

ASEAN Aviation Integration Platform (AAIP)
Policy Paper No. 1 / 2018

Integrating ASEAN Economy Through Liberalisation of Investment in the Aviation Sector

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Executive Summary

1. Decades of integration initiatives among South East Asian countries through the Association of Southeast Asian Nations (ASEAN) have turned the region into one of the World's most dynamic and fastest growing region.
2. To increase intra-ASEAN and ASEAN connections to the rest of the world, further liberalisation of investment (ownership and control) is needed in the aviation sector. Aviation has the ability and function to integrate the people and the economy of a region of 650 million people. It will contribute towards safe and convenient mode to travel between; provides logistic support for goods to travel within ASEAN; and contribute towards higher level of development in tourism sector.
3. Governments across ASEAN limits the access of the aviation sector to the much needed capital by restricting the ownership and control of aviation companies. The OECD shows that FDI restrictions in the air services sector in several ASEAN Member State (Brunei, Singapore and Thailand are not measured) is higher than the OCED (0.346) and non-OECD (0.347) average. The FDI Restrictions Index in air services sector for Malaysia is at 0.438, Indonesia at 0.498, the Philippines at 0.665 and Vietnam at 0.520. In these countries, air operators' licence and benefits to bilateral air services agreements are normally granted to nationals of the ASEAN Member State concerned owning not less 51% of the ownership in the airline. Only Lao PDR and Myanmar scores are lower than the OECD and non-OECD average as these two counties have liberalised ownership and control in the airline companies.
4. There is a need to re-look at the policies on aviation and air services ownership across ASEAN. The existing rules do not provide a conducive environment for the aviation industry to have access to higher amount of capital or to tap capital from abroad or from within the region. For nationalistic and nostalgic reasons, one may leave the so-called flag carriers out of the liberalisation process. But ASEAN Member States must allow other airlines, who are not designated flag carriers to have access to capital.
5. To ensure consumer interests are protected against unfair practices and potential price fixing, each corporate exercise involving airlines ownership and control may be subject to regulatory scrutiny.
6. There are at least 3 options for ASEAN to achieve the liberalisation of ownership and control. One is by allowing full liberalisation, meaning 100% foreign ownership. This will meet with objections as some may argue that ASEAN airlines should remain within ASEAN ownership and control. Another is by allowing 100% ownership by ASEAN

Investors as defined in the ACIA. The third mode, to be in-line with the AFAS, ASEAN may allow up to 70% ownership by ASEAN Investors, leaving 30% to be owned by nationals of the country where the airlines is registered.

1. Introduction

- 1.1 Under the ASEAN Economic Community Blueprint 2025, Forging Ahead Together, ASEAN plans to become a highly integrated and cohesive regional economy that supports sustained high economic growth. The intent can be achieved through increasing trade, investment, and job creation; improving regional capacity to respond to global challenges and mega trends; deeper integration in trade in services; and a more seamless movement of investment, skilled labour, business persons, and capital. To achieve the ASEAN 2025, ASEAN has to increase connectivity between ASEAN Member States. One of the tools for increased connectivity is through the aviation sector.
- 1.2 Aviation is an important sector within ASEAN. Aviation has the ability and function to integrate the people and the economy of a region of 650 million. No one can deny that aviation sector contributes to the deeper integration between ASEAN Member States by providing access to people to people interaction and creating a higher level of economic integration. In archipelagic ASEAN, like Indonesia and the Philippines, people rely on aviation as a safe and convenient mode to travel between an island and another. Aviation also provides logistic support for goods to travel faster within ASEAN thereby contributing to movement of perishable and sensitive goods at a faster rate. Aviation also contribute towards higher level of development in tourism sector.
- 1.3 In dealing with airline designation and authorization under their bilateral air services agreements, States generally retain the right to withhold, revoke, or impose conditions on the operating permission a foreign air carrier needs in order to operate the agreed services if the carrier is not “substantially owned and effectively controlled” by the designating State or its nationals.¹
- 1.4 The national ownership and control criterion, which has been used since the 1940s, provides a convenient link between the carrier and the designating State by which parties to the agreement can: a) implement a “balance of benefit” policy for the airlines involved; b) prevent a non-party State through its carrier from gaining, indirectly, an unreciprocated benefit; and c) identify those who are responsible for safety and security matters. National defence consideration is also a factor in some cases.²

