

UK Aviation

No Open Skies Post Brexit

DECISIONPOINT™
— by WNS

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U.K. AVIATION: NO OPEN SKIES POST BREXIT

SUB-HEAD: AN AVIATION SECTOR IMPACT ANALYSIS

The United Kingdom's (U.K.) aviation sector forms the backbone of its transportation services industry. It has the largest share in the U.K.'s global trade in transportation services, constituting GBP 16,500 Million worth of exports and GBP 13,500 Million worth of imports in 2015.¹ Aviation services also enable wider economic growth, serving the business passenger, accessing suppliers in foreign and domestic markets and transporting cargo. In 2016, the total number of terminal and transit passengers across all U.K. airports was approximately 268,492,426. The total freight carried from all major U.K. airports was approximately 2,385,230 metric tons.²

The European Union (EU) is the single largest destination market for the U.K. in aviation. The EU accounted for 65 percent of international passenger movement and 54 percent of scheduled commercial flights in 2015 from major U.K. airports³, surpassing the United States (U.S.) and Japan.

This EU-U.K. partnership in aviation is built on a framework of a single regulatory regime that governs all the EU Member States. However, with the Brexit negotiations underway, this mutually interdependent trading relationship between the two regions in the aviation market will need a new strategic direction in order to be able to sustain itself.

1. Office for National Statistics, The Pink Book: 2016, Chapter 3.2 Trade in services, July 29, 2016.

2. U.K. Civil Aviation