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The views expressed in this working paper are those of the author and do not necessarily reflect the views of the European Union or the EU Centre in Singapore.

The European and Southeast Asian Single Aviation Markets

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Abstract

Civil aviation in Europe is one major area where landmark changes have taken place since the late 1980s – the liberalization and deregulation of the sector by member states in three “packages” in the 1980s has transformed an economic sector historically characterized by heavy protectionism, collusion and strong state intervention. Today, the European Union’s (EU) aviation sector contributes to 2.4% of European GDP and supports 5.1 million jobs. The Association of Southeast Asian Nations (ASEAN) has also eagerly taken steps to integrate its aviation markets as part of the ASEAN Economic Community (AEC) in 2015.

This background brief chronicles the changes made in the aviation sector in Europe through regional integration and examines how these changes have affected policymaking in member states, the airline industry and consumers. The brief also examines ASEAN’s own effort in the integration of its own aviation sector and, taking into account the EU’s strong interest in cooperating with ASEAN on transport and civil aviation policy, whether the changes in the EU are applicable in the ASEAN context.

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The European and Southeast Asian Single Aviation Markets

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Introduction

Civil aviation in Europe has undergone landmark changes since the late 1980s. Liberalisation and deregulation taken to construct a European Single Market has transformed an economic sector historically characterised by heavy protectionism, collusion and strong state intervention. Today, the European Union (EU) aviation sector supports 5.1 million jobs and contributes €365 billion, or 2.4% to European GDP (EP Research Service 2014b). ASEAN, too, is eager to follow the EU's example and integrate its aviation markets as one of the goals of achieving the ASEAN Economic Community (AEC) in 2015. This background brief details the changes made in the process of integration in the aviation sector in Europe, and examines the impact of these changes on policymaking in member states, the airline industry and European consumers. It also considers the applicability of these changes for ASEAN, taking into account the EU's interest in cooperating more closely with ASEAN on transport and civil aviation, and desire to have a region-to-region civil aviation agreement.

History of Post-war Aviation Regulation

The groundwork for the principle of state sovereignty in aviation was developed at the 1919 Paris Convention, where rules for governments to address the political difficulties and intricacies involved in international aerial navigation were set. Governments met again in Chicago in December 1944 to reaffirm the principles of the Paris Convention and to agree on the technical and economic aspects of industry regulation. The

development of the post-war framework was not without disagreement as European governments blocked the United States-led effort for a generalised freedom of the air where their carriers would be able to pick up passengers in a foreign state and set them down in another. At that point of time, European countries had a territorial advantage in terms of colonial trading posts in Asia and Africa, and these countries were reluctant to accept liberalisation in fear that the recovery of the aviation sector in Europe and their colonies would be threatened (Kassim and Stevens 2010: 22-24). Governments eventually agreed on the Convention on International Civil Aviation (also known as the Chicago Convention) which was the most important of the documents agreed. Key developments at the Chicago meeting include:

- The setting up of the International Civil Aviation Organisation (ICAO) to manage technical rules;
- The International Air Transport Agreement (IATA), or the freedoms of the air, which serves as a base document of bilateral air services negotiation (see Table A on page 3);
- The regulation of non-scheduled air services (Article 5 of the Chicago Convention);
- Full discretion by states to regulate domestic air services;

(above adapted from Kassim and Stevens 2010: 24-29).

Despite a restrictive regulatory approach, further technological advances, a glut of military aircraft and the rise of middle-class spending power led to continued and rapid growth in the commercial aviation sector in the post-war world. (Butcher 2010). The post-war Chicago regulatory regime proved to be popular with governments as it provided them with far-reaching powers and the right to be represented in the skies regardless of their size or economic clout. Most importantly, the Chicago framework firmly placed states at the centre of the commercial aviation sector by making them the main actors in the development of bilateral air services agreements (ASAs) to develop commercial air traffic ties. Airlines – state-owned and private alike – were heavily reliant on

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governments in negotiating for their commercial opportunities abroad.

Table A: Freedoms of the Air

Freedom	Description	Example
1st	the right to fly over a foreign country without landing	London - Mexico City by a British carrier, overflying the USA
2nd	the right to refuel or carry out maintenance in a foreign country without embarking or disembarking passengers or cargo	London - Tokyo by a British carrier company, stopping for fuel in Anchorage
3rd	the right to fly from one's own country to another	Berlin - Singapore by a German carrier
4th	the right to fly from another country to one's own	Berlin - London by a British carrier
5th	the right to fly between two foreign countries on a flight originating or ending in one's own country	Dubai - Singapore - Melbourne by a UAE carrier
6th	the right to fly from a foreign country to another while stopping in one's own country for non-technical reasons	Hong Kong - Jakarta - Perth by an Indonesian carrier
7th	the right to fly between two foreign countries while not offering flights to one's own country	Amsterdam - Berlin by a British carrier
8th	the right to fly inside a foreign country, continuing to one's own country	Beijing - Shanghai - Bangkok by a Thai carrier
9th	the right to fly inside a foreign country without continuing to one's own country (also known as "cabotage")	Beijing - Shanghai, by an Singapore carrier

Adapted from ICAO (n.d)

ASAs designate the airlines that can operate and ownership rules, the routes that designated airlines are allowed to fly, provisions that relate to capacity, the right to approve or reject tariffs, and the right to take corrective market action. In particular, the typical ASAs between post-war European governments involved the designation of a single airline from each side, permitted services to specific points and granted limited fifth freedom

rights. Frequency and capacity limits were explicitly set by agreement between governments, and a compensatory structure was set up through pooling arrangements.