¹ International Civil Aviation Organisation, Liberalization of Air Carrier Ownership and Control, Working Paper, ATConf/6-WP/12, 18-12 March 2013, 10.12.12 (ICAO 2012).

² ICAO 2012.

- 1.5 The last few years saw the change of trend in the way airlines operate their business.³ International air carriers have sought to adapt to increasing cost pressures, need for capital and heightened competition in a number of ways, including through cooperative arrangements such as alliances, such as Star Alliance, One World, Sky Team, code sharing, joint ventures and franchise operations, some of which have involved transnational investment (obtaining equity in air carriers from other States). Privatization of formerly state-owned air carriers has sometimes resulted in foreign investment in the privatized carriers. Transnational investments in air carriers have also occurred against a backdrop of widespread multinational ownership in other service industries.⁴ Hence, the original bases for use of the ownership and control criterion are increasingly at odds with this changed global business environment in which the industry must operate.
- 1.6 In Southeast Asia, ASEAN's aviation industry offers compelling potential for growth. Although uneven levels of development, cautious reforms, government protectionism, and inadequate infrastructure impede development in the short term, the region's vast long term potential outweighs these issues. As ASEAN develops a single economic market, integrating aviation is inevitable. Further, the bloc already has an aviation agreement in place with China, and is considering more with powers such as India and the European Union. In order to compete with bigger markets and bigger airlines from China, the European Union, and India, ASEAN must develop and consolidate its airlines to establish larger regional companies that can compete with airlines beyond South East Asia. Although ASEAN's aviation industry is not uniformly rosy, its expansion is seemingly inevitable if the bloc aspires to reach its ambitions of regional integration and global competitiveness.

2. ASEAN Aviation Liberalisation and Its Limits

- 2.1 Bailing out of aviation companies are not unheard of in ASEAN. The Malaysian Airlines have gone through a fair share of restructuring. The same applies to Garuda Indonesia and Thai Airways International. Most of the time the restructuring involves utilisation of public funds to the value of billions of US dollars. Governments could save their money from bailing out airlines by allowing higher level of liberalisation of foreign ownership in ASEAN registered and licenced airlines.
- 2.2 There are two types of liberalisation in the aviation sector, either on its own or through implementing both types of measures. The first type is through allowing ASEAN aviation operators of one ASEAN Member State to have access to the market in another ASEAN Member State. The second type is through liberalising ownership and control of aviation operators in ASEAN Member States.

³ Michael Boyd, The Forbes, A New Destructive Economic Model is Emerging in the Airline Industry, 10 July 2017.

⁴ ICAO 2012.

2.3 For the first type of liberalisation, ASEAN has concluded various measures to integrate and liberalise aviation sector since 2004. ASEAN has introduced market access liberalisation through 3 main agreements, Multilateral Agreement on Air Services 2009 (MAAS); Multilateral Agreement for the Full Liberalisation of Passenger Air Services 2010 (MAFLPAS); and Multilateral Agreement for the Full Liberalization of Air Freight Services 2009 (MAFLAFS).

2.4 Under the ASEAN Framework Agreement on Trade in Services (AFAS) 10th package, ASEAN Member States make the following commitments:⁵

“MAAS, MAFLPAS, MAFLFAS: Each contracting party shall have the right to designate as many airlines as it wishes for the purpose of conducting international air freight/passenger services in according with the agreement [...] On the receipt of such designation, and of application from the designated airline [...] each contracting party shall grant the appropriate authorisation and technical permission with minimum procedural delay, provided that: [...] subject to the acceptance of the contracting party receiving the application of a designated airline, the designated airline is incorporated in and has its principal place of business in the territory of the contracting party, and is and remains substantially owned and effectively controlled by one or more ASEAN member state and/or its nationals, and the designating state has and maintains effective regulatory control [...]. [domestic air transport not covered].”

