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**Competition Policy Review Panel**  
**Research Paper Summary**

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**Title: Foreign Ownership Restrictions in the Canadian Aviation Industry: A Review and Assessment**

**Subjects Addressed:**

- Foreign ownership restrictions in the aviation sector

*Origins of Foreign Ownership Restrictions:*

Foreign ownership restrictions on airlines emerged from the 1944 Civil Aviation Conference, where 52 nations agreed that the airspace over a country was the property of that country, which airlines had nationalities, and that governments had a central role in negotiating route rights. Foreign ownership restrictions were included in subsidiary accords. The reasons for restricting ownership included national security (options for emergency usage of civilian aircraft), economic security (control over a major foreign exchange earner, continuity of air service in difficult times), concerns about differentials in safety and employment standards, confidentiality, concerns about airlines with overlapping ownership not competing against each other, and the bilateral agreements that demanded national ownership (and the fact that amending them might allow airlines from countries without bilateral agreements to buy air rights).

*Foreign Ownership Restrictions on Airlines in Canada:*

The goal of the Canada Transportation Act (1996) is efficient, low-cost transportation through “a competitive, economic and efficient national transportation system that meets the highest practicable safety and security standards and contributes to a sustainable environment.” So far, Canada has signed few open skies agreements, and those that were signed were with minor countries with the exception of the US. It is negotiating an open-skies type agreement with the EU and has bilateral agreements with 19 EU member states. (The United States has 90 open skies agreements.)

Canada limits foreign ownership of Canadian air carriers to 25%. In addition, foreigners may not control a Canadian air carrier. The Canada Transportation Act allows the Governor in Council to change the foreign ownership percentage, but only an amendment to the Act can remove the no-foreign-control provision. Most of Canada’s bilateral air services agreements with other nations also require that any carrier designated by Canada for international service must be ‘substantially owned *and* controlled’ by Canadians.

When under bankruptcy protection, Air Canada maintained the 75% Canadian ownership by issuing variable voting class A shares for a holding company, ACE,

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to foreign investors, watering down their voting rights. Foreign investors own roughly 75% of ACE's equity and 17% of Air Canada's equity. Since ACE is deemed to be Canadian, 83% of Air Canada is considered to be currently owned by Canadians, even though foreigners own three-quarters of ACE. West Jet is between 20 and 25% foreign owned and has put a special procedure in place for non-Canadian share transfers. It plans to follow its rivals by reclassifying its stock as variable voting shares to allow non-Canadians to own more than 25% of the equity while reducing voting rights.

*Canada's International Aviation Agreements:*

The governments of Canada and the United Kingdom negotiated an "Open Skies" air transport agreement effective as of 2006. Canadian airlines are able to offer an unlimited number of flights to and from third countries via the U.K., as U.K. airlines will also be able to do via Canada. There are no restrictions on setting prices but some restrictions on carrier designation, city designation, capacity controls via designation of aircraft type, and tariff zonal single disapproval (double disapproval on cargo).

Canada and the European Union are negotiating an Open Skies-type air transport agreement that would govern all aviation relationship under a single regime. Canada now has bilateral agreements with 19 of the 27 EU members.

Canada and the United States revised their bilateral agreement in 2005, introducing unrestricted fifth freedom rights<sup>1</sup> for both passengers and cargo; unrestricted seventh freedom rights<sup>2</sup> for cargo; full cargo co-terminalisation; through flight numbering on sixth freedom<sup>3</sup> operations; pricing freedoms on fifth and sixth freedom operations; and removal of previous regulations on computer reservation systems. The 2005 agreement did not include cabotage, rights of establishment and passenger 7th freedom operations.

*Foreign Ownership Restrictions on Airlines in other Countries:*

Currently, Chile is the only country in the world where there is no limit on foreign ownership of domestic and international airlines. The United States and Canada restrict foreign ownership to 25%; however, the US has allowed up to 49% foreign ownership on a case by case basis. In May 2003, the US government proposed raising the allowable percentage of total foreign voting stock ownership to 49%, but this is still being debated. The EU has taken steps to liberalize within Europe and sets a 49% limit on non-European ownership.

In 2007, EU and U.S. authorities signed a preliminary Open Skies accord to allow EU and US airlines to operate direct flights between any city in the U.S. and

<sup>1</sup> Putting down and picking up traffic to and ~~from a third state~~ in a signatory state on flights originating or ending in the airline's home country.

<sup>2</sup> Transporting traffic between the signatory state and a third country without stops in the airline's home country.

<sup>3</sup> Transporting traffic between the signatory state and a third country via the airline's home country.

