# Over and out
BREXIT AND AVIATION

In this latest bulletin on the impact of Britain's vote to leave the European Union, Frontier's Dan Elliott explores the impact of the vote on passengers and the aviation industry, as well as the knock-on effects - in the UK and well beyond its borders. Achieving the most liberal outcome to the negotiations is of huge importance to business and consumers of all nationalities. But although it's in everyone's economic interests, it won't be straightforward to achieve.

The consequences of Brexit for aviation received relatively little attention in the public debate before June 23rd. But falls in airline share prices after the vote have brought the sector into sharper focus – as well as illustrating the wider debate on Brexit's impact.

Much of this debate has focussed on whether the UK can negotiate continued access to the single market while refusing to sign up to the EU's rules on the free movement of labour. Great emphasis has been placed by Brexiteers on the UK's ability to negotiate new trade agreements with the EU and other countries, and on the strength of the bargaining position that the UK may have in those discussions. In aviation, these expectations will rapidly be put to the test.

The immediate economic consequences for the sector seem clear enough, since there is a well-established historical relationship between economic growth and the demand for air travel. With the vast majority of economists predicting that Brexit will dent UK GDP in both the short and long term, the International Air Transport Association (IATA) is forecasting that it will reduce demand for travel to and from the UK by 3-5% by 2020. Unsurprisingly, shares in airlines particularly exposed to the UK market – Ryanair, easyJet and IAG (the holding company for British Airways) – have been badly hit in the aftermath of the Leave vote.

Figure 1 – Recent changes in IAG's share price
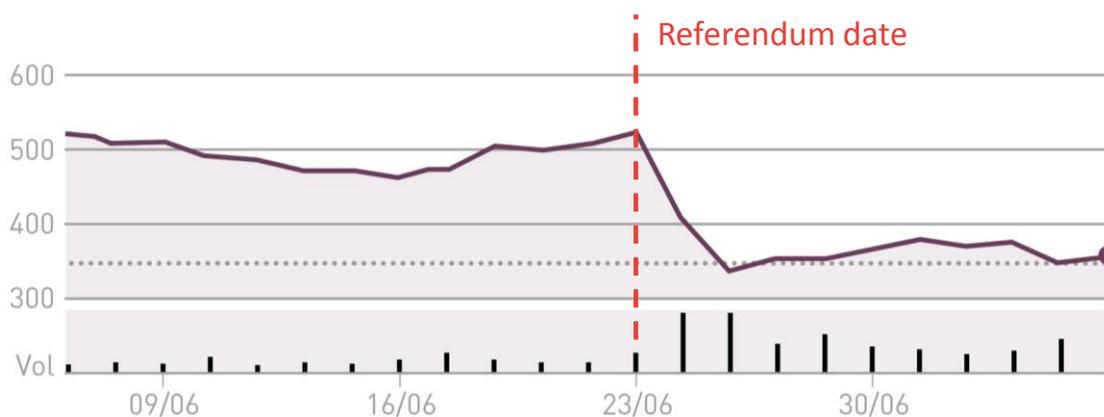
One short-term consequence of this downturn might be to raise new questions over the development of another runway in the South-East of England, a decision that should now be urgent business for the new Prime Minister, Theresa May. In fact, the case for new capacity remains strong, since the projected drop in demand is modest compared with the current capacity shortfall, let alone with the

gap projected by the UK's Airport's Commission over the next decade. However, the current state of uncertainty is not going to make it any easier to secure the necessary finance, even though all sides would now dearly like to see significant capital committed to major UK infrastructure projects in the near future, to signal "business as usual".

But meanwhile there are some big trading policy issues for governments to resolve, in the EU and beyond. As well as presenting the UK with a huge logistical challenge, these could inhibit the liberalisation of aviation markets and have a knock-on economic impact outside the aviation sector.

Traffic rights

For both historical and – most importantly – technical reasons, aviation markets are highly regulated. Airlines' rights to offer services between any two locations in two different countries are governed by specific agreements between the governments concerned. And – unusually in today's world of multinational companies – these agreements relate specifically to the nationality of the owners (at least at the corporate level) of the airlines concerned. This is an echo of the days when civil aviation was almost entirely conducted by state-owned "flag carriers", and there were security (or at least political) concerns about allowing "foreign" airlines unfettered access to "our" skies.

This approach to traffic rights has not caught up with the modern reality of aviation. Today's airlines are large private corporations. And host countries' principal security concerns relate to the threat to aircraft and their passengers from hostile political groups.