2.5 Under the second type of liberalisation, ASEAN Member States may undertake liberalisation of the aviation sector through both the ASEAN Framework Agreement on Services (AFAS) and the ASEAN Comprehensive Investment Agreement (ACIA). ACIA encompassed four pillars: liberalization, facilitation, protection, and promotion, containing new features to further promote and encourage FDI inflows into ASEAN. The existing legal structure in ASEAN Member States, even after the AFAS 10th package agreed in 2018 restricted the formation of an aviation company owned and control by ASEAN investors (or generally known as “community carrier” as understood in the European Union (EU).) The restriction is based on the traditional restrictions in bilateral air services agreements, which states that:

“Each Contracting Party shall have the right to refuse to accept the designation of airlines or to refuse to grant the operating authorisation..., in any case where the said Contracting Party is not satisfied that substantial ownership and effective control of those airlines are vested in the Contracting Party designating the airlines or in its nationals.”

2.6 The commitments made under the AFAS 10th package (Table 1) is meaningless as ASEAN Member States does not clearly state the limit as stated in the national law relating to air transport or aviation for the issuance of air operators’ licence (AOL). Many ASEAN Member States do not make any clear commitments on the liberalisation of ownership and control by stating “unbound” on the commercial presence of “Selling and Marketing of Air Transport Services.” Some ASEAN Member States make commitments based on their existing domestic regulations. Being “unbound” means the

⁵ Protocol to Implement the Tenth Package of Commitments on Air Transport Services under the ASEAN Framework Agreement on Services, 13 October 2017.

respective ASEAN Member States backtrack from the existing domestic regulations and impose more restrictive measures.

ASEAN Member States	Ownership Restrictions in Commercial Presence (Mode 3) (AFAS 10th Package) Selling and Marketing of Air Transport Services	Existing Domestic Regulations
Brunei	No commitment	49% foreign ownership
Cambodia	No commitment	100% foreign ownership allowed
Indonesia	Maximum foreign equity of 49%	49% foreign ownership. Indonesian shareholders should be a single majority. Human Resource Director should be an Indonesian.
Lao PDR	Up to 100% foreign ownership	49% foreign ownership
Malaysia	No limitation of market access and national treatment	45% foreign ownership for Malaysian Airlines. Maximum ownership for a single foreign entity is limited to 20%. 49% for other airlines.
Myanmar	No clear commitments	100% foreign ownership allowed
Philippines	No commitments	40% foreign ownership
Singapore	Unbound but with foreign equity participation of up to 70%	49% foreign ownership
Thailand	Foreign equity not exceeding 49% of the registered capital and the number of foreign shareholders must be less than a half of the total shareholders	49% foreign ownership
Vietnam	No limitation on market access and no limitation on national commitment	49% of the registered capital. One single individual or legal entity shall not exceed more than 30% of the capital.

Table 1: AFAS 10th Package over National Regulation

Source: AFAS 10th Package, Author's own analysis.

- 2.5 The OECD FDI Restrictiveness Index shows that FDI restrictions in the air services sector in several ASEAN Member State (excluding Brunei, Singapore and Thailand) is higher than the OCED and non-OECD average, at 0.346 and 0.347 respectively (Figure 1). The FDI Restrictions Index in air services sector for Malaysia is at 0.438, Indonesia at 0.498, the Philippines at 0.665 and Vietnam at 0.520. The scores for Lao PDR and Myanmar are lower than the OECD and non-OECD average. Compared to select ASEAN Dialogue Partners, China, Japan, Korea, Russia and the US have higher restrictions than all ASEAN Member States. India, on the other hand, has notably undertaken measures to reduce FDI restrictions in the aviation sector, where the index was down from 0.813 in 2010 to 0.28 in 2016. On the other hand, the EU countries of the Netherlands, Germany and the United Kingdom; and Switzerland have lower FDI restrictions than most ASEAN Member States.

