

# Policy Priorities in Air Transport Markets in the APEC Region\*

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## Overview

Recent developments are forcing the reinvention of the air transport sector, including the carriers as well as the airport infrastructure and security service providers.

The air transport sector plays a vital role in economic growth because of its now indispensable and pervasive nature. This role is being augmented year by year as the region deepens its integration allowing greater freedom of movement of people and cargo.

However, the sector itself is locked and severely constrained within an outdated and overly restricted ownership and operating model. Because of this, the sector is relatively ill-prepared for making the orderly structural changes needed when its role is so important in economic growth and regional integration.

Recent developments have had an indelible effect on the industry, including the challenges of September 11 then SARS, terrorist activities in various locations, the demands for higher levels of security and the challenge of the low-fare carriers.

These “shocks” should not be seen in isolation and they should be addressed within the bigger context of ongoing and comprehensive reform. Some of the shocks are directly the result of the prevailing outdated model. The risk is that the current approach of rigidly dividing up the aviation cake not only constrains the sector itself but also restricts growth of the overall economic cake.

The sector will therefore continue to be susceptible to exogenous “shocks” and its own circumstances will also induce further challenges.

While there might be a respite, if the problems of SARS, of meeting new levels of security and re-financing the government-owned traditional full service carriers are resolved, the pressures for change are basic and imperative.

Now is the time to prepare and respond. The aviation sector needs to operate under clear and open skies. There are ways of handling the current turbulence but there is no substitute for fundamental change in the long haul.

The immediate priority for policy makers is to set the agenda for reform. The preparatory steps include action to:-

- 1) avoid regulatory impediments to bring about an efficient response to the demands for higher levels of air transport security;
- 2) remove the constraints to airport development by promoting private sector partnerships and reviewing regulation of airport pricing;
- 3) use the opportunity which these circumstances present to prepare for fundamental reform of the international regulatory arrangements for air transport.

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## Background

\* Reported here for the consideration of APEC Ministers and Officials are the results of a two-day meeting on air transport sector issues organised jointly by the Australia and Singapore Committees of the Pacific Economic Cooperation Council and the Chartered Institute of Logistics and Transport in Singapore. The 80 participants include officials with responsibility for air transport and airport matters, academics working in the field and business people with interests in air transport (both passenger and freight and logistics) and related infrastructure as well as complementary services. Representatives of international organizations related to air transport also participated. Further details of the meeting are available from [www.pecc.org/airportroundtable](http://www.pecc.org/airportroundtable)

The air transport sector plays a key role in regional growth because of its pervasive nature and operating as vital link in logistics management. Its role is increasing as integration deepens. But recent developments are forcing a reinvention of the air transport system in the Asia Pacific in all its dimensions.

Pressures for change apply to the operations of the traditional full service carriers, the providers of related infrastructure services especially airports and suppliers of other complementary services, including in the freight sector.

### ***The drivers of change***

Key drivers of change include, firstly, the greater risks and uncertainties in the transport systems associated with the threat of terrorism. The transport system has had to adjust to minimizing this risk, incurring substantial costs in the process. A large part of these costs will eventually be passed on to consumers of the services, both travellers and buyers of freight services. Other sectors of the economy, including tourism or sectors which depend heavily on air transport, will then also be affected.

At the same time, as the industry is confronting the security agenda, there is pressure from governments and from shippers and passengers for fewer impediments to the clearance of goods through customs or people through immigration and health checks. The facilitation of the movement of goods and people is also likely the only source of significant reduction in total travel times (flight times being far less able to be reduced). But progress on passenger and cargo facilitation at airports is challenged by the new stringent security demands. Technology is available to help meet this challenge but it requires new investment and the development of appropriate human resources.

The emergence of new business models in the air transport sector is another driver of change. The low-fare carriers are here to stay and provide a welcome stimulus in regional markets while also helping more and more people with access to air transport. They also provide a major challenge to the traditional full service operators, many of whom are government owned in the Asia Pacific. Without commitments to adjust their own pricing and service packages and to cut their costs many will face a rapidly deteriorating financial situation.



The profitability of the traditional air transport operators is already generally low because of conditions on the demand side of the market, including the impact first of September 11 and more recently of SARS, although these shocks had the effect of exaggerating an existing trend associated with slower global growth. On the other hand, some important and positive developments on the demand side are the emergence of China and more recently India. These economies are new sources of demand for air transport, both within their economies and in international markets.