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any city in any EU country. Services can also be operated between any third country via the European Community and onwards, via any intermediate point, to any point or points in the United States and beyond, or vice versa. This provides greater opportunity for mergers between EU carriers since carriers will not lose their transatlantic rights if acquired by a foreign investor. The agreement does not give European carriers the right of cabotage (to take on passengers in the US destined for another US city). EU investors may hold up to 49.9 percent of the total equity in a U.S. airline and, on a case-by-case basis, even more, provided that foreign nationals do not own more than 25% of the voting stock and the airline is under the actual control of U.S. citizens. Likewise, US investors can hold minority interests in EU airlines.

Delta and Northwest Airlines, United and Continental, and USAirways and American Airlines are apparently preparing to pursue mergers. This would leave three major carriers in the US, each with a global reach through their alliances. Europe has had numerous large cross-country mergers and acquisitions. The consolidation in the US and Europe may result in a world network of three strong alliances with strengths in different regions.

In Australia and New Zealand, foreigners are permitted to acquire up to 49% of the equity of an international carrier (with some special restrictions for Qantas) and up to 100% of a domestic airline. Most other countries have foreign ownership restrictions of 49% or less on all airlines.

*Rights of Establishment:*

Besides relaxing the rules on foreign ownership percentages in general, another way to gradually liberalize foreign investment restrictions is to grant a right of establishment. This allows a foreign air carrier (or other investor) to establish a separate air carrier in the host country either by acquiring an existing carrier or starting up a new one. The carrier would provide domestic services only and would be subject to Canadian taxes, rules and regulations, employ Canadian workers and use Canadian equipment. Right of establishment has been allowed in Australia, and has significantly stimulated the domestic market through lower fares and more route choices. All limits on aviation services and investment have been removed within the European Union (EU) and between the EU and Iceland, Norway and Switzerland.

*Arguments against Relaxing Foreign Ownership Restrictions:*

Opponents of the right of establishment have argued that such domestic carriers would operate as feeders to the parent company's mainline destinations, effectively granting cabotage rights. Foreign carriers could thus siphon the profitability from Canadian carriers by operating only on the lucrative routes.

Related to this are concerns that foreign airlines taking over domestic ones would discontinue servicing less profitable routes. A discontinuation of routes would only occur if they had been operated at a loss, through cross-

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subsidization. However, this has rarely been observed and never been proven and makes no economic sense unless there is a market failure. Any well-run carrier will enter routes which will yield profitability.

A related argument is that aviation is important to national economic development and that it is easier for the government to exercise control over its national airlines, for example to encourage airlines to serve non-profitable regions to promote local economic development. However, this can better be achieved through subsidies.

Some arguments for foreign ownership restrictions are based on national security concerns, although foreign airlines have to follow national laws.

Pilots have been vocal opponents arguing that domestic jobs, particularly the well-paid international routes, would go to foreign workers; however, it is not good policy to place restrictions on access to markets and capital so one labour group can increase their portion of rents.

*Arguments for Relaxing Foreign Ownership Restrictions:*

On the positive side, liberalized ownership controls would allow airlines to access a greater pool of capital, reduce the average cost of capital, retire debt, consolidate, improve services, and potentially avoid filing for bankruptcy.

An entry of foreign airlines creates competitive incentives for both existing and new airlines to promote lower fares and differentiated products. Foreign investment can also involve the transfer of new technology, knowledge, skills and other resources and intangible assets.

Foreign investors benefit through better access to a restricted market by acquiring equity in a national carrier and access to more slots at busy airports. National airlines benefit through expanded networks, especially if they have small domestic markets. Alliances, from simple marketing arrangements and codesharing to co-investments and matching schedules and products, can provide some of the same benefits, but are an imperfect response to ownership and market access restrictions.

Given the EU-US deal, it is essential that Canada complete one as well, otherwise the potential for traffic diverting to US airports for access to world markets will grow. If Canada completes an open skies agreement with the EU which contains no ownership restrictions, foreign carriers established in Canada may enjoy the conditions of the open skies agreement between Canada and the US (depending on the US response).

We should not make liberalization conditional on reciprocity. However, a multilateral or plurilateral approach has merit. Multilateral liberalisation, as in the recent US-EU accord, requires a more liberalised approach to cross-border

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investment and the relaxation of national constraints on international competition. It involves greater reliance on the competitive international marketplace in setting fares, determining routes and capacity, and facilitating new entry.

*Conclusions:*

Three actions are needed: first, an immediate shift to 49 percent foreign ownership allowance. Second, rights of establishment for domestic carriers. These two actions would create the clear signal that moves to liberalization were increasing and that the needed changes should be put in place before the remaining ownership restrictions could be removed.

These changes include clear ways by which domestic regulatory control over safety and security can be maintained; means of ensuring domestic firms would not lose their 'identity' when negotiating access to foreign markets; and an apparatus to prevent abuses under flags of convenience and shell corporations, as well as free riders from third countries that do not have an open skies agreement with a receiving country.

In the medium term, there should be negotiations to change the basis on which an airline is deemed a domestic carrier from substantially owned and controlled by citizens of the country to predominant place of business (head office location is too easily changed).