It is also worth noting that along with the ASAs, national governments were strongly interventionist in their approach to commercial aviation, providing the means of funding through subsidies and the state ownership of shares. In many cases, airlines were forced to fly unprofitable routes and expenditure by governments on airlines was considered as public policy expenditures (O'Reilly and Stone Sweet 1998). The main beneficiaries of such agreements and policy approaches towards aviation were of course national flag carriers such as Air France, KLM, British Airways and Lufthansa. Unsurprisingly, these airlines experienced rapid growth in the post-war years and gained a near monopolistic market position at the expense of private airlines who could not enter the market without government permission and assistance.

Within Europe, national governments also agreed to form a pan-European aviation body with the help of the Council of Europe and the ICAO – the European Civil Aviation Conference (ECAC) was formed in 1955 and sought to harmonise civil aviation policies and practices amongst its Member States (ECAC 2015). National and private airlines also played their part in development of the International Air Transport Association (IATA), formed in Havana in 1945 and open to airlines from ICAO member states. IATA is tasked with setting the standards of ticketing, appointment and payment of travel agents, and the quality of inflight services.

Member States' Conservatism and Changes Abroad: 1958-1983

Since the founding of the European Economic Community (EEC) in 1958, member states have focused attention on creating a common market by eliminating borders between member states to contribute to the free movement of goods, services and labour (Zabokrtsky 2011). When the EEC was founded, the pre-existing international

system for the aviation sector was based on the principle of state sovereignty where access to a country's aviation market is negotiated and granted on a bilateral basis. The interests of member states in aviation prevailed over the interest of the community - states retained the power to decide on the extent of market access, capacity and tariffs in the aviation sector, and most did not attempt to come to an agreement on this issue until the late 1970s. Although it was not ready to discuss the integration of the aviation sector then, the EEC had given special recognition to that sector as early as 1958 through Article 80 of the Treaty establishing the European Community (TEC) which recognised that air transport had a special status as compared to road, rail and inland waterway transport.

Two events in the 1970s arguably provided the impetus for the European Community's advocacy for aviation deregulation in Europe and the subsequent development of a European single market. The first is a ruling in the European Court of Justice in the French Merchant seaman case of 1974, which gave the European Commission the opportunity to place aviation on the Council's agenda and strengthened the hand of those who advocate for community action in this economic sector (Stanisland 2008: 66-67). As noted by Kassim and Stevens (2010), the period after the ruling was marked by cooperation between the Commission, the Council and the European aviation world, leading to the creation of a working group on aviation within the Permanent Representatives to the Council (COREPER).

The second major development was the deregulation of the US aviation industry in 1978 following the US Airline Deregulation Act² (Morris 2013). Although this did not radically undermine the Chicago Convention, the new US policy heralded a challenge to the restrictionist

assumptions that governments worldwide had based their aviation policies. Supporters of the traditionalist system were challenged by the British and Dutch governments, consumer groups, business representatives and independent airlines who wanted the European Community to loosen regulatory restrictions, and these champions of aviation liberalisation increasingly made their voices heard in the ECAC and IATA (Kassim and Stevens 2010: 83-84)

As Kassim and Stevens (2010: 84-85) noted, these circumstances boosted the European Commission's argument for the deregulation of the aviation sector in Europe. The Commission had already become more assertive with regards to its approach towards the reforms required to make the aviation sector more competitive, and it drew heavily upon ECAC studies and hearings by experts on the US deregulation to support its own arguments and proposals in a memorandum in 1978. The growing support for liberalisation in the aviation sector meant that at some point of time in the future, national governments had to seriously entertain the possibility of turning the idea of a single aviation market into reality.

Liberalising the European Aviation Sector: 1983 - present

The move towards the European single market in aviation began in earnest in 1983 after European Council adopted a directive that concerned community authorisations for inter-regional air services between EC member states. A year later in 1984, the European Commission published a more detailed memorandum based on the ECAC's studies on aviation deregulation, as well as a set of proposals that would form the basis of the first of three packages or stages of deregulation measures (see table B on pages 5-6). The memorandum proposed that governments would be prohibited from entering capacity or revenue sharing agreements, that a zonal system for fares would be introduced, and discrimination would be prohibited. The proposal would also give the power to the Commission to grant block exemptions from anti-trust provisions, thus freeing airlines from the need to apply for individual

² The bilateral aspect of the US Airline Deregulation Act allowed for multiple designations of airlines to operate abroad, the right for US carriers to enjoy access to any point in the territory of a bilateral partner, further fifth freedom rights with only some restrictions, open access for charter services and the abolishment of government control over capacity and frequency

exemptions when engaging in areas such as slot allocation and passenger tariffs (Kassim and Stevens 2010: 89).

Two of the European Court of Justice's rulings in the 1980s strengthened the Commission's liberalisation agenda. The first was a 1985 ruling in which the ECJ upheld a case brought by the European Parliament against the Council for its "failure to act" in the Common Transport Policy more generally. Although the Common Transport Policy did not apply directly to air transport, the ECJ's ruling gave the Commission more attention and support in its goal to develop a Community strategy for aviation (Teasdale & Bainbridge 2012 and O'Reilly & Stone Sweet 1998). The second is the 1986 case *Nouvelles Frontières* where the ECJ ruled that EC competition law applied to air transport, even if it was not automatically included in the Common Transport Policy (Staniland 2008: 79). In this latter case, the Court also highlighted the need for a common legal framework to cover Community aviation.

It is important to note the pivotal role of the member states holding the presidencies of the EU between 1986 and 1987 in driving aviation sector liberalisation. As Kassim and Stevens (2010: 97-98) noted, conservatism prevailed among member states despite the ECJ's rulings. France and Germany rejected the Commission's 1984 memorandum and proposed a more conservative approach to setting fares and route capacity. This in turn led to the UK to respond with an uncompromising liberal counterproposal that argued for the freedom for airlines to set tariffs and capacity according to their own commercial judgment. The UK's Presidency of July to December 1986 eventually saw further compromises in liberalisation as well as continued divisions among member states, but two important outcomes were achieved: UK firmly placed aviation liberalisation at the top of the agenda, and the European Commission was persuaded by these events to put together a package that would be broadly acceptable to all member states.

