opportunities than their United States competitors.<sup>9</sup> This should serve as further incentive for Canada to diligently implement the 2008 Air Services Agreement with the European Union to allow Canadian carriers equal market access.

### **Survival: Ongoing Industry Consolidation**

Not only would liberalization of foreign ownership restrictions by Canada assist its airlines to secure full market access into, beyond, and ultimately within the European Union Member States, it would also allow Canadian carriers greater access to foreign capital, and ultimately the possibility to participate in global consolidation which has gathered pace in light of poor financial performances of airlines, especially between 2008 and 2010. Consumer demand was first stretched in 2008 when oil prices hit \$147 per barrel and airlines were forced to rapidly increase fares – largely through fuel surcharges.<sup>10</sup> Worse was to come later in 2008 when the financial crisis hit hard and demand for premium cabin travel imploded as travel budgets were slashed. Although the industry was profitable in 2010, fears remain for 2011 with a persistent fear of a double dip recession threatening again to menace business and discretionary travel. Moreover civil unrest in North Africa has served to push oil prices above \$112 per barrel, a level only ever previously seen in 2008. The IMF forecasts oil prices will remain in this ballpark throughout 2011 and 2012.

Demand for legacy airline services is also being threatened by a redistribution of travel patterns. With strong capitalization, positive brand image and lower operating costs, airlines from the Middle East have emerged as strong competitors to the traditional trunk carriers. This, in

combination with other factors forcing efficiencies, has contributed to a remarkable round of consolidation in Europe and the United States. Since 2008, the six US trunk carriers have shrunk to four with the merging of Northwest into Delta and Continental into United. In Europe, in 2010, British Airways was finally able to complete its merger with Iberia, thereby joining fellow powerhouse airlines Lufthansa and Air France in the consolidation process.<sup>11</sup> In the ongoing battle to survive, the industry has unequivocally declared that bigger is better. However Canadian airlines have little opportunity to consolidate.

Although there are two major competitors in the Canadian domestic market, Westjet has a very limited presence on the international stage with its international route network focused on leisure destinations. Therefore Canada's only international scheduled network carrier, Air Canada is excluded from consolidation. This goes some way to explaining the regulatory rhetoric of the Canadian government faced with applications for significant service from Gulf-region carriers.<sup>12</sup> Under the status quo of 25 per cent foreign ownership caps in both Canada and the United States and the 49 per cent cap in the EU, Air Canada is prevented from merging with any other scheduled network carrier. Alliances generate efficiencies, but not of the scale enjoyed by mergers. Despite Air Canada having immunity to operate joint ventures transborder with United and transatlantic with United and Lufthansa, each airline has an independent commercial presence in airports and cities in North America and Europe. This is just one example that underscores the limits of alliance relationships. Airlines, shareholders and competition authorities in Europe and the United States have almost unanimously supported consolidation in the industry. Air Canada should have equal opportunity to participate in this, if and when a viable opportunity arose. This gives further impetus to the support given for Canada to proceed with its amendments to the Canada Transportation Act, to liberalize foreign ownership restrictions thereby opening up greater market access opportunities in Europe and paving the way for Canadian airlines to participate in global industry consolidation.

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<sup>1</sup> The incumbent restrictions are found in the Canada Transportation Act s. 55 and Council Regulation (EEC) No. 2407/92 of 23 July 1992 on licensing of air carriers.

<sup>2</sup> Protocol to Amend the Air Transport Agreement between the United States of America and the European Community and its Member States, signed on April 25 and 30, 2007, online: European Commission <[http://ec.europa.eu/transport/air/international\\_aviation/country\\_index/united\\_states\\_en.htm](http://ec.europa.eu/transport/air/international_aviation/country_index/united_states_en.htm)>.

<sup>3</sup> Agreement on Air Transport between Canada and the European Community and its Member States Annex 2 Section 2.

<sup>4</sup> *Ibid* Section 2.2.

<sup>5</sup> As a point of comparison, European Union airports represent 13/26 or 50% of Air Canada's intercontinental destinations, whereas for British Airways the Canadian market represents 4/77 intercontinental destinations and for Lufthansa 4/86 intercontinental destinations

<sup>6</sup> Brent Jang, "Air Canada to Launch Cut-rate Carrier" *Globe and Mail* (12 Apr. 2011).

<sup>7</sup> Canada Transportation Act (S.C. 1996, c. 10), S. 55: Definition of "Canadian".

<sup>8</sup> The United and American Airlines fifth freedom services are believed to respond to a different but equally important commercial imperative for the airlines. In view of soft demand at the peak of the global financial crisis, the launching of fifth freedom service to Brussels, located only 218 miles from London, permitted the carriers to protect their invaluable "use or lose" slots at typically congested Heathrow while reducing transatlantic service in line with demand shortfall. This was a commercial freedom facilitated by the Open Skies framework between the United States and the EU. This is shown by the take off and arrival times of the aircraft which left Heathrow at 13:20 PM and returned at 06:20AM, which would reflect a typical in and outbound transatlantic service itinerary. See Brett Snyder, "American Follows United From London to Brussels", online: Business Network <<http://www.bnet.com/blog/airline-business/american-follows-united-from-london-to-brussels/1105>>.

<sup>9</sup> Under the 2010 Second Stage Agreement between the European Union and the United States, each Contracting Party may name five points to serve directly from the territory of the other Party (seventh freedom services). The Joint Committee, a consultation group established by the first stage agreement, may

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increase this number at any time. See Protocol to Amend the air Transport Agreement between the United States of America and the European Community and its Member States signed on April 25 and 30 2007, Art. 6.3(b) and 6.4(b) amending Article 21 of the original agreement. This would have facilitated further the slot protecting flights such as those launched by United and American in 2009, since the flights could operate as standalone sectors using any aircraft rather than as a beyond sector using a wide bodied plane.

<sup>10</sup> Charles E. Schlumberger, “The Oil Price Spike of 2008: The Result of Speculation or an Early Indicator of a Major and Growing Future Challenge for the Airline Industry” (2009) XXXIV *Annals Air & Space L.* 111.

<sup>11</sup> Air France completed its merger with KLM in 2004, Lufthansa commenced its merger with Swiss International Airlines in 2005 and has since also acquired BMI, a controlling interest in Austrian Airlines and a 45% share of Brussels Airlines which may increase to 100% from 2011.

<sup>12</sup> Canada continues to have strained diplomatic relations with the United Arab Emirates as a result of the denial of increased service connecting Dubai and Abu Dhabi to Toronto and other Canadian destinations. The bilateral agreement between the countries allows the UAE’s two super carriers: Emirates and Etihad only three frequencies each per week into Canada. Retaliation from the UAE has seen a Canadian military camp in the Emirates closed and the imposition of visa requirements for Canadian nationals visiting the UAE.