



The benefits of opening Japan's sky for competition

The European Business Council Airlines Committee (EBC) is committed to promote the further development of a dynamic travel industry in Japan. However as of today, the required administrative procedure prior to the introduction or change of airfares, cumbersome filing requirements, complicated distribution, insufficient infrastructure, and high operating costs create major obstacles in responding swiftly and adequately to market needs and opportunities.

By comparing Japan's policies with the developments on the international market, the EBC would in this paper like to elaborate the arguments further. Given the current acceleration in the global trend towards "free sky" agreements between major economies, failing to alter current policies may risk leaving the Japanese Consumers and Airline Industry behind the rest of the world which is reaping the benefits of liberalisation and global airline industry integration.

Competition curbing policies will hamper the flow of passengers traveling on the Europe-Japan routes. Additionally the serious capacity problems of the Kanto region will also have to be addressed if to give European Carriers a true chance to contribute to the Government of Japan to fulfill its goal of bringing 1 million tourists to Japan annually by 2010. Current price setting restrictions and lack of access to landing slots at Narita for European Airlines makes simply an expansion of services impossible.

Before providing specific policy proposals, however, this paper provides a general introduction to the development of the global airline industry.

The role of the Airline Industry

The Global Economy depends on networks, be it telecommunication or transport on the ground or in the Air. The services of the Airliners are indispensable for the smooth and efficient functioning of global trade and the integration of the world economy. With the same token, the success of the Global economy is to a large extent a function of a well functioning link between economies and countries. Although aviation is an enabler of globalisation, paradoxically, the airline industry itself has for long remained subject to highly restrictive national controls on cross-border competition and investment, restrictions unthinkable in most other sectors of the Economy.

Beginning in the U.S. in 1978, however, many governments have gradually abandoned route and price control to foster competition. Liberalisation has henceforth unleashed the forces of

competition and generated substantial gain of consumer benefits.

Liberalisation in the U.S.

The Airline Deregulation Act of 1978 put an end to 40 years of rigid, public-utility type regulation of the US domestic aviation market. Most economists believe that deregulation has triggered an explosion of air travel by allowing inexpensive travel to people of relatively modest means.

Economists calculate that Airline fares are 20 percent lower than they would have been if the industry still were regulated, and 80 percent of passengers (accounting for 85 percent of passenger miles) are paying less than they would have under regulation. A major source of the fare decline is heightened competition, particularly on routes served by new entrants. By spurring competition and giving air carriers incentives to innovate, deregulation also has led to significant improvements in airline operating efficiency, such as the creation of network structures with using hub airports. Operational efficiencies have, furthermore, allowed carriers to lower their costs by 25 percent since deregulation. All in all, changes in fares and service is estimated to produce annual net benefits to travelers in the U.S. of more than €15 billion since its introduction.

Also on the international scene has the U.S. Government worked to foster competition by negotiating so-called “open sky” agreements with foreign governments typically granting rights for U.S. carriers to fly from any point in the U.S. to any point in the other country and vice versa. The carriers are, under these agreements, free to decide their own prices and frequency of operations as well as picking up and leaving traffic en route.

The Single European Aviation Market

European Union has gone even further in liberalising the Airline Industry than the United States, though starting the process later. The old patchwork of bilateral agreements has become obsolete by the development of a single European internal market..

The European Commission’s liberalisation measures have removed essentially all commercial Controls on aviation services and investment within the 25 EU Member States, as well as Iceland, Norway, and Switzerland. As in Open Skies regimes, airlines have complete freedom to determine their fares and cargo tariffs but the European Common Airline market goes even further: Airlines from Member States can operate with full traffic rights and no capacity restrictions on any route within the European Union. This includes cabotage routes within individual EU countries. Perhaps most significantly, EU nationals or companies from any Member State can buy or set up an airline in any other Member State.

As a result of these steps the air travel tripled 1980-2000 and is expected to double before 2020. The number of intra-EU routes doubled 1992-2004 and overtook number of domestic

routes already in 2001. The number of airlines operating has increased with 25% since 1990, much due to the emergence of low-cost carriers. The expansion of these carriers is rather remarkable – they moved from a 1% market share in 1996 to a 20% market share today. This has forced the traditional airlines, who are all members of the EBC, to rationalize. The productivity gains over the period 1990-2002 are calculated to be more than 90% for the largest airlines. This all has translated to lower prices with more, and substantially cheaper, promotional fares. Also employment in the sector has raised considerably during this time.

The liberalisation is not stopping at the EU borders.

Europe Negotiating as one first with U.S., then also with China and Russia

Following a judgment by the Court of Justice of the EU in 5 November 2002 saying that bilateral air service agreements concluded by some Member States with the United States infringed Community Law, it was concluded within the European Union that the “nationality clauses” in bilateral agreements signed by Member States with foreign governments may breach community law. As a consequence, in order to restore legal certainty, existing ASAs should be amended.