As well as the national/political aspects of traffic rights, the sector is of course also subject to extensive regulation related to security, safety, air traffic management and the environment. Many of these rules are pan-global, determined by the International Civil Aviation Organization (ICAO), the aviation agency of the United Nations. Where they are not, these standards need to be agreed between the parties with the traffic rights, so that all countries know that the aircraft flying in their airspace are well-maintained, safely operated and not needlessly noisy. But they also need to make sure that the rules are not being used to block competition.

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At present the UK is a member of the European Common Aviation Area (ECAA), which includes all the EU states plus some others, including Norway, Iceland and the non-EU Balkan States. Any airline predominantly owned by companies based in a member state is free to operate anywhere within the ECAA, without any restriction as to frequency, capacity, and so forth.

By the same token, airlines owned by non-member companies have restricted rights. They can typically operate services into and out of the ECAA (in the technical jargon, these are known as the 3rd and 4th "freedoms"), but cannot carry passengers within the ECAA (business covered by the 5th to 9th "freedoms"). This illustrates the point that these so-called freedoms are very narrow. And even these permissions for "foreign" carriers are determined either by a specific agreement between that country and the EU, or by bilateral agreements between that outside nation and each member of the ECAA individually.

At present, both easyJet and British Airways count as UK-owned airlines and have UK-issued Air Operator's Certificates (AOCs). Both enjoy the full freedoms provided by the ECAA. The low-cost airline easyJet, in particular, has made full use of this freedom, as has its Irish-registered rival Ryanair. Some 43% of easyJet's services are between non-UK airports.

When the UK leaves the EU, without special arrangements the UK's membership of the ECAA would lapse; and these airlines would lose all their automatic rights to operate to, from and within the ECAA. Furthermore, their rights would also lapse on routes that are now governed by agreements between the third-party country and the EU.

Most importantly, all the rights held by UK airlines to fly to the US are governed by the EU-US "Open Skies" agreement, which would no longer automatically apply. However, it is important to note that

these rights are reciprocal. US carriers would lose their automatic rights to fly to the UK, as would other ECAA carriers.

Get a move on

The forecast of economic damage to UK-related traffic is clearly an issue for all airlines. But what about the loss of rights? For easyJet, this may be unfortunate rather than disastrous. It would not be difficult for easyJet to become an EU-based airline. It has already become clear since the vote that easyJet is courting suitors within the EU to provide it with a new home and AOC. To begin with, this might also only require a modest transfer of head office staff to a new continental base, although in the long run it would probably lead to a more significant rebasing of aircraft in mainland Europe. The UK, in short, would become more of a destination and less of a home.

IAG already has a Spanish AOC through its ownership of Iberia, and by similar moves or reconfiguration of its European network it could mitigate the effects on the group of a UK loss of unfettered access to the ECAA. But rights to fly between the UK and the rest of the world would remain an issue for British Airways, in developing its network from London.

So while the UK-owned airlines can mitigate some of the direct effects, they have clearly been affected by the uncertainty. Significantly, their Irish rival Ryanair – also exposed to the UK-specific effects, but less exposed to the wider EU rights issues – has seen less of an impact on its share price.

There is an urgent need for the UK to replace the traffic agreements that will, potentially, be lost as a result of Brexit, and it seems pretty obvious that the UK should seek continued membership of the ECAA. And it might seem reasonable to suppose that the EU would be happy to agree. But it is far from clear that the UK can gain access to the ECAA without signing up to common technical rules, which are unlikely to be a problem, and without making significant concessions on economic integration, which may be a more significant stumbling block.

The price of re-entry

There are a series of obstacles to achieving re-entry to the ECAA. First, and probably least, membership requires the UK to (re)sign up to a wide array of common regulations on safety, security, etc. This might seem to run contrary to the desire expressed in the Leave campaign to free the UK from EU "red tape". However, it hardly seems plausible that the UK would seek a bonfire of safety standards in aviation to make a point about sovereignty. Nobody is (credibly) arguing that there is too much safety regulation in aviation. And since much European regulation comes down from ICAO, it in practice applies whether the UK is in the EU or not.

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Aviation is a classic case where shared regulatory standards have huge benefits to all participants. The standards one country applies have to be acceptable to all other countries, or they will block access for the first country's aircraft. Equivalent-but-different standards are feasible, but terribly inefficient as this requires reciprocal ratification of each other's procedures, so everyone is satisfied they amount to the same thing.