The crucial breakthrough came during the Belgium's Presidency of the Council in January to June 1987, putting the liberalisation agenda on its top priority. The Presidency also dealt well with the Commission's renewed threats to withdraw its proposals and proceed with legal action by convincing several state-owned airlines to cooperate with the Commission. A deal in principle for the first of three packages of aviation liberalisation was finally struck by the end of June 1987 after all member states were able to agree on the reduction of fares, market shares, cabotage and the rules of governance. An ongoing dispute between Spain and UK over Gibraltar pushed back the final adoption of the first package to December 1987 (Kassim and Stevens 2010: 99-102). At the time of its adoption, the first package reduced fare restrictions and granted airlines additional flexibility for cooperation within existing agreements.

Table B: The Three Packages (1987 – 1992, effective until 2008)

Packages	Contents of Package
First Package (1987)	<ul style="list-style-type: none"> Fare restrictions were reduced Carriers were also given additional flexibility for cooperation within the limits of existing air service agreements. <p><u>Relevant laws:</u></p> <ul style="list-style-type: none"> Council Regulations 3975/87 and 3976/87 laid down the procedure of applying competition rules to undertakings and to certain categories of agreements and concerted practices in the air transport sector Council Directives 601/87 and 602/87 respectively
Second Package (1990)	<ul style="list-style-type: none"> All European airlines allowed carrying passengers to and from their home countries to other EU Member States (3rd and 4th freedoms). Airlines granted 5th freedom flights, i.e. intra-European flights with stop-over in a third country and the right to pick-up and drop-off passengers during the stopover Fare and capacity restrictions were further abolished.

	<p><u>Relevant Regulations:</u></p> <ul style="list-style-type: none"> • Council Regulation 2343/90 on market access • Regulation 2342/90 on air fares and capacity • Regulation 2344/90 on the application of the TEC to certain categories of concerted practice
<p>Third Package (1992)</p>	<ul style="list-style-type: none"> • Common licensing of carriers & freedom of access to the market- all carriers holding a community license were allowed to serve any international route within the European Union. • Carriers given almost full freedom to set fares subject to safeguards against unfair pricing • In 1997, all carriers holding a community license were given the right of cabotage (i.e. the right to operate domestic routes within the whole of the EU). <p><u>Relevant regulations:</u></p> <ul style="list-style-type: none"> • Regulation 2407/92 governed the licensing of airlines/air carriers • Regulation 2408/92 set out the rules on access for Community air carriers to intra-Community air routes and public service obligations (PSOs) for small and disadvantaged communities in the Community • Regulation 2409/92 set out further rules on fares and rates for air services • Regulations 2410/92 and 2411/92 amended and updated Regulations 3875/87/EEC and 3976/87 EEC, bringing them into line with the changes agreed in the third package

more airtime to the arguments of the cautious majority. Nevertheless, the liberal activism within the Commission, the UK and Dutch governments towards the opening of markets and a last-minute change in France’s position due to internal political pressures within the French administration eventually won the day. After the second package was concluded, airlines gained the right to carry passengers to and from their home countries to other EU member states and benefitted from further abolishment of fare and capacity restrictions (Kassim and Stevens 2010).

In terms of the third package, the Council and the Commission were pre-committed to further liberalisation and an agreement was reached during the Portuguese Presidency. The Council and Commission both presented radical proposals such as the liberalisation of fare setting and the abolishment of the nationality clause respectively. When implemented, all EU carriers holding a community license were given the full freedom to set fares and capacity. Furthermore, they were allowed to operate domestic routes within the whole of the Community from 1997 onwards (Kassim and Stevens 2010). These three packages were reviewed by the European Commission from 2003-2008, and after extensive consultative input from the European Parliament and various stakeholders, provisions for environmental protection were added and the packages were combined as Regulation 1008/2008 in September 2008.

The EU also expanded and secured the single aviation market within its own neighbourhood by signing up non-EU member states Norway, Iceland and Switzerland to aviation rules under the 1994 agreement that created the European Economic Area (EEA). Furthermore, the EU has more or less secured its competence to act in determining not just EU aviation policy but bilateral agreements with other third parties as well. An ECJ decision in a complaint by the Commission against member states’ negotiating ASAs with the US stopped short of recognising that the Commission had exclusive competence in the field of aviation, but nevertheless ruled that negotiations of ASAs between EU member states and third parties were

Two further packages completed the Single Aviation Market in Europe. The negotiation of the second package was beset by resistance from member states such as Denmark, Greece and Portugal as well as calls for harmonisation of competition from the French and German governments – in fact, France led the opposition to further liberalisation during its presidency of the Council from July to December 1989 and gave

discriminatory towards airlines. Essentially, this strengthened the mandate of the Commission to negotiate open skies agreement with third countries and swept aside the state-centric bilateral basis for air services negotiations (Kassim and Stevens 2010: 169-170).

Present Regulation of the Single Aviation Market in Europe

The aviation sector in Europe has changed rapidly since the European Commission's liberal memorandum in 1984, and a host of treaty mechanisms and regulatory tools ensure the smooth running of the aviation sector in Europe. The regulation of the single aviation market is the responsibility of the European Commission's transport and competition departments, DG TREN (Transport) and DG COMP (Competition). The Commission is responsible for administering a growing body of law in the single aviation sector, and it is able to exercise its formal powers with regards to the economics, competition and state aid through a range of treaty provisions and regulations that have been developed for the Single Market in Europe or specifically for the aviation sector.

