A PROPOSED POLICY REGIME FOR ENSURING THE SUSTAINABILITY OF THE CARIBBEAN'S AIR TRANSPORT SERVICES SECTOR

"Looking for a Better Way"

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Prepared by the Caribbean Tourism Organisation (CTO) under the Research Component of The Caribbean Regional Sustainable Tourism Development Programme (CRSTDP)

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A. Introduction

Given the archipelagic nature of the region, it is commonly accepted that the sustainability of Caribbean tourism, and indeed Caribbean business, cannot be guaranteed without safe, reliable, efficient, easily accessible and affordable air transportation. The region's domiciled air transport sector is made up of a number of small commuter and jet airlines that are all very weak financially and continue to lose millions of dollars year after year, while most Caribbean countries experience mounting difficulty in securing the required funding for their many development needs and the attendant scourges of poverty, social turbulence and general inefficiency are ever present.

The cold fact is that Caribbean tourism has not advanced as robustly as it could due to, among other things, the high cost and inefficiency of regional air services. Caribbean tourism growth as well as growth in air passenger traffic has lagged behind the world average for the last ten years or more and even then most of that regional growth has been fuelled by the larger destinations, particularly Cancun, Cozumel, Cuba and the Dominican Republic. Urgent restructuring of the regional air transport sector, particularly in the Eastern Caribbean, for improved competitiveness and sustainability is therefore required.

A. Mandate

The Ministerial Caucus at the CTO's June 2007 *Caribbean Week* in New York selected a sub-committee comprising Antigua & Barbuda, Aruba, Cayman Islands, Curaçao, Jamaica, St.Vincent & the Grenadines and Trinidad & Tobago to review proposals on ameliorating the region's air transport services sector in order to ensure the continued development and safeguarding of the crucial tourism industry. The results of the sub-committee's deliberations would serve as the main discussion platform for a high-level conference of Ministers of Aviation/Transport, Ministers of Tourism, Civil Aviation Authorities, regional airline executives, relevant regional and international institutions and air transport experts, which would consider, amend if necessary, and make recommendations on those proposals to Heads of Government in CTO member countries.

As the World Bank indicated in its 2006 Study entitled, *Caribbean Air Transport- Strategic Options for Improved Services and Sector Performance*, …"efficiency and cost effectiveness of air transport services will be the major consideration in increasing the contribution of air services to economic development of the Caribbean region as a tourism destination."

Thus the interest of the CTO and Caribbean Tourism Ministers in ensuring that efficiency and cost effectiveness is the primary basis for this exercise.

A. <u>Objective & Challenges</u>

The main objective of restructuring the regional air transport sector is to offer the best prospects for safe and secure air services, cost-effectively, reliably, sustainably, and consistent with governments' long term economic development and fiscal strategies.

The key challenges to be explored are:

I. How can the region better manage international and intra-regional air transport in order to maintain and improve the important tourism sector and promote greater business, social and institutional integration?

II. How can the Caribbean make the most of available strategic options focused on three (3) specific areas:

a) *Improving sector policy and regulation for air services*

b) *Addressing the future role of regionally owned and operated airlines and the contribution of governments to those airlines*

c) *Promoting the welfare of the regional travelling public while safeguarding the region's business, economic and strategic interests*

A. <u>Deliverables</u>

The primary deliverables or key results to be achieved by this exercise are as follows:

1 Provide critical information to assist air transport policy development
2 Identify measures for the development of a sustainable regional air transport sector
3 Propose workable business management practices for the successful operation of regional airlines and air transportation, on a low cost, high quality basis
4 Recommend, where necessary, actual implementation plan (s)

A. Reality of Current Situation

Caribbean Tourism & Travel Trends

❑ 22.2 million (19.5 minus Cozumel & Cancun) stayover arrivals, 19.1 million cruiseship passenger visits in 2006

❑ 0.92 % overall growth below World average of 4.5%

❑ 2.3% share of World Tourism arrivals represents a declining market share although increasing in absolute numbers

❑ Multi-destination and intra-regional tourism under-exploited/under-developed

❑ Fifty–eight (58) percent of the wider region's stayover tourist visits originate from North America, while Europe accounts for 25% and intra–Caribbean arrivals make up 6.5% of the total

❑ Cruise tourism share of total arrivals steadily increasing

❑ Dismal financial performance of regional airlines over last 5 years, whether privately owned or not:

! *AJ lost US$700 million during ten years of privatization (1994-2004) and US$ 136m in 2005, US$252 in 2006 =* **US$1088**

! *Caribbean Airlines (formerly BWIA) loses tens of $millions, restructures but with reduced regional schedules. It is now targeted for privatization*

! *Bahamasair has lost over $250 million since 1990*

! *'Merger' of Caribbean Star and LIAT is ongoing but fares have increased substantially and that has negatively affected intra-regional travel as well as connecting traffic from the region's primary tourism source markets in Europe and North America*

! *Reduced baggage allowance while also instituting other charges for services like connecting flights*

! *Non-fare travel costs also up sharply*

! *Combined regional losses >* ***US$1.6 billion***

! *Fiscal impact (direct & indirect) on relevant governments tremendous: estimated at* ***US$ 2.1 Billion*** *over 5 years in CARICOM alone*

! *Leaves less money for tourism and other sectoral development*

❑ Ownership and Profitability not necessarily linked; efficiency of operations whether public or privately owned is key!!

