

THE LIBERALISATION OF AVIATION

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Seminar**

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Ladies and Gentlemen,

It's a great pleasure to address this seminar this afternoon, and I thank the Japan Transport Institute for the opportunity – and also the Royal Aeronautical Society for providing the venue.

Let me apologise at the outset for the fact that, regrettably, I shall have to leave shortly after I finish my remarks. This is because my presence is required at the House of Commons to give evidence to the Transport Select Committee.

The latter invitation arrived long after I had accepted the Institute's request to speak here.

However, invitations from the Select Committee are not ones that can be turned down – so I am grateful to the Institute for the understanding it has shown in amending its timetable for this afternoon so that I can at least make a contribution to your deliberations before I am obliged to depart.

How to make progress in liberalising aviation has been a recurrent subject for discussion in industry forums for decades.

But rarely can an event such as this seminar have taken place at such a timely moment in the industry's history.

So today I intend to address five specific themes:

- the current situation facing the industry;
- the historic structural problems that have played such a part in the industry's weakness;
- the case for liberalisation;
- the background to next week's EU-US negotiations;
- and finally the prospects for a positive outcome.

CURRENT SITUATION

The global aviation industry has a habit of lurching from crisis to crisis. Economic hard times never seem to be far away. But the outlook for the global industry at this precise moment is in some ways perhaps more challenging than it has ever been.

At around \$120 a barrel, world oil prices are at an unprecedented level – three or four times as high as five years ago. That is an enormous additional cost burden for the industry to absorb in such a short period.

Fuel is now the industry's biggest single cost - and one over which it has no significant degree of control.

The fast-growing economies of Asia and Latin America are placing relentless upward pressure on demand for oil, while – for a variety of reasons - supply is relatively restricted.

So we are facing the prospect of record prices on a more or less permanent basis. At British Airways, we estimate our fuel bill will rise about £450 million – or between 20 and 25 per cent this year alone.

And alongside this massive extra cost, airlines are facing a significant softening of demand, as the effects of the credit crunch spread outward from the United States and weaken consumer confidence.

Last month, the International Air Transport Association – whose airlines account for 94 per cent of world passenger traffic - downgraded its industry profit expectations for 2008 for the second time in four months.

IATA is still forecasting a positive bottom line for the industry of \$4.5 billion this year, which some people might regard as a reasonable result.

But the truth is that a net profit of \$4.5 billion will have been scraped from a global turnover forecast to exceed \$500 billion. In other words, the worldwide aviation industry's net operating margin is expected to be less than one per cent.

Margins of less than one per cent are no way to run businesses.

And the even more shocking truth is that for all the difficult economic circumstances of the current year, tiny margins are aviation's historic par for the course.

In 2007, the industry's operating margin was 1.1 per cent. (For the avoidance of doubt, I should make clear that British Airways' operating margin was rather higher than that – as we shall announce shortly.)

But 2007 was a good year for the global industry. In each of the four years before that, the global operating margin was negative.

HISTORIC PROBLEMS

Why is this? How come so many thousands of airline executives spend so much time losing so much money?

The simple answer is that in large areas of the aviation industry, normal market forces do not operate.

Air routes are highly restricted, with agreements between different national governments laying down strict limits on who can fly where, how often and sometimes even at what price.

Around the world, there are more than 3,000 international treaties of this type – almost all of which stipulate that an airline operating a specific route must be majority-owned by nationals of the country in which the airline is based.

So if British Airways wanted to fly between Amsterdam and Cape Town, we would not be allowed to – because we are not 51 per cent Dutch-owned or 51 per cent South African-owned.

And you can't get round the rules by setting up a subsidiary airline in one of the countries concerned – because 'effective control' of the subsidiary would be deemed to be outside the relevant country. And therefore illegal.

These treaties date back to the earliest days of international civil aviation in the 1940s.

I can understand why they were felt appropriate then. Countries were recovering from world war. Mass air transport was in its infancy. Flights were infrequent, and relatively hazardous.

It was not surprising that governments should seek to guard airline ownership (or assume it themselves) and impose regulations intended to shore up standards of safety and security.

But what was understandable in the 1940s, when there were no more than nine million passengers worldwide per year, is incomprehensible today for a mature industry with an outstanding safety record, carrying 38 million passengers a week.

Aviation is the industry that underpins globalisation. Yet these outdated restrictions on operations and ownership prevent aviation from itself enjoying the benefits of globalisation.

Airlines simply cannot achieve the kind of sensible consolidation across national boundaries that is taken for

granted in banking, telecoms, pharmaceuticals, electronics and so many other industries in the modern world economy.

The result is inefficiency – and operating margins of one per cent or less.

There are too many airlines – at least 500 of significant size worldwide. You don't need 500 airlines to create competition.

There is too much state ownership. And there is too much subsidy.

Even in the United States, supposedly the home of free-market capitalism, the Chapter 11 bankruptcy procedures have been exploited to provide financial safe havens for airlines struggling with the forces of economic reality.