In terms of the legal aspects of regulating the single aviation market, Regulation 1008/2008 (see Table C on the right) has combined the important aspects of legal rights from the previous packages - market access to routes and the setting of airfares is comprehensively covered under this regulation, alongside the obligation for member states to grant a license to any airline that meets the criteria laid down in the regulations. There are also numerous competition rules to prevent the distortion and/or restriction of competition, as well as regulations that concern the regulation of mergers and acquisitions such as in the case of the Air France-KLM merger in 2004. Last but not least, the liberalisation of the aviation market meant that member states' governments cannot freely offer financial aid to national flag carriers. Rules to ensure EU state aid to airports and airlines were recently updated in April 2014, and the Commission can rely on Article 107 as the basis for

acting against state aid that distorts competition in the aviation market.

Table C: Current Regulations and Treaty Articles concerning the SAM

Area	Specific Legislation	Contents
Licensing	Regulation 1008/2008 Chapter II, Articles 3-14	Requires member states to grant a license to any airline that meets the four criteria laid down in the regulations.
Market Access	Regulation 1008/2008 Chapter IV, Articles 22-24 Regulation 1008/2008 Chapter II, Articles 15-21.	Enshrines the right for Community air carriers to freely set airfares. Ensures access to routes, defines public service obligations (PSOs) Governments can limit or refuse the exercise of traffic rights by another community airline, such as protecting services to small communities under PSOs.
Competition	Regulation 487/2009 and Regulation 411/2004 Regulation 139/2004 Regulation 1008/2008 Chapter II, Article 16-18	These two regulations concern the application of Article 101(3) TFEU to certain categories of agreements and concerted practices in the air transport sector, as well as individual and block exemptions. Empowers the council to rule on the validity of mergers in the aviation sector. Sets out the general conditions and criteria for awarding a PSO in order to minimise distortion of competition
State Aid	TFEU Article 107 (1-3)	Provides that state aid is incompatible with the common market if it distorts competition, unless it qualifies for exemptions under the provisions of Article 107(2) or (3)

Impact of Single Aviation Market on Aviation Services and Domestic Policy Making in the EU

The regulatory regime governing the creation of the single aviation market as well as market access and competition rules have been credited for the success in the liberalisation of the aviation sector. A European airline establishing its base of operations within the EU can look forward to non-discriminatory air carrier licensing, full market access with no capacity restrictions, the right to operate domestic routes in any EU member states and any route within the EU, and the freedom to set fares. National governments are not allowed to interfere in their decisions, nor are they allowed to provide state aid to their competitors. Commercial incentives, then, are the primary consideration for airlines to open or close a route, to add or reduce capacity, and to increase or reduce fares.

Protectionism has been drastically reduced since the 1990s as European governments gradually adjusted their policies towards the liberalisation of the aviation market. Today, member states' governments no longer make aviation policies independently but have to share the decisional authority with each other and with EU institutions. National actors are now subsumed within a wider, more diffuse system of decision making at the EU level, which includes the member states', the European Commission, the European Parliament and special interest groups at the EU level. Traditional state-flag carrier links are eroded – with some national airlines being privatised - and many member states have responded to the EU regime and internal factors by shifting their policymaking agenda to accommodate the interests of other private airlines within their borders (Kassim and Stevens 2010: 241-245).

The main beneficiaries of the single aviation market are the independent low-cost carriers (LCCs) that have successfully carved out a blue ocean low-fares market in the Europe. The launch of British low-cost airline EasyJet's international routes to European destinations in 1996, as well as the expansion of Irish airline Ryanair into the EU market, led the way for greater competition

between private airlines and flag carriers (Miller 2013). Thanks to the freedom to fly from any point to another in the EU, these budget airlines would rapidly expand in the new millennium alongside other privately owned low-cost aspirants such as Air Berlin, Norwegian Air Shuttle and Wizz Air. The enlargement of the EU in 2004 and 2007 gave these carriers more opportunities to tap into new markets in Central and Eastern Europe. Undoubtedly, European low-cost airlines have been instrumental in expanding the aviation market in Europe - Ryanair and Easyjet now command 31% and 21% of the European low cost market respectively, and the sector itself constitutes 26% of the total market share for air services in the EU (EP Research Service 2014).

Although the aviation services market has grown, national airlines – big and small – have suffered from the rise of Europe-wide (LCCs) and Gulf carriers on intercontinental routes. In fact, many smaller national airlines have gone into the red. In order to survive within the new regulatory regime, airlines have to make major attempts to consolidate their domestic and Europe-wide positions through imitating the low cost model, partnerships, and acquisitions and mergers with other European airlines to reduce cost and increase revenues. Major airline groups such as Air France-KLM, Lufthansa-Austrian-Swiss and British Airways-Iberia have emerged as a result of the changes in the aviation environment in Europe, while smaller airlines such as Czech Airlines have attracted investment capital from abroad (Wall 2013 and Rousek 2014). It is little wonder that in this tough competitive environment national flag carriers have also entered the low-cost market with brands such as Germanwings, Vueling and Transavia to win a share in this market segment. This unfortunately comes at the cost of layoffs in the parent groups to improve financial returns (Bachman 2014).

All in all, the result of aviation sector liberalisation is that the market for air travel, in particular the low-cost sector, has expanded rapidly. The number of intra-EU routes has increased by 250% between 1992 and 2011, while intra-EU routes with more than two carriers have increased by 420% in the

same time frame (European Commission 2011). Low-cost airline capacity has grown at an average rate of 14% per year against the 1% average annual growth rate of legacy flag carriers in that time – the low cost market has tripled from below 10 million seats to over 30 million in 2013, with the overall market volume in the legacy segment increasing by only 2.8 million seats, or less than 311,000 seats per year (OAG 2013). There has also been significant increase in passengers using secondary and regional airports as low-cost airlines continue to create more hubs, and legacy carriers have been forced to adapt by reducing their fares and increasing efficiency (Vidović et al 2013 and EP Research Service 2014a). There is no doubt that the liberalisation of the market has offered more choices to consumers in terms of destinations, lower fares, and represented a stimulus to independent travel and tourism within the EU.