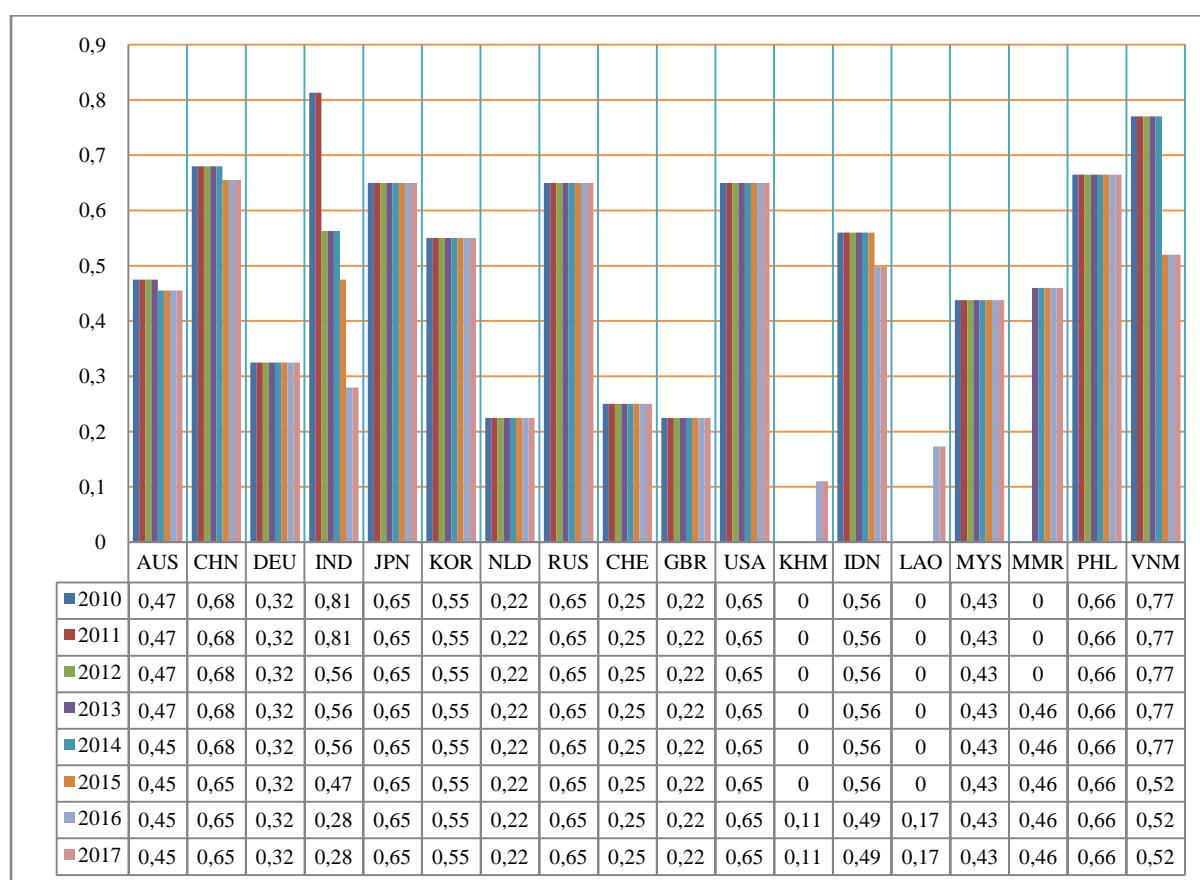


Figure 1: FDI Restrictions in ASEAN and Dialogue Partners, 2010 - 2017

Source: Organisation for Economic Cooperation and Development, 2018

3. Liberalising Ownership and Control

3.1 As an alternative to the concept of “Community Carrier,” ASEAN Member States may liberalise the ownership and control through domestic regulations. Meaning ASEAN Member States may amend domestic laws to allow higher percentage of equity ownership and to allow foreign investors to manage and control and airline. ASEAN may liberalise the ownership and control of aviation companies either through an ASEAN agreement or through autonomous liberalisation. Liberalisation through an ASEAN agreement may be carried out under AFAS, i.e. improvements through AFAS 10th Package or through ACIA. ACIA accommodates further liberalisation of investment sectors in all ASEAN Member States.

3.2 There are several reasons for liberalisation of ownership and control in ASEAN:

3.2.1 As the aviation industry is a cyclical business, pressures are building on the industry from interest rates, oil prices and operation costs such as salaries.⁶

⁶ IATA, Future of Airline Industry 2035 (2018).

- 3.2.2 Increasing competition is impacting airline yields although passenger demand is offsetting that to keep profits up. Airlines view South East Asia particularly as the “growth engine of the world”, along with China. Indonesia, Malaysia and the Philippines are high growth areas in terms of passenger numbers and GDP growth, which is encouraging for airlines.⁷
- 3.2.3 Liquidity remains but the recent past has shown that market shocks can cut off sources of liquidity abruptly.⁸ The strength of the dollar has caused some issues in developing countries in 2017, which has cooled of late and airlines have been aided by the stable and low oil price.⁹
- 3.2.4 Airlines need to invest in technology and big data to help drive predictive maintenance and better consumer services. For example, despite being impacted by new technology disruptors in the financial services space, the aviation finance business seems insulated from the worst of this change and lags behind advances that could help to commoditise products. This investment will assist airlines to cut costs and attract more customers.¹⁰
- 3.2.5 In air transport, despite the agreement on the creation of an ASEAN Single Aviation Market by 2015, many impediments remain, obstructing development of regional tourism and shifting competitive advantages to China’s carriers. ASEAN authorities should work toward quickly establishing a truly unified regional aviation market by removing existing barriers and agreeing on higher integration targets.¹¹