Negotiations started with the U.S. Government and led up to a general agreement between the parties in November 2005. Given the sheer magnitude of the size of the markets (combined share of the US and EU markets in aviation is close to 60% of world traffic, with some 40 million passengers carried between the European Union and the United States yearly) the agreement is likely to influence and set the standards for the entire industry. The winners will, again, be the consumers. The increased competition and rationalisations following the agreement are estimated to bring benefits to passengers of some €4 billion yearly in price reductions.

Also Russia, China and India are on the move.

The European Commission has announced that it will move further on with negotiations to expand the European Common aviation area. It wishes to create a common airspace with neighboring countries by 2010 and is currently negotiating air agreements with Morocco and the countries of the Western Balkans. It is moreover recommending that negotiations be opened also with China and Russia.

Much of future growth in the airline industry will come from major markets such China, India and Russia. The European Union is already the destination of 75% of all passenger traffic from Russia while China, now EU:s largest trading partner, is expected to become the largest Asian market and leading hub for air passenger traffic within 10 years. Chinese airlines carried 138m passengers last year, a number that has doubled in the past five years and

already turned the mainland into the second largest aviation market behind America. China now has 130 airports handling more than one million passengers a year, with another 55 international airports planned by 2020. The Government is rapidly liberalising the market, allowing competition on domestic and easing pricing requirements on international routes. European Carriers can now in China, in contrast to Japan, in practice freely decide and market prices directly to the market. China has, furthermore, expressed interest in discussing further liberalisations with major markets and informal talks towards that end are already underway. The same could be said for India although infrastructural barriers will for long hamper a radical expansion of services.. The government has nevertheless departed on a comprehensive liberalisation Journey. Pricing is largely deregulated, competition is promoted by allowing new entrants to the market. Foreign Carriers have, furthermore, been granted extended access to slots to India and negotiations of open sky agreements are topics on the agenda.

Notwithstanding the difficulties in going all the way and reaching agreement on all details in negotiations, the trend is clear. The EU and the U.S. have gained a lot from domestic deregulation and are therefore actively working for a deregulation also on the international level. This will lead to an open skies market between the two biggest airline markets in the world and in a not too distant future to one liberalised market comprising more than 2 billion people. For once, liberalisation has already made its imprint on the industry. Free pricing on international routes is for instance already a globally accepted practice.

Lack of deregulation in Japan

Compared to most other countries, the air transport market in Japan is still very much regulated. The Civil Aeronautics Law, which governs the industry, requires that airline companies obtain Government licenses to enter the market. Licenses were long linked to supply and demand considerations; a special clause to protect over-establishment effectively hindered new entrants to the market until it was removed in year 2000.

Japan started to cautiously liberalise the domestic air transportation market in the mid 1980s. The point of departure was an accord reached with the United States in 1985 under which both governments decided to allow new entrants on the U.S. – Japan routes. JAL was at this moment privatized and given the rights to serve also on domestic dense routes while ANA was given rights to fly also the U.S. This was simply a shift to allowing further competition of operation under unchanged regulatory requirements. Quite predictably, prices and productivity were hardly affected by the changes.

It was, however, not until the entry of a new carrier in 1998 and the revision of the Civil Aviation Law in 2000 when demand-supply regulations were abolished that the domestic industry turned to anything close to the liberalised domestic markets in Europe and the U.S. This changed triggered also competition, rationalisations and price cuts.

Capacity Problems, Stiff pricing regulation, and Old-type bilateral agreements inhibit competition and development of air travel to and from Japan

The high fees for landing, navigation, airport terminal rent, airport terminal common usage, and cargo handling at Japan's major airports have clearly played a role in diminishing the effect of the liberalisation of the domestic industry. The EBC has addressed this issue for a long time as it also affects foreign carriers negatively. The current drive to lower costs initiated by the management of the newly privatized Narita airport is in this regard a welcome development but if Japanese consumers are to reap the benefits of modern airline transportation, the government must continually work towards reducing charges overall.

European Carriers have, however, even more serious concerns. Moves to open up the control of international travel have been very reluctant, almost non-existent. The bilateral agreements controlling access to Japan's airports for foreign carriers are basically modeled after the "old" Bermuda Agreement, concluded between the United States and the United Kingdom in 1946, the standard bilateral during the heydays of government control.

Only the United States have negotiated somewhat better access. The accord from 1985 which opened up for "further expansion" of access was followed by an "historic" agreement signed in January 1998 which enabled expansion of access also to non-incumbent carriers in a regulated manner over time along with fifth freedom rights (to pick-up or disembark traffic en route) for cargo carriers to Asia. The agreement granted also more slots at Narita also for incumbent carriers. Moreover, a more flexible approach of handling approvals for fares has also increased the freedom and lowered prices on trans-pacific routes.