The liberalisation of air services in Europe has also led to changes in other areas. First and foremost, regional and secondary airports have benefited from the boom with the inflow of passengers, and this has meant that member states and the European Commission had to consider the allocation of airport slots³ as well as other areas such as liberalisation in ground handling services. Secondly, the increase in flights and aircraft has led the European Parliament and Council to launch the Single European Sky (SES) and Single European Sky II (SES II) to work towards the smooth integration of European airspace. Last but not least, the European Council and Parliament have also looked into the integration of air safety standards with the establishment of the European Aviation Safety Agency (EASA) in 2002, as well as the rights concerning the assistance and compensation of passengers due to inconveniences in scheduled air transport (Zabokrtsky 2011: 167-177). The European Parliament Research Service (2014b) has however, identified shortcomings with regards to a lack of consistency with the Single European Sky

³ Regulation 95/93/EEC, as amended by Regulation 894/2002/EC and 793/2004/EC, came into effect in 1993 and dealt with rights of airlines to hold slots in different seasons, the recognition of secondary rules established by IATA with regards to slots and retaining, and new slot demands and requirements for airlines

and inefficiency in slot allocations - these must be addressed in order for the cost and social benefits of the Single Market in Aviation to be fully realised.

ASEAN and the push towards the Single Aviation Market (ASAM)

Following the example of the EU, the Association of Southeast Asian Nations (ASEAN) aims to integrate the various national aviation markets into an ASEAN Single Aviation Market (ASAM) by the end of 2015. The drive to create ASAM began in 1996 with a memorandum on air services policy⁴ and it has yielded two multilateral agreements in 2009 and 2011 which have redefined 3rd, 4th and 5th freedom rights in the region as well as restrictions on ownership. However, the road to complete ASAM has not been smooth. ASAM requires the ratification of a minimum of three states before it can enter into force, and it is only among those states that ASAM will apply. ASAM also contains restrictions for certain host countries that do not exist in the EU's Single Aviation market or even in other international air agreements, and the development of ASAM has been driven solely by governments of member states and not by the ASEAN Secretariat. This is understandable since ASEAN is inter-governmental and the Secretariat does not wield any policy making power, unlike the European Commission which has the power to initiate policies.

The move towards the liberalisation of aviation markets in ASEAN is recent. The initial push towards the liberalisation of the aviation sector in 1995 only dealt with soft rights such as marketing and reservation systems, while hard rights such as traffic and capacity setting were excluded. ASEAN governments later expressed their desire in the 1996 Ministerial Understanding on ASEAN co-operation in Aviation to develop a competitive air services policy and the vision of an ASEAN single aviation market. In fact, ASAM was identified as a key area for development when ASEAN member

⁴ The Ministerial Understanding on ASEAN co-operation in aviation outlined the need to develop a competitive air services policy with a view of creating the ASEAN single aviation market, the liberalisation of the aviation market in the region

states came together at the 13th ASEAN Summit to adopt the ASEAN Economic Community (AEC) Blueprint which serves as a master plan for limited economic integration by the end of 2015 (Severino 2009). The AEC Blueprint sparked further negotiations on aviation liberalisation, and in 2009 the Multilateral Agreement of Air Services (MAAS) instituted unlimited 3rd, 4th and 5th freedom rights between ASEAN capital cities. The Multilateral Agreement for the Full Liberalisation of Air Services (MAFLPAS) extended this right to all 72 international airports across ASEAN. Further to this, enhanced ownership rules were introduced to allow ASEAN based shareholders to own up to 70% of ASEAN based airlines, up from the current 40-49% limit.

Table D: ASEAN Liberalisation Agreements

Multilateral Agreements	Contents of Agreement
2009 Multilateral Agreement of Air Services (MAAS)	Unlimited 3 rd /4 th /5 th freedoms between and among the 10 ASEAN capital cities (break down into protocols)
2010 Multilateral Agreement for the Full Liberalisation of Air Services (MAFLPAS)	Unlimited 3 rd /4 th /5 th freedoms between and among the other cities with international airports (break down into protocols)

However, the implementation of ASEAN's vision of open skies has been constantly undermined by disjointed liberalisation strategies. Firstly, ASEAN has engaged in ASA negotiations also with its East Asian neighbours, and in 2010 it successfully inked the ASEAN-China Air Transport Agreement – ACATA – which provided carriers with unlimited third and fourth freedom rights to fly from any international airport within ASEAN to any international airport within China. However, ACATA gives Chinese carriers an unfair advantage over ASEAN carriers – Chinese airlines are now able to create multiple air hubs and enhance connectivity at the expense of Southeast Asia's major airlines (Tan 2013 and Sim 2013). This, of course, has caused some concern among airlines such as AirAsia, worried about the effects of lopsided competition on the Southeast Asian aviation market (Koh 2014).

Secondly, some ASEAN member states have been active in concluding open skies and aviation services agreements with other third parties ahead of a bloc-wide aviation services agreement. For example, Singapore and Brunei chose to enter into an open skies agreement with some members of the Asia-Pacific Economic Cooperation (APEC), such as New Zealand, ahead of enhancing connectivity between their immediate neighbours (Government of New Zealand n.d.). Singapore and Brunei had also concluded with Thailand a highly advantageous open skies agreement in December 2004 that granted Singapore and Thai carriers' unlimited 1st to 6th freedom rights (Kyodo News 2004). So far, this has led Singapore based airlines such as Jetstar Asia and Scoot to take advantage of using Thai airports as intermediate stops to other destinations in North Asia in order to sell more seats.