A greater obstacle to the UK seeking re-entry to the ECAA is the requirement that members establish a "framework of close economic cooperation" with the EU. So membership of the ECAA cannot be divorced from the wider negotiations about the UK's relationship to the single market. Complete access to the single market is not essential, but the extent of co-operation required is not yet clear. So the central issue of the UK's attitude to the free movement of labour could yet impede its ability to stay within the ECAA.

Finally, there is the question of whether the ECAA members will agree to have the UK. On the face of it there is common interest in maintaining liberal access to European aviation markets. But it is still

possible that the EU might withhold, or at least delay, membership as part of its punishment strategy for the UK's decision.

And there is a further risk. The ECAA is a multilateral agreement between the EU and its members, which means that – at least in theory – the UK's membership may be blocked by any other member. One such might choose to block membership to protect its own airlines from the competitive threat of easyJet. So paradoxically, if easyJet were to cease to be British and become European this could actually help the UK, because it would make it clear that blocking UK membership is unlikely to yield any protectionist advantage.

If the UK does not seek, or fails to gain, entry to the ECAA, other avenues are still open to it. It could negotiate a bilateral open skies agreement with the EU. Switzerland is not part of the ECAA, but enjoys virtually the same status by virtue of a bilateral agreement with the EU. However, it should be noted that this agreement is closely tied to other agreements relating to economic integration. The recent referendum decision in Switzerland calling for restrictions on the mobility of labour will, if implemented as its stands, terminate Switzerland's traffic agreement. On the other hand, if Switzerland achieves a deal on immigration compatible with continue ECAA membership, this may beat a track for the UK.

A further option would be to negotiate bilateral deals with individual EU countries. These could be signed without any reference to closer economic ties with the EU. But the practical challenges for the UK would be huge, and it is not clear why individual member states would agree to this approach. Furthermore, it would certainly lead to the relocation of easyJet, as bilateral deals could not provide easyJet with the freedom to operate services between two EU countries, which are central to its business model.

Similar problems face the UK when it comes to transatlantic traffic rights. Again, it could try to remain a participant in the EU-US Open Skies agreement, as Norway, for instance, is. Or alternatively, the UK could seek to negotiate its own new bilateral deal with the US. But none of this is easy; and on any route, the UK would in effect be attempting to renegotiate its way back into the advantageous agreement it has wilfully chosen to leave. It is reasonable to suppose that both the EU and the US would seek to drive a harder bargain. And unless it can find its way back into the ECAA, in future the UK will be negotiating one-on-one with the likes of China and the Gulf Co-operation Council, rather than as part of a trading block of 500 million people. All reasonable expectations must be that the outcome for the UK would be worse.

So the case for seeking to remain in the ECAA is very strong. But what happens if, in the face of economic logic and its best endeavours, the UK fails to reach an agreement with the EU, or indeed with other countries, before it leaves? One answer (amongst a debatable number) is that rights would revert to those embedded in the last treaty in force prior to the EU agreements. In the case of the UK-US arrangements, this would be Bermuda II, which dates from 1977 and was last revised in 1997.

Basing modern traffic rights on a treaty that dates from a time when the landscape of aviation was completely different would be likely to cause severe disruption. So in practice, it is more likely that the UK would seek to sign simple MoUs with those countries it had failed to negotiate an agreement with, extending current arrangements until such time as a new agreement could be reached. This could work as a stop-gap, but such agreements would inevitably be time-limited, merely delaying the decision point. However, that might at least allow time for tempers to cool.

Closing doors?

The renegotiation also provides an opportunity for certain parts of the industry to push for more protectionism. This pressure could already be seen, pre-Brexit, in some of the opposition in the EU and the US to the growth of Gulf carriers like Emirates and Etihad. Agreements that fall short of true "open skies" may include restrictions on capacity and limit the scope for competition from airlines of third-party countries. In a new UK-US bilateral deal, for example, what would be the scope for other EU airlines to serve the London-US routes?

An EU "punishment strategy" might provoke UK protectionism, to the detriment of consumer choice – and lead to a reduction in pressure on prices and quality. This, in turn, would reduce international

connectivity. The link between economic growth and air travel is not one-way: business travel is an essential input into the well-functioning modern economy.