- 3.2.6 Restrictions to airlines’ ownership and control will limit access to the capital market. It could provide air carriers with wider access to capital markets, and reduce their reliance on government support.¹²
- 3.2.7 It could permit airlines to build more extensive networks through mergers and acquisitions or alliances. Even where airlines are privately owned, they may be effectively protected from takeover by foreign entities where this would cause them to lose the traffic rights associated with their previous home country. Thus if an airline is now controlled from a different country, it might be excluded from domestic routes (in cases where access to some or all routes is restricted to national airlines) and/or international routes (where bilateral air transport agreements restrict access to these routes to the national airlines associated with them). A removal of such nationality restrictions, or even a broadening of the criteria that are used to define a nationally-owned or controlled airline, will provide greater freedom for changes to occur without airlines risking a loss of their existing routes.¹³
- 3.2.8 Liberalisation of ownership and control of airlines may increase efficiency in the management of airlines. Increased liberalisation may increase the chance of a poorly

⁷ KPMG, The Aviation Industry Leaders Report 2018.

⁸ IATA, Future of Airline Industry 2035 (2018).

⁹ KPMG, The Aviation Industry Leaders Report 2018.

¹⁰ KPMG, The Aviation Industry Leaders Report 2018.

¹¹ ADBI, ADBI Tokyo, ASEAN 2030.

¹² ICAO 2012.

¹³ NERA Economic Consulting, The Impact of International Air Transport Liberalisation on Employment, October 2008 (IATA, 2008).

performing airline will be taken over. An increased threat of takeover could place greater pressure on existing management to improve the airline's performance. If an airline is performing poorly, and its existing management cannot rectify the situation, then with greater liberalisation there could be action from shareholders or debt holders to bring in new management, or the airline might be taken over and new managers installed. In addition, airlines that merge or are taken over may gain from access to a wider pool of potential owners and managers, with more opportunities to benefit from international experience and best practice.