Thirdly, the full implementation of ASAM has been slowed by the varying levels of support among member countries to fully ratify the two agreements. Brunei, Malaysia, Myanmar, Singapore, Thailand and Vietnam can be considered as strong supporters of liberalisation as they have fully ratified MAAS and MAFLPAS, while partial supporters of ASAM are Laos, Cambodia and the Philippines - the former two having ratified only MAAS⁵ while the latter has only ratified MAFLPAS (Aziz and Wattanawong 2013). However, Indonesia has not fully ratified MAAS and has refused to ratify MAFLPAS. Instead, Indonesia seems to be selective with signing ASAs with ASEAN countries such as Singapore (CAPA 2013 and Citrinot 2013). While Laos' and Cambodia's reluctance to ratify MAFLPAS can be attributed to their weak aviation infrastructure, Indonesia's protectionist attitude may be attributed to a geographic imbalance in the number of entry points that it must offer to non-Indonesian airlines after ratification of MAFLPAS – for example, Singapore and Brunei can only offer one point of access, the Philippines 10, while Indonesia has to offer 29 international airports as entry points. Through bilateral agreements, Indonesia is able to

⁵ Indonesia, Cambodia and Laos have yet to ratify MAFLPAS protocols 1 and 2, which offer fourth and fifth freedoms between secondary cities.

restrict foreign carriers from operating into Jakarta, Surabaya, Medan, Makassar and Bali (Tan 2014a and Meszaros 2014).

Arguably, the slow pace of aviation services integration can also be attributed to the political context of intergovernmental cooperation in ASEAN. The bloc's member states were reluctant to give up their national sovereignty, preferring to engage with each other through "the ASEAN Way" where inter-governmental consensus and consultation rather than taking a legalistic, formal approach is the norm (Centre for International Law 2009). When the idea of economic cooperation and AFTA was agreed to in 1992, ASEAN governments included into the agreement the right to withhold the implementation of intra-ASEAN economic arrangements if the states are not ready, owing to the unequal level of development between the countries in ASEAN. In terms of aviation policy, ASEAN governments continue with the principle of state sovereignty vis-à-vis the Chicago Convention in addition to the existing ASEAN framework of consultation and consensus.

The rush by ASEAN and member states to complete external connectivity before internal connectivity therefore raises questions about its member states' actual motivations towards ASAM. ASEAN has attempted to address this issue with the Memorandum of Understanding on the ASEAN's Air Service Engagement with Dialogue Partners in November 2010 to ensure that ASEAN-wide ASAs will be approved before ASAs between ASEAN and its dialogue partners, but so far only Myanmar, Singapore, Thailand and Vietnam have ratified this document (Tan 2014a). A lack of action on the part of member states on securing internal integration of the aviation services market in terms of the two agreements (MAAS & MATFLAS) and 7th, 8th and 9th freedom rights spells great implications for the future of aviation in the region. As each country continues to liberalise external connectivity with other partners such as the EU, Southeast Asian carriers may be faced with a long term disadvantage from airlines that can operate flights from different points in their home countries or regions just like what their

counterparts from China currently enjoy, but without having to face much competition from ASEAN carriers (Tan 2014b).

Airlines and the push for ASEAN open skies

Despite the slow pace of air services liberalisation, aviation markets in ASEAN member states have experienced strong growth and airlines have been finding ways to grow despite this. Intra-ASEAN travel has grown strongly at a compounded annual rate of 13% from 2009-2013, and some analysts have projected an annual growth rate of 8% for the next two decades (Ministry of Transport 2015). Most attributed this growth to the growing middle class, but airlines have also thrived here thanks to the adoption of a blue ocean strategy⁶ and creative ownership rules via "institutional arbitrage"⁷. Malaysian low-cost airline group AirAsia Berhad – a former government owned airline that was revived by entrepreneur Tony Fernandes – has defied the odds to become the foremost intra-ASEAN airline with 120 destinations and a fleet of 184 aircraft (Chin: 99). Setting up operations in Kuala Lumpur in 2002, the low-cost airline later expanded into Thailand through a joint venture with Shin Corporation in 2004 and added an Indonesian subsidiary in 2005. The airline later ventured into the Philippine market with Philippines AirAsia in 2012 and with AirAsia Zest in 2013 when slot restrictions were freed at Manila International Airport, as well as long-haul operations through its AirAsiaX subsidiaries (Chin: 99). In these cases, the AirAsia Group entered each

⁶ A blue ocean strategy is the simultaneous pursuit of differentiation and low cost to open up a new market space and create new demand. This concept was coined in 2005 by INSEAD academics W. Chan Kim and Renée Mauborgne in a book entitled "Blue Ocean Strategy: How to Create Uncontested Market Space and Make Competition Irrelevant".

⁷ Institutional arbitrage in the airline industry involves cases where investors who are nationals of foreign states enter into joint ventures with domestic companies or nationals of target country. Foreign investors take care to maintain the maximum foreign ownership levels allowed by the domestic investment of air transport of the target country in order to organize a new airline. Since the new airline is considered a registered company in the target country, it is entitled to the traffic rights of the target country (Dy 2014:24)

market as minority shareholders in order to skirt around ownership restrictions.

Another major airline that has expanded at a rapid pace is Indonesia's Lion Air, which has followed AirAsia's strategy of joint partnerships in Thailand and Malaysia with Thai LionAir and Malindo Air – the Lion Air group now boasts a fleet of 182 aircraft and flies to 120 destinations within Southeast Asia (Elista 2015 and CAPA 2014c). Other airlines such as Singapore-based Jetstar Asia and Tigerair have attempted to penetrate and capture a share of the low-cost aviation market in ASEAN not just with flights to other ASEAN destinations but with similar joint partnerships as AirAsia. Nevertheless, results have been mixed for these airline groups: Tigerair's joint partnerships in Indonesia and the Philippines have so far ended in failure, while its counterpart Jetstar Asia has seen moderate success in Vietnam's domestic and international markets (CAPA 2014b). National carriers have also benefited from the liberalisation of air rights between capital cities by adding more flights, but almost none are active in launching flights between secondary cities due to the competitive advantage of budget airlines.