❑ Many islands/countries, many airports, disparate systems & administrations, relatively few people = lack of economies of scale

❑ Relatively liberal approach to Air Service Agreements (ASAs) with 3rd countries {Canada, UK, USA etc.} but fairly restrictive within region e.g. CARICOM Multilateral Air Service Agreement (MASA) does not now allow cabotage rights (freedom to pick up and drop passengers between different points in another member country)

A. Context and Empirical Evidence

Caribbean development is now at a crossroads. Adjusting to the realities and demands of a rapidly changing world necessitates a much clearer focus on improving growth and competitiveness while moving to a new level of development. Globalization and the information era dictate that governments must find new and creative ways to meet the mounting expectations of a more knowledgeable people. In the region, this would mean, among other things, reducing the usual dependence on traditional markets for goods (trade preferences) and services (travel & tourism). Economic strategy would therefore have to be more forward thinking and must be formulated and implemented at both national and regional levels if the region's small states are to effectively exploit new potential sources of growth. Significant infrastructural development (physical {public & private} as well as in infrastructure for providing services) would be required to enable the Caribbean to become more competitive in higher value service industries and to enhance its declining market share in the global tourism sector.

The following realities in respect of air transport services need therefore to be considered as the region seeks to enhance the competitiveness of its tourism product through, inter alia, reforming the vital air transport sector.

❑ Regional airline monopoly (s) may benefit individual carriers and their shareholders but does not necessarily promote the general welfare and economic development of the region

❑ Empirical evidence indicates that blanket subsidization and support for inefficient airlines create a "moral hazard" (disincentive to increase efficiency) and hinders investment from more competitive providers

❑ International competitiveness of tourism industry is crucially affected by air transport re:
   - Price: affects demand, competitiveness and net spend in destination;
   - Connections: availability, convenience and ease of access
   - Brand recognition: reputation, value-for-money perception, reliability, service quality, efficiency
   - Safety record (perceived or real)

❑ Efficiency and reputation of regional carriers would best be promoted through regional market integration (removing artificial barriers in order to achieve critical mass), functional cooperation (pooling resources and minimizing costs) and deeper alliances (single frequent flyer card would generate greater demand; interlining would facilitate seamless connections both internationally and regionally)

❑ Evidence from international experience supports the view that a policy of liberalization is effective in securing cost effective, reliable and quality air transport services in most cases

❑ Competitive forces and technological change in the industry (smaller, more efficient aircraft) increase the opportunity to provide services to various markets at a profit. This holds true inter alia in the Caribbean sub-region where recent empirical evidence suggests:

- Lower fares from the United States to destinations adopting an "open skies" regime compared to those that do not;
- Examples include Aruba, Chile, Dominican Republic, Jamaica
- Some examples of where private sector airlines are able to profitably service small island/country markets include Cape Verde Islands in West Africa; Zambia, Montserrat (WinAir); Seychelles and Belize

1   In Cape Verde there has been a successful exercise to contract out inter-island passenger services on a competitive, least subsidy basis. This has apparently engendered an increase in the frequency and reliability of services, and the cost to the public purse has been reduced

2   The cases of Win Air to Montserrat and Air Caraibes to Dominica are cited as examples where private sector driven supply in thin markets may be possible even without subsidy if freedom is allowed on frequency of service and type of aircraft (though evidently if countries want to specify a higher level of service they may have to pay through a subsidy or otherwise for that service)

3   The example of Zambia is intended to illustrate the fact that the demise of a single, state-owned carrier does not have to doom a country to inferior service - in fact in this case, just the opposite happened as more frequent, competitive services are provided on domestic and regional routes than ever before

4   The Aruba experience as a whole could be very useful as far as illustrating the impact of "open skies" in the Caribbean: Before the Open Skies Agreement with the USA, American Airlines was the only scheduled USA carrier with around 33% share in total air passenger arrivals. After the agreement, other airlines namely Delta, United Airlines, Continental and US Airways, started to operate on a regular (scheduled) basis, together with American Airlines accounting for

64.4% of total passenger arrivals in 2004. In addition to scheduled carriers, at least 5 chartered companies and 3 all cargo carriers are serving the market. The number of passenger arrivals to Aruba by charters increased 3.6 times in 1998 following the implementation of the Open Skies agreement.