Reduced connectivity is causally linked to lower levels of trade and foreign direct investment, which can exacerbate the immediate effects of the uncertainty and the higher barriers to trade with the EU threatened by Brexit. As the diagram below illustrates, reducing connectivity costs jobs, not just in the aviation sector, but also in the sectors that use aviation.

Figure 2 – The connectivity feedback loop
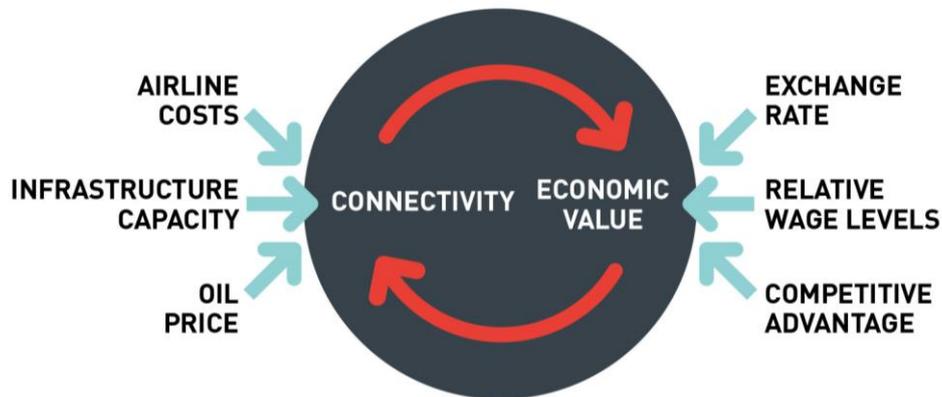
Business deals require nurturing and agreement at the human level. For all the advances in technology and communications, there remains a vital role for face-to-face contact. If a destination ceases to be served, is served less frequently or expensively, then contact will become more difficult. And while it's foolish to try to map these effects to specific transactions, they can be significant in aggregate. In the modern interconnected world of multinational companies and distributed international supply chains, you are less likely to invest in production plant or regional head offices in places that are less easy to reach. Estimates produced by Frontier, using empirically-tested models, suggest that the incremental effects of connectivity are highly significant.

These effects would be felt most strongly by the UK (and reinforce the need to get on with the new runway), but they will be felt more widely. All passengers travelling to or from the UK would be affected, along with the (substantial) proportion of transatlantic passengers flying through European hubs to connect to their final destination. UK-US routes form a key competitive constraint on other carriers flying to other hubs. Any reduction on competition on these could therefore have knock-on effects on a much wider set of routes.

Conclusions

Brexit creates huge challenges for the aviation sector, starting with the impact on demand for air travel and extending into the enormously complex web of international traffic agreements that will need to be renegotiated.

The political constraints on the UK Government negotiating Brexit, the need for other governments to ensure the UK does not "win" from its decision, and pressures from vested industry interests in other countries all mean there is a risk that the outcome will be a reduction in competition detrimental to the interests of consumers and businesses in both the UK and beyond its borders.

For the UK, securing its place in the ECAA and in the EU-US Open Skies Agreement would appear to be the key objective for the forthcoming negotiations, both to secure the long-term future of at least two major airlines as UK-centred operations and to maximise connectivity with the world at large. Delay is likely to be against the UK's interests to avoid lasting negative effects, and while negotiation of the equivalent rights through new agreements is possible in principle, that is a long and even more complicated path to follow.

This outcome is important not just to the UK but to consumers right across the EU, to maintain the momentum of growing competition in aviation markets. The EU also has an interest, if a less immediately obvious one, in seeing that US-UK routes remain in the Open Skies agreement, in order to maintain keen price competition on all transatlantic services.

As a key first step, the UK should signal early on that it is prepared to continue to conform to all the relevant international standards that underpin the ECAA. The remaining challenge will be to reach agreement on the meaning of "close economic cooperation" in a way that reconciles Brexit with membership of the ECAA. Full membership of the single market is not required, but what needs to be thrashed out is how close is close enough. In this as in so many other areas, the UK is likely to want to maximise its access to the single market, but how this will be squared with a determination to restrict the free movement of people from the EU is as yet unclear.

The most important point for all sides to remember is that less competitive aviation markets would mean higher ticket prices, further reducing demand and connectivity – creating a feedback loop that would damage the economy as a whole, and in particular those businesses that make most use of aviation. The potential, severe, knock-on effects should give all countries party to the negotiations that are about to begin reason to aim for the most liberal outcome possible.

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