In the four years after 9/11, America's supposedly private-sector airlines soaked up nearly \$20 billion in subsidies and loan guarantees as they failed to cope by their own efforts with the challenges the industry faced.

If the world aviation industry wants to be profitable and to use its fair share of the world's resources efficiently, it cannot continue like this.

CASE FOR LIBERALISATION

We need a new world order in aviation. A world order in which the structure of the industry is determined not by government hand-outs or directives, but by the needs of the travelling public.

Customers do not care who owns airlines. They are not interested in governmental imposition of route rights. What they want are safe, secure airlines flying where they want to go at a price they want to pay.

Of course it is right that governments should act together to lay down consistent, relevant rules to guarantee the highest levels of safety and security.

But that is where government regulation should end. Governments do not need to run airlines, or bail them out when they run into trouble, or decide who can fly where when.

Surely, the lesson of the last 25 years of economic history is that these issues are best resolved by markets.

We know that liberalisation works. The creation of the Single European Aviation Market in 1993 transformed both supply and demand and showed how artificial the old regime had been.

Deregulation allowed any airline to fly any route as often as it liked and to set its own fares.

It led to new operators, new routes, new markets, massive competition, greater efficiency, lower fares and a bonanza for consumers.

The average annual growth rate in traffic in the years immediately following deregulation was almost double what it had been in the years immediately before.

The competitive pace certainly proved too hot for some airlines. Swissair and Sabena were two of the most high-profile casualties. And Alitalia has been surrounded by intensive care screens for so long that no-one's sure if the patient is still alive.

There was a big shake-out among European regional carriers too, and some of the early entrants to the no-frills business discovered that life was harder than it may have looked.

So, yes, there were losers as well as winners. That is what happens in normal competitive markets.

But the European short-haul sector as a whole has experienced an unprecedented boom since deregulation. Airlines, airports, regional economies, local tourism and construction industries have all benefited enormously – as has labour mobility across the entire EU.

The medicine has worked in other markets too. A study two years ago of deregulated routes around the world found that traffic growth after the liberalisation of air services agreements typically averaged between 12 and 35 per cent, significantly greater than in the pre-liberalisation periods.

In a number of cases, growth levels comfortably exceeded 50 per cent once previous restrictions were relaxed.

The study went on to predict that the liberalisation of 320 country pair markets that are currently restricted would lead to traffic growth of more than 60 per cent and more than 24 million full-time jobs.

Ladies and Gentlemen, it is surely clear from both practical experience and economic analysis that deregulation generates significant additional benefits for consumers, business and employment.

So how do we push forward the goal of deregulation in markets that remain restricted, and in particular ensure that deregulation applies to airline ownership too?

EU-US: STAGE TWO

It is here that our thoughts turn toward Slovenia and next week's first round of the Stage Two negotiations between the European

Union and the United States on a new transatlantic aviation agreement.

At British Airways, we made no secret of our view that the Stage One agreement struck last year was a poor deal for Europe.

It gave the Americans almost everything they wanted - access to Heathrow airport and the EU domestic market, and the right to pick up passengers in Europe and fly them on lucrative routes to the Middle East, Asia and Africa.

In return, the US yielded no meaningful concessions whatever. No access for EU carriers to the US market. No significant rights for EU carriers to fly on beyond the US. And no hint of movement on the most crucial issue of all: allowing overseas companies to take controlling stakes in US carriers.

For those of us who had hoped that the EU-US negotiations could act as a catalyst for the economic consolidation the airline business so desperately needs, the Stage One agreement was disappointing.

I should add that we are not sulking on the sidelines complaining. We are pragmatists and we are exploiting fully the limited opportunities that the Stage One agreement offers.

Stage One lifted restrictions on the US destinations we can fly to from Heathrow, and the number of times we can fly to them.

So from March 30, the day Stage One came into effect, we began flying to Dallas Fort Worth and Houston from Heathrow rather than from Gatwick.

In addition, we are increasing frequency on our Heathrow-New York JFK route from 51 flights a week to 55. Similarly, frequency on the Heathrow-Seattle route is going up from 10

flights a week to 13, and on Heathrow-Washington from 21 services a week to 24.

In other words, we will make full use of Stage One as a means of reinforcing our market-leadership between London and America, offering 41 flights a day (including those from Gatwick) to 18 destinations across the US.

And we are not stopping there. We will launch our first services from Gatwick to JFK in October, and next year we will bring long-haul to London City airport – commencing all business-class services to New York in Airbus A318s.

We also have plans to launch direct services between Continental Europe and the US. This network will be operated by our new subsidiary, which - partly in honour of the Stage One agreement - we have named OpenSkies.

These new services would tap into our long-established expertise in providing for the transatlantic business market, and our strong brand and deep roots in the US.

The second reason we chose the name OpenSkies was to signal our commitment to Stage Two of the EU-US negotiations, and the need to create a genuine Open Aviation Area.

That area would establish a common deregulated framework for flights within Europe, flights within the US and flights between the two. The outdated restrictions on ownership and control of airlines would be relaxed, so that EU investors could take majority stakes in US airlines, and vice versa.