Airports also face new challenges. Demand for their services is changing due to expectations of their contribution to the passenger and cargo facilitation and security agendas. The emergence of the low-fare carriers will shift the mix of airport services demanded, but also create some new business opportunities, especially for other businesses located in airports. At the same time, total passenger numbers will continue to grow over the long term which leads to demands for additional airport capacity, not just at the major airports but also those at second and third tier levels. Airport planners need to better plan and manage this strong growth if they are to avoid mistakes made by congested and capacity constrained airports in Europe.

In summary, the drivers of change include the new security requirements in air transport systems, the demand for better facilitation of the movement of goods and people, competitive pressures on traditional full service airlines from low-fare carriers and demand side shocks like those of September 11 2001 and of SARS.

### ***Comprehensive reform***

These "shocks" should not be seen in isolation and they should be addressed within the bigger context of ongoing and comprehensive reform. Some of the shocks are symptomatic of the outdated model. The risk is that the current approach of rigidly dividing up the aviation cake not only constrains the sector itself but also restricts growth of the overall economic cake.

Even if the problems of SARS, of meeting new levels of security and re-financing the government-owned traditional full service carriers are resolved, then while there might be a respite, the pressures for change are underlying and strong. The extent of their intervention in the sector means that governments will also have to be active participants in the adjustment process. Privatisation of airports while desirable creates regulatory challenges.

Most of all, the aviation sector needs clear and open skies. There are ways of handling the current turbulence but there is no substitute for clear and open skies in the long haul.

The immediate priority for policy makers is to set the agenda for reform.

It is important to establish a dialogue among all the stakeholders to anticipate and respond to policy issues and establish the priorities for action. APEC is a forum in which



this discussion can be facilitated but it is also important to learn from the experience of the rest of the world, from Europe in particular.

There are a number of immediate priorities in building the process of change.

## Policy Priorities

**The first policy priority is to avoid regulatory impediments to the efficient response to the demands for higher levels of security.**

(1) Good practice in regulation: There is a risk that trade facilitation and tourism will suffer from the movement to higher levels of security. In some cases, technologies exist for resolving this dilemma. It is important, therefore, for business to have an opportunity to innovate in order to meet the security demands. Innovation may also provide other benefits for firms in the supply chain, for example, in terms of their capacity to manage their assets or monitor the condition of their cargos. But this innovation is only possible if regulation is not overly prescriptive. The regulatory structure should focus on achieving the desired outcomes, which themselves should be proportionate to the risk to which the policy is responding. The regulatory system should not focus on detail of the processes to be employed. Newcomer suppliers should be able to demonstrate that they can meet the levels of security required and conformity of processes with the new global security standards should be assessed in a non-discriminatory and objective manner.

(2) Liberalisation of the supply chain: A complementary initiative in this respect is to facilitate innovation in the supply chain via liberalisation of the component activities (multimodal transport, warehousing, third and fourth party logistics, etc) based on commitments in the current round of services trade negotiations in the WTO. These commitments could be based on models developed and discussed in the APEC process.

(3) Cargo sector reform: Continuing improvement in supply chain performance, alongside higher levels of security could also be supported by separating the economic regulation of international air cargo from that of passengers. Both markets are subject to high degrees of economic regulation and there is little prospect of their inclusion in the GATS negotiations from which they are explicitly quarantined by an annex to that Agreement. A more liberal and competitive air freight sector will be more innovative. At the same time, moving to open markets does not mean that all regulation should be removed. Governments retain the right to regulate, including for security purposes. Within this framework, airfreight could be liberalised on the initiative of groups of like-minded countries. One model for further study for that purpose is the plurilateral agreement signed by a group of APEC members, although the value of agreement is questionable as a result of the slow rate of accession by other APEC members.



(4) Collection and processing of information on travellers and freight: An important contribution of APEC to the facilitation agenda is to intensify its work on the application of new technologies to the processing of traveller information and their clearance through immigration procedures, complemented by the experimentation with various types of digital passports. Work on new systems for collecting and processing cargo information is also valuable. Sharing knowledge and experience of the scope to apply new information technology to their work helps keep customs and immigration officials 'on board' for the implementation of this agenda item.

(5) Crisis management: It is important to be prepared for another big SARS-like shock to the industry. The source of the shock may not yet be clear. The focus in the regional security agenda has shifted in relative terms to matters related to maritime shipping but risks remain the air transport and airports sector. A concern for some time has been the threats from cargo carried on passenger aircraft or from luggage carried on board by passengers. The threat from attacks on aircraft from the ground outside the airport perimeter is now also more apparent. Other matters of concern in the industry are the likelihood of rising aircraft accident rates, associated with aged aircraft fleets and congestion in air traffic control systems. Whatever the origin of an incident, recent experience has shown the value of systems that offer rapid assessment and deployment. Flexibility and a willingness to operate across traditional bureaucratic boundaries are critical to a successful response. There are special questions about how airports might prepare even better for these sorts of incidents, including through the interaction of the various service suppliers who operate there.