The situation for European Carriers remains clearly less favourable both in terms of access to slots and freedom of pricing.

No improvement can be seen in the lack of access to slots at Narita. The facilities at Narita are simply not commensurable with its role as the main international gateway to Japan and its facilities are used not efficiently enough. Politically motivated restrictions of flight movements per hour and separate allocation slots for the two runways make the situation even worse. The situation is unlikely to improve in the immediate future as indispensable extension of the second runway to 2500 meters and suitable taxiway infrastructure permitting operations of heavier aircraft will not be completed until 2009 at the earliest, while so far Haneda remains off-limits for regularly scheduled international flights.

The EBC believes a first step to correct this unsatisfactory situation would be for the government to give consideration to the importance of the EU as a trading partner and travelling destination and allocate substantially more slots to European Carriers. In the

medium- to long-term, current policies on usage of the aviation infrastructure in the Kanto region should be thoroughly reviewed.

The EBC believes that Japan cannot afford to restrict traffic in and out of the Tokyo region any longer, while acknowledging that only a step by step approach might be possible due to political sensitivities. Narita capacities should be organized in a more efficient way, allowing higher utilization of existing structures. The European airlines have proved able to create highly efficient Hub airport systems are more than willing to share their experiences with the Narita Airport Management in order to improve the situation..

The planned opening of Haneda airport for international flights and the availability of new slots should allow the Japanese Government to offer to European Airlines at least access during night hours which currently are used for Charter operations only.

A significant change of policies is even more important as neighbouring countries (most notably China) build capacity, cut prices, liberalise, and start negotiations on new air agreements with Europe and the U.S. Unless Japan squarely faces its long-standing capacity and cost problems in the Tokyo area, it risks losing a lot of traffic to Asian hubs which will be able to offer better services to lower prices also for tours to and from Japan.

Also Pricing restrictions remain a significant problem for European Carriers. The Japanese system of pre-approved air fares is an outdated practice that only imposes a cumbersome process on airlines and inhibits true competition. Airlines are still not allowed to advertise and sell fares for international travel to and from Japan at rates not officially accepted by IATA, or in the case of group travel, at lower rates set by the Ministry of Land Infrastructure and Transportation.

The European Business Council in Japan Airline Committee (EBC) has continuously argued that Japanese consumers are facing strong disadvantages due to the lack of freedom for International, in particular European, Carriers to offer their products directly to consumers at flexible market prices. The rates set by the IATA do seldom reflect market conditions, most individual fares are repackaged group discount fares sold through licensed travel agents.

Most bilateral agreements between EU member states and Japan provide that any new fares or change of fare will have to be accepted by **both** Ministry of Land Infrastructure and Transport (MLIT) as well as the other incumbent carriers (JAL and ANA). This places European carriers at a disadvantage. They typically have only one destination to offer the market and hence not the required economies of scale to set up their own de facto direct distribution channels (such as own tour operators or travel agencies). The Japanese carriers

however are able to run such subsidiaries reaching the market therefore much more efficiently. Therefore, the introduction of a more market oriented and less complicated approval regime not requiring the explicit prior approval of the Japan carriers in every single case is highly appreciated.

The airlines have in this regard little control of the final price while licensed travel agencies are benefiting considerably from the intransparent system. Commissions made by travel agencies are high, 7% at lowest, costs that end-consumers have to absorb.

Online direct distribution by airlines is generally permitted only within a very small margin of flexibility in price setting, not permitting carriers to match lower prices even for their own products offered through traditional channels thus creating a negative customer perception.

The rigorous filing and control requirements inherent in the system entail also costs that inevitably translate to a higher price level. The EBC cannot see why Japanese consumers should not be enabled to enjoy a variety of products at different prices in a transparent market-based system.

The EBC can see no other plausible solution than a full price liberalisation.

An adjustment to all bilateral aviation treaties towards that end should be initiated. EU and Japanese Carriers enjoying freedom in pricing will spur competition on all EU destinations and will without doubt result in higher consumer welfare.

In this context, Japan should not wait any longer with the necessary deregulatory measures. The global industry is currently moving towards further liberalisations, which bring remarkable economic benefits, consumer freedom and welfare.

Despite very difficult economic conditions, the European airlines have in recent years proved able to successfully adjust to inevitable changes. The EBC is now more than willing to share this experience with their Japanese partner with the view of helping the local travel industry adopting a more global vision and approach.

About the EBC:

The European Business Council (EBC) is the trade policy arm of the 17 European national chambers of commerce and business associations in Japan. Established in 1972, the EBC works to improve the trade and investment environment for European companies in Japan. The EBC currently represents more than 3,000 local European companies and individuals who are members of their national chambers of commerce. 350 of these companies participate directly in the EBC's 28 sector-based committees.