The Open Aviation Area would be one market, covering 60 per cent of current world traffic.

If that did not send out a powerful signal to the rest of global aviation, I don't know what would.

WHAT IS DIFFERENT THIS TIME?

In the long history of transatlantic Open Skies negotiations, I know there have been many disappointments.

So there will be many wiseacres inside and outside the industry who will predict that the Stage Two negotiations will achieve no radical step forward and end in failure.

I am not going to forecast what will happen. But I do believe that the prospects for success are not as weak as the pessimists suggest.

Firstly, the EU does have some leverage.

There is a clause in the Stage One agreement, which gives the EU (or any individual EU state) the right to terminate the new deal if by 2010 the US has not made sufficient progress toward acceptance of a genuine Open Aviation Area – with equal traffic rights and removal of ownership restrictions.

In other words, having secured their long-held objective of access to Heathrow, the new US entrants would lose it again if their negotiators were obstructive.

British Airways will not be the only airline monitoring these negotiations very closely over the next two years – and standing ready to hold the UK Government to its word to nullify the existing deal if a true liberalisation is not achieved.

Secondly, it is blindingly obvious that these negotiations will not take place in a vacuum. Oil prices look set to remain at a level that poses fundamental questions about the industry's structure. Evidence of slowing demand in key markets, particularly the US, is all around us.

This uncomfortable outlook is aggravated by two other factors. The rate of delivery of new aircraft to airlines will increase this year, increasing overall capacity and putting further pressure on yields.

And across the Atlantic, the implementation of Stage One of the EU-US deal has naturally intensified competition. So the volume of seats between London and the US has risen about 13 per cent this summer, compared with last year, and other markets – notably between Spain and the US – have jumped even more. Again, the pressure on yields is obvious.

Rightly, airlines will look to cut costs. But in the years since 9/11, most operators have made significant efficiencies and improved labour productivity. In terms of new savings, there are not many low-hanging fruit around.

In recent weeks, we have seen some consequences of these economic forces. In the US, five airlines have either gone out of business or sought Chapter 11 protection. In the UK, the all-business transatlantic operator, Eos, has disappeared – shortly after its rival Maxjet went the same way. Speculation about the lone survivor in that market, Silverjet, remains active.

Within the US, we have also seen moves toward consolidation between the majors. Delta and Northwest are seeking approval for a merger, which they say will allow them to align their networks and fleet more efficiently and explore joint-buying potential in the oil market.

Continental was discussing a possible link-up with United. But no agreement was reached.

And yes, you will know that Continental is now in talks with American Airlines, and with British Airways, about opportunities for possible future co-operation.

Ladies and Gentlemen, I am afraid I am not in a position to offer you further enlightenment on the progress of these talks. But if and when we have something to announce, we will do so in the normal way.

The relevance of these recent events for the EU-US negotiations is that sentiment among carriers, governments and regulators may be more sympathetic to the creation of a framework for consolidation than we have ever seen before.

Though it was not widely reported, it was encouraging two months ago when the US Department of Transportation (DoT) and the European Commission announced a new joint research project aimed at (and I quote from the official press release) ‘deepening their understanding of how alliances have affected competition in transatlantic markets’.

The DoT and Commission will analyse air traffic data and interview airlines, travel agents, industry analysts and consumer groups as they prepare their report for publication around this time next year.

I believe this is another potentially helpful development that could play a part in moving the climate of opinion toward radical change.

Let me say a word about jobs. I know that whenever there is any talk of consolidation, there are fears expressed that jobs will be lost. This is perfectly natural, and understandable.

I would make two simple points. Firstly, the way to guarantee that jobs will be lost is to carry on with a failing business model.

Ignore your rising costs. Ignore your weakening demand. Ignore your falling yields. Just sleepwalk on till you reach the edge of the precipice.

If you want jobs to survive, you need your employer to survive.

Secondly, liberalisation creates jobs. It creates growth and it creates opportunity. It is estimated that a transatlantic Open Aviation Area could generate more than 70,000 jobs within five years – a third of those directly within aviation. And total economic benefits worth 12 billion euros.

So the value of a general industry consolidation that resulted from the EU-US process could be truly enormous. Let us face the future not with fear, but with confidence.

CONCLUSION

To sum up, Ladies and Gentlemen, the global aviation industry cannot continue as it is.

A fragmented industry of hundreds of airlines generating net profit margins of around one per cent isn't good for consumers, employees, shareholders or governments.

Airlines need to be able to develop into global businesses, using resources efficiently for the benefit of consumers.

Those concerned about jobs should recognise that the industry's current structure offers no employment security.

And governments should recognise that they are just not equipped to run airlines in the best interests of their citizens.

A financially strong aviation industry can invest for the benefit of consumers, staff and shareholders. It can also find the resources to advance solutions to the industry's environmental challenges.

Liberalisation can bring that financial strength.

I look forward to the negotiations that begin in Slovenia next week, and I hope they mark the start of a process that could transform our industry for the good of all.

Thank-you very much indeed.

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