The successful examples of AirAsia and LionAir Groups mentioned above fly in the face of the difficult regulatory environment that airlines operate in. Unlike the EU's open skies where community carriers have the freedom to set up bases wherever they deem fit, ASEAN based airlines have to rely on joint partnerships with companies in countries they wish to expand their operations due to the restrictions in the freedoms of the air in the region (Tan 2014a). Establishing subsidiaries such as ThaiAirAsia or Malindo Air have allowed the two largest low-cost airline groups to not just launch more flights to other points in Southeast Asia with fewer restrictions, but also, to change how consumers approach air travel in Southeast Asia. Low cost carriers now account for over half of the seats in Southeast Asia's four largest domestic markets – Indonesia, Malaysia, the Philippines and Thailand, as well as a 50 per cent stake in the intra-Southeast Asia international market (Nadaraj 2014). They have also helped to increase the capacity and boost

tourism to frontier markets in ASEAN: Myanmar's international seat capacity increased by 77 per cent while Cambodia's three international airports (Phnom Penh, Siem Reap and Sihanoukville) have attracted 5.1 million passengers in 2013, an 18 percent increase than in 2012 (Huang 2014).

Undoubtedly, the main beneficiaries of a fully liberalised ASAM with unlimited 7th freedom rights would be large airline groups in ASEAN. After all, in a true single aviation market, entering into joint ventures would be unnecessary as all airlines would be able to operate freely within the region. However, this is far from the truth. For example, the LionAir Group along with Indonesian flag carrier Garuda Indonesia have significant leverage in Indonesian aviation policy and they oppose air services liberalisation – Garuda Indonesia itself has the authority to coordinate and allocate international flights slots in Indonesia's airports, a privilege that is often held by independent slot coordination authorities or aviation regulatory boards in other ASEAN member states. The reluctance of these airlines to see increased competition is unsurprising as Indonesia faces a geographic imbalance of entry points compared to their ASEAN partners (Saraswati and Hanaoka 2013). This geographic anomaly has shaped the way these airlines and the Indonesian government view the ASAM, where liberalisation could derail attempt by the country's two largest carriers to create aviation hubs at major international airports, and by extension, employment opportunities for many Indonesians (Meszaros 2014).

The AirAsia Group, however, views ASEAN integration in a more positive way and its chairman, Tony Fernandes is a firm believer in ASEAN integration and has consistently advocated for the single aviation market in ASEAN. In fact, the AirAsia group had launched their regional headquarters in Jakarta in 2012 as part of their AirAsia ASEAN growth strategy to take advantage of the launch of ASEAN SAM in 2015, with Fernandes even going as far to say that Jakarta is "the future of ASEAN" (Chin 2014: 134-136). In the wake of the AirAsia Indonesia QZ8501 tragedy in December 2014, Fernandes had also called on ASEAN to establish a common regulator to streamline a fragmented

safety framework and ensure common standards for aircrew training in the booming industry (Business Times 2015). Unsurprisingly, Indonesia, its national airlines and ASEAN do not share the same sentiments as Tony Fernandes – although AirAsia is among the largest and more influential airlines in Southeast Asia, its push for liberalisation and integration has been hampered by the lack of support from ASEAN’s Secretary General and active opposition by its rivals in Indonesia. Nevertheless, Fernandes has insisted that his goal to create an ASEAN community airline remains and that he would “rather try and fail than not try at all” (Chin 2014: 140).

EU’s Open Skies and ASAM: Comparisons and the road forward

There are several takeaways from comparing the EU’s successful single aviation market and ASEAN’s attempt to create one. Firstly, there is a similarity in that governments in both the EU and ASEAN had been initially reluctant to create a single aviation market because of their desire to protect their own airlines from foreign competition. However, here is where there is a clear difference in terms of institutional capacity in each bloc resulting in different outcomes. The EU supranational institutions such as the European Commission and the ECJ have had a major impact in helping to overcome resistance by member states and pushing for the creation of the EU’s single aviation market. Today, both these institutions help to regulate the aviation sector with a comprehensive package of legal mechanisms that cover licensing, market access and competition, and other pan-European bodies have been created to regulate aviation safety and security.

ASEAN, on the other hand, lacks the kind of executive and legislative bodies that the European Union has, as it remains a purely inter-governmental organisation and member states, jealously guarding its sovereignty with no intention in the foreseeable future to go the EU way. It is rather contented to stick to its ASEAN Way, which refers to the centrality of consensus building in policymaking within the region and reluctance to “push its members beyond what they are willing to

accommodate” (Narine 2002). As mentioned, intergovernmental consensus coupled with the principle of state sovereignty has meant that the regional bloc does not have the institutions or the force of law to compel its members to agree to aviation liberalisation, nor can it even expose its members for non-compliance to whatever that has been agreed. Even if ASAM is completed, ASEAN would not be able to regulate ASAM because it would lack the institutions capable of doing so. ASEAN integration, as well as that of ASAM, may therefore have to take a different evolutionary path than that of the European Union.

Secondly, the importance of leadership in supranational policymaking is central to the developments of the single aviation markets in Europe and Southeast Asia. The intervention of certain member states such as the UK and the Netherlands in the midst of German and French resistance has clearly been an important factor in the EU’s march towards a single aviation market, and at times, the pivotal role in creating the single aviation market has been played by countries that have been strong advocates of liberalisation. In the case of ASEAN one would expect Indonesia – the bloc’s largest and most populous member state – to take the lead in economic integration. There are some indications that Indonesia has taken the leadership role through the promotion of an activist agenda for ASEAN during its presidency in 2011 (Yeo 2013). Yet, Indonesia has had little or no interest in accelerating the pace of completing ASAM perhaps due in part to its geography and size and the context of aviation development in Indonesia. Much more can be expected from Indonesia, although as the EU case showed, the pivotal leadership role does not necessarily need to be taken by the largest or richest countries. As Dy (2014:27-28) suggests, it can be taken up by countries with moral suasion and possibly those whose carriers are not seen as a threat by sceptical states such as Indonesia and Philippines.