5   There are few cases where the public sector has been able to run an airline efficiently and profitably [Singapore Airlines & Emirates]; those Governments do not engage in management decisions but simply set a clear policy framework and regulatory environment within which those airlines are allowed to operate on purely commercial principles

6   A number of airlines in the Caribbean region are partly or wholly publicly owned. These airlines are generally undercapitalized and are facing serious operational and financial problems with consequent negative impacts on the quality and reliability of regional services

7   Theory and experience strongly suggest that markets for air travel and air cargo should be competitive. Existing or new commercial airlines will serve markets that are expected to be profitable. The more efficient the airline, the smaller the market that can be profitably served. There are risks, like in any other market, and exit as well as entry of airlines is a fact of life. Inefficient airlines or those without access to on-going funds [under-capitalised] will always be at risk.

8   Experience in the U.S.A, Europe and even the Caribbean has shown that eliminating government-imposed economic barriers to entry into the airline market can generate considerable economic benefits. Indeed, the process of regulatory reform in aviation is often cited as one of the most visible benefits of microeconomic reform, particularly in the EU. Such policy reform has seen the rapid expansion of airlines using a new business model, the so-called low cost carriers [LCCs]. These airlines are taking advantage of more efficient aircraft with expanded capacity – as well as of lower fixed costs - with the result that air fares are falling in real terms.

9   It has been said that de-regulation in the U.S.A. has resulted in airfares being 24% lower than if the market was still regulated. In addition, an Oxford Economic Forecasting study suggests that increasing air connections by 10% increases long run GDP by 3.7%.

A.   Proposed Policy Regime

The strategic response to the current situation, which was described above, must build on the region's strengths and recognize the realities; Industrialization in the region is a most difficult proposition given the relative lack of financial, natural, technological and technical resources. **Tourism** is perhaps the most internationally competitive product in the Caribbean and therefore a strategy for development of tourism and other services is required. **If the region continues to do the same things that it has always done in respect of air transport it cannot expect different results!** The following proposals for the urgent reform of the Caribbean's air transport sector are presented thus:

- ❑ Caribbean nations with ownership interests in regionally based airlines would be well advised to adopt clear and appropriate policies and to take necessary actions to allow such airlines to compete, to become profitable and to earn appropriate returns

- ❑ Open-ended, non-transparent and unpredictable government support for these airlines should not continue. A formal ownership agreement between each government and the airline board could be struck covering, inter alia: target rates of return; lines of business; risk management policy; dividend policy; Board accountability to the government; and financial support from the government necessary to implement the policy

- ❑ No regional or national airline should have an inherent right to survival. The only inherent right to be safeguarded should be the right of Caribbean nationals and visitors alike to competitive, efficient, reliable and value-for-money airline services

- ❑ Governments should adopt – and disseminate – appropriate civil aviation policies that, inter alia, provide for the elimination of economic entry barriers, including ex-ante fare control

- ❑ International evidence suggests that there are many countries adopting liberal air services policies that have recognized the importance of securing social services (public service obligation). There are a number of working schemes in place for addressing this need, though relatively few so far in developing countries. Caribbean nations would be advised to adopt appropriate policies in regard to public service obligation, which would underpin, for example, the award of subsidies to airlines for selected routes and services on the basis of a competitive process (that is to ensure competition *for* the market as in done currently in Montserrat or the Cape Verde Islands) where "competition *in* the market" cannot be sustained. The policy should clearly establish inter alia: objectives; target beneficiary groups or communities; payment arrangements; and performance monitoring

❑ The foregoing reform strategy must attempt firstly to remove the artificial barriers and divisions between the islands and countries in the Caribbean, starting first with the Eastern Caribbean and gradually moving to the wider Caribbean. The strategy must ignore colonial, language and political differences and seek to build natural alliances as for example between Dominica, Guadeloupe, Martinique and St.Lucia; between Trinidad & Tobago, Barbados, Grenada, Guyana and St.Vincent & the Grenadines; between The Bahamas, Cayman Islands, Haiti, Jamaica, and the Turks & Caicos Islands; between Antigua & Barbuda, British Virgin Islands, Montserrat, St.Martin/St.Maarten and St.Kitts & Nevis. Those smaller groups of islands can strive to make things work well between them and then join with the other groups in a bigger alliance. In that way we would be making small but more realistic steps towards eventual full Caribbean integration.