**The second priority is to remove the constraints to airport development by developing private sector partnerships and reviewing regulatory arrangements applying to airports.**

(1) Models of private sector participation: Airport and ground service providers are under substantial pressure to adjust their service mix and improve efficiencies while meeting the growth in traffic volumes. Governments are likely to be less able to either manage or finance these changes. A greater role for the private sector is a priority, but in many economies, the case for private sector participation is yet to be made. It is important to develop a wider understanding of the different models that might be applied to partnership with the private sector and the various conditions in which different models might be selected. The models range from various types of contracting to outright ownership. Full privatisation is not required to achieve significant benefits from private participation.

(2) Options for regulation: Complementary to consideration of private sector participation is an examination of options for the regulation of privately owned airports, many of which will retain considerable market power. There is substantial experience to be shared in the region on the different outcomes under heavy-handed compared to light-handed regulation. There is a debate



emerging between airlines, led by IATA, and airport operators on this issue. IATA is concerned about the monopolistic structure of airports and the level of charges at some airports. A roadmap for the transition between types of private participation and the complementary reform of regulatory arrangements might be prepared.

(3) GATS commitments: A more extensive set of commitments to liberalisation of markets for airport services and for ground handling is a valuable complementary initiative. Those commitments would add to the confidence of foreign investors in these services. Currently these activities are regarded as grey areas in the treatment of air transport in the GATS and the review of the GATS annex on air transport has made little progress in resolving the uncertainty. APEC economies could include these sectors in the request and offer process now underway in services.

(4) Environment matters: Airports pose a variety of potential environmental impacts on both noise and air quality. It is important to apply the principles of good regulation to those effects. Further, it is important not to let airports become hostage to other developments, for example, the encroachment of urban areas on an airport perimeter that subsequently constrains airport operations on the grounds of its environmental impact.

**The third priority is to use the opportunity which these circumstances present to prepare for fundamental reform of the regulatory arrangements for air transport**

(1) Review the ownership rule: The regulatory system applying to international aviation is notoriously slow to change. A pillar of the system is its rules on ownership, and the restriction on foreign participation in particular. That rule will be under pressure to change as traditional full service carriers look for further finance from capital markets while they work to respond to demand shocks and threats from competitors. Governments are unlikely to be able to fund the development required. Restrictions on ownership raise the cost of funds to the carriers involved and limit the scope for developing economies to capture the benefits of their comparative advantage in this service. The immediate priority is to develop frameworks for reconciling changes in ownership rules with the terms of the aviation bilateral agreements now in place.

(2) The political impact of new actors: There are pressures for reform of the regulatory system from within the industry, as just described. These pressures may become more intense as more and more new actors take a greater interest in the supply chains for freight and in the provision of services for passengers. The tourist sector has shown a long-time interest in these matters. Another constituency likely to take an increasingly vocal position on these questions are the private financial investors in the airport sector. Their financial prospects depend on the regulatory structure applied to air transport and their engagement in the policy dialogue will be constructive.



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(3) Competition policy cooperation: Regulators of competition policy in different countries might find themselves working on the same issues as the traditional full service carriers put up proposal for adjusting their operations. These proposals are likely to include higher levels of cooperation between carriers, which in some cases will affect the extent of competition in various markets. Some level of cooperation and coordination may eventually be required and a first step in that direction is to establish capacity building programmes on competition policy applied to these sorts of network industries.

(4) Environment matters: While economic regulation is the main focus of current attention, the industry also faces longer-term problems in the application of environmental regulation, especially with respect to the treatment of its contribution to the climate change emissions. While now small, that contribution is expected to increase in relative terms. Various measures have been proposed and the industry is currently assessing their impact. Participation in emissions trading systems is emerging as its preferred approach.

### **Final Word**

Now is a good time to start and establish a dialogue on these matters. The state of the industry makes the traditional main actors, especially the full service carriers, to be more amenable to dialogue on policy reform. As the world economy recovers and demand growth returns, the intensity of the interest in these issues may decline. But that effect is only temporary and the next big demand shock will bring the same set of economic, financial and regulatory issues to the fore again.