Thirdly, there is a key difference in terms of how large and successful pan-bloc airlines have developed: as discussed above, airlines such as AirAsia and LionAir grew through institutional arbitrage, unlike Ryanair and Easyjet which had

reaped the benefits of aviation liberalisation in the EU to become community airlines. At the same time, it is worth considering how airlines and consumers alike can shape the thinking process of governments in ASEAN. As Dy (2014: 24-27) had observed, there is a possibility that institutional arbitrage could even evolve into a stage where business interests and even middle-income consumers could have an impact on policymaking. For example, a group of investors from different ASEAN member states who pool resources in a brand new airline in another ASEAN member state may have a vested interest to see that the industry further liberalised in order to increase profits. Also, middle-income consumers may demand more aviation services than what government-protected legacy carriers can offer. The increase in pressure by industry players and consumers may eventually be enough to convince national governments that ASAM is actually in their national interest.

The completion of ASAM is important for ASEAN because it also affects how the association engages its foreign partners as a bloc and not as single states. As discussed by Kassim and Stevens (2010: 165-171), the EU's own experience with encirclement by the United States in the 1980s had helped to catalyse the move towards the EU's single aviation market, and these lessons as well as the possibility of encirclement should be in the minds of policymakers in ASEAN especially with the ongoing negotiations for an EU-ASEAN Open Skies Agreement (European Commission 2014). Since not all the bilateral ASAs share the same set of rules, it is therefore unsurprising that ASEAN member states might choose the level or rights they seek to acquire. On the European side, the EU may bypass the option of waiting for ASAM to be completed and instead engage in encirclement by negotiating with individual ASEAN member states for the execution of open skies agreements. The danger here is that ASEAN countries that have secured more rights from the EU may have the ability to divert traffic away from those with fewer rights, while EU airlines may take the opportunity to exploit the gaps in ASEAN's disjointed aviation market by developing multiple hubs to serve Southeast Asian destinations (Dy 2014). This will certainly be very disadvantageous for ASEAN as

passenger traffic would be bled away from their carriers.

It may also be prudent for ASEAN member states to place less emphasis on the "ASEAN Way" or insist on taking care of their own interests first as there may be more to the ASAM than meets the eye. Instead, ASEAN member states should consider – be it through the leadership of a member state with moral suasion or through frank negotiations – that the creation of ASAM would be a win-win proposition. As Baumen and Ng (2012) argue, there will always be a scarcity of a particular skill and resource in some countries within a broader economic landscape, and there is a need for economic sectors in ASEAN to be fully integrated in order to establish productive complementariness. In the case of ASAM, ASEAN member states with a weak aviation industry and limited resources can agree to divert resources to industries it can fare better in. Here, countries would not compete to attract passenger traffic or freight, but rather, efficiently allocate air services to those destinations that can benefit most from aviation services agreements with third parties such as the EU (Dy 2014: 25-26). Such liberalisation can benefit ASEAN not just in enhancing commercial aviation connectivity within Southeast Asia, but it can also prove to be a catalyst for the successful development of other sectors of the ASEAN Economic Community.

Conclusion

There is little doubt that the EU has brought about a revolution in European aviation by creating a highly integrated aviation services market. The discussion in this background brief has examined the policy approaches taken by the European Commission as well as the role of leadership by several EU member states in the liberalisation of the aviation services market. The three packages that were implemented between 1987 and 1992 have imposed restrictions on government actions and interventions, thereby forcing the abandonment of protectionist policies and the shifting of policymaking focus from member states to the European Union level. The changes have also meant that in theory all European Airlines

have the freedom to operate from and to any point in the EU, but in practice the single aviation market has benefitted the low-cost segment of the market more than legacy carriers. This is not to say the EU's single aviation market and related sectors are complete – among the many policy issues that exist with regards to aviation, the Council and Commission have much work to do in the integration of the air traffic control networks in Europe, the efficient allocation of airport slots and the enhancing of passenger rights in the Union.

ASEAN, on the other hand, is still grappling with the development of its own single aviation market. The 2009 Multilateral Agreement of Air Services (MAAS) and the 2010 Multilateral Agreement for the Full Liberalisation of Air Services (MAFLPAS) have been created by member states, but these only cover 3rd/4th/5th freedoms without addressing the need for 6th, 7th, 8th or 9th freedoms. The protectionist attitude by member states such as Indonesia has been a stumbling block towards the completion of ASAM. Furthermore, the rush by ASEAN and member states to complete external connectivity before working on its own internal market raises questions on whether too much is being ceded to external third parties. For example, Chinese airlines will benefit more from an ASEAN-China ASA than Southeast Asian carriers. In order to grow and thrive in a disjointed ASEAN aviation services market, some of these carriers have even resorted to institutional arbitrage so that they may set up hubs in different ASEAN member states.

Unlike their counterparts in the EU which has the right to establish bases as community airlines, aviation operations within ASEAN require extra inconvenient steps for these airlines.

The most important lesson that ASEAN member states can learn is that the establishment of a common market is advantageous for everyone. With the EU serious in its intent to conclude an open skies agreement with ASEAN, a Southeast Asian aviation market divided by protectionist sentiment will only weaken ASEAN carriers at the expense of European ones – as the EU had learnt two decades ago, encirclement by external parties has the potential to harm the long-term potential of an aviation market. Large countries such as Indonesia and the Philippines are keys to ASEAN's long term success, and it is up to member states to take up the leadership mantle and persuade their skeptical counterparts that the benefits of 7th, 8th and 9th freedoms can bring more benefits to the bloc. ASEAN airlines such as AirAsia may also have a role in persuading governments to change tact even as they continue to engage in institutional arbitrage. After all, in the long term, the opening of markets to each member states' airlines and relaxing ownership rules will only serve the interests of ASEAN and its people and catalyzed genuine ASEAN connectivity and further integration in the region.

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