3.2.9 It could also help improve economic efficiency of the airline industry by enabling more competitive carriers and greater variety of services in the market, which in turn could feed into consumer benefits.

3.3 However, liberalization also carries certain risks which may be causes of concern, such as:

3.3.1 The potential emergence of “flags of convenience” in the absence of effective regulatory measures to prevent them; potential deterioration of safety and security standards with increasing emphasis on commercial outcomes; and possible flight of foreign capital which could lead to less stable operations.

3.3.2 There could be impacts on labour, national emergency requirements and assurance of service.

3.3.3 Finally, and in the long run there may also be potential implications on airline competition as a consequence of possible industry concentration (i.e. the air transport system being dominated by a few mega-carriers through mergers or acquisitions), a reality that exists in most other service sectors. However, this may be addressed through the parallel development of regulatory measures against anti-competitive practices. In considering liberalization, each State needs to take into account all these benefits and risks when making its choice.

3.3.4 Some countries have attempted to mitigate these adverse effects through a range of measures, such as the “Essential Air Services program” in the USA and the EU regulation 2408/92 authorizing member States to enact “Public Services Obligations” applicable to economically marginal routes under strict eligibility criteria.¹⁴

4. Way Forward and Conclusion

4.1 What ASEAN Member States could possibly do is to lift the barrier to access to capital, by liberalising FDI rules in the aviation sector. The liberalisation will be in-line with the spirit of the ACIA which seeks to make ASEAN as a single investment destination. Some may argue, for nationalistic reason that airlines need to be within the fold of each nation. However, one has to remember that British Airways are no longer owned by the

¹⁴ World Bank, Liberalization of Air Transport, <http://siteresources.worldbank.org/EXTAIRTRANSPORT/Resources/5151801262792532589/Liberalization.pdf>.

state of United Kingdom and Swiss International Airlines (successor to Swissair) is no longer owned by the state of Switzerland. British Airways is owned 100% by the International Consolidated Aviation Group (IAG) with dual listing in London and Madrid. IAG also owns several other airlines including Iberia of Spain and Aer Lingus of Ireland. Swiss International Airlines, on the other hand, is owned by the German carrier Lufthansa, who also owns Austrian Airlines.

- 4.2 For nationalistic and nostalgic reasons, one may leave the so-called flag carriers out of the liberalisation process. But ASEAN Member States must allow other airlines, who are not designated flag carriers to have access to capital. To ensure consumer interests are protected against unfair practices and potential price fixing, each corporate exercise involving airlines ownership and control may be subject to regulatory scrutiny.
- 4.3 There are at least 3 options for ASEAN to achieve the liberalisation of ownership and control.
 - 4.3.1 One is by allowing full liberalisation, meaning 100% foreign ownership. This will meet with objections as some may argue that ASEAN airlines should remain within ASEAN ownership and control.
 - 4.3.2 Another is by allowing 100% ownership by ASEAN Investors as defined in the ACIA.
 - 4.3.3 The third mode, to be in-line with the AFAS, ASEAN may allow up to 70% ownership by ASEAN Investors, leaving 30% to be owned by nationals of the country where the airlines is registered.
- 4.4 Liberalisation of ownership and control may lead to healthy outcome, where one may be able to see formation of aviation groups within ASEAN. This move will also assist ASEAN Member States to grow other related activities such as the maintenance, repair and overhaul (MRO), engineering services and catering services. The move will also contribute towards development of ASEAN based airlines semi-skill workers and professionals beyond pilots and air crews.
- 4.5 In conclusion, as aviation is a capital intensive industry and opens to various market vitality and risk, ASEAN must move forward from the archaic ownership and control rule towards substantive liberalisation. With this the industry will thrive and will contribute towards a higher level of ASEAN integration.

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