❑ The strategy would also allow the region to optimize the use of existing international hubs in the region as is done, for example, with the San Juan, Puerto Rico hub between the region and the USA. Similar hubs could be explored and exploited with European hubs in (i) the French Antilles (Martinique & Guadeloupe into France and continental Europe); (ii) Netherlands Antilles (Aruba, Curaçao and St.Martin into Holland and continental Europe); (iii) Cuba and Venezuela into Spain, Italy and continental Europe. This would widen the options available to potential travellers between Europe and the Caribbean particularly as airfares from the English speaking Caribbean to the traditional European hub in the UK are, in general, significantly higher than those mentioned alternatives

❑ This would be a good platform on which to begin the process of air services cooperation, gradual liberalisation, and harmonization within the region with a view to creating **one single regional air space**. The region must begin to see itself as a single market, a single economic space, a single tourism destination and a single air space if it is to realize its true potential. Presenting the world with a single market of seven (7) million, or even 35 million people if Cuba, Dominican Republic and Haiti are added, is certainly more sensible than several small islands, some with no more than 10,000 people, doing it alone. The reform agenda for air services would be greatly helped by a new attitude that sees the Caribbean as one large space instead of several isolated small ones.

❑ It would also be useful to integrate the proposed air services strategy into a wider transport strategy that allows marine and riverine transport services including, where feasible, fast ferry services to complement air transport services

H) In summary, securing the future of air transport services in the region would require some basic as well as some more complicated measures to be put in place. The key policy recommendations include:

1. Adopt and implement measures aimed at the creation of a single air space within the region
2. Upgrade/Amend CARICOM MASA and, where feasible, promote harmonization of similar policies throughout the region
3. Common safety oversight systems across CARICOM, then Caribbean
4. Negotiate "open skies" collectively with US, UK etc. and ensure "Community of Interest" principle
5. Effective policy & Regulatory capacity still required and exchange of ideas, resources and expertise should be arranged
6. Efficient, effective, hub & spoke operation, where required, must be facilitated
7. Ensure FAA Category 1 status across the Caribbean
8.
9. Adopt clear, prudent policies for supporting regional airlines
10. Effective capital structure for all regional or national airlines [Properly capitalize domiciled airlines]
11. Purely commercial mandates must govern the operation of regional or national airlines in order to allow them to succeed [Maintain strong, efficient business model for airline operations]
12. Competent market-driven management must be in place for all airlines
13. Performance-based staffing is required
14. Sensible functional cooperation among regional airlines
15. Regional airlines must be allowed to fly internationally from any Caribbean airport and must also be allowed to fly between any airports in the Caribbean (cabotage)

A. Best Practice Airline Management

Some of the key recommendations for facilitating proper airline management are suggested thus:

❑ Airline management decisions should be left entirely in the hands of the airline executives while the Boards of Directors and shareholder governments concentrate on monitoring and ensuring adherence to previously agreed strategic and corporate policy

❑ Airlines in small, resource poor developing countries should readily embrace new technologies that help overcome economies of scale, as these would create a more level scenario for competition with larger carriers. Governments should therefore provide the necessary facilitating environment [removal of administrative, legal and fiscal disincentives] to facilitate the acquisition of those technologies. Those technologies include:

- 100% move to electronic ticketing; this is estimated [IATA] to lower operating costs by about 10 %

- Implementation of the Common Use Self Service System [CUSS]; IATA estimates that this would cost US$0.55 per person as compared to the current US$4.50 with the traditional check-in system and would process 40 persons per hour as compared to the current 18-20 persons per hour

- Adoption of bar code boarding passes(BCBP), which would enable home check-in and would thereby increase efficiency, reduce airport check-in congestion and lower airline processing costs

- Use of Radio Frequency Identification Detector [RFID] baggage systems in order to significantly enhance baggage handling processes and ultimately reduce costs

- Implementation by all regional airlines of a common frequent flyer card similar to the One World Alliance (AA, BA, Cathay Pacific, FINNAIR, Qantas, LAN etc.); Revenues from One World Alliance fares and sales activities increased by more than 10% in 2006 to almost US$675, helping its partners to remain the most financially sound grouping of airlines.

In conclusion, it is worth underscoring that reform of the critical air transport sector would be based on the enabling framework of a single regional air space and travel market so as to exploit economies of scale and scope as well as to ensure efficiency and competitiveness of the region's air services and tourism sectors. Additionally, it goes without saying that adequate capitalization; strategic business planning; competent market-driven management; equally competent staffing; optimal use of technology; prudent functional cooperation, networking and forging of alliances; optimal fleet, revenue and route management; efficient cost structures and visionary leadership are some of the key ingredients for the successful operation of Caribbean-based air transport service providers. Regional policy-makers may wish to adopt, as soon as practicable, the foregoing recommendations if the objectives of air transport services reform and the goal of enhancing the economic development of the region and that of its people is to be realized.

A. Implementation Matrix & Timelines

That section would depend on input from and further discussions with Ministers, civil aviation Authorities and airline executives and would therefore be done at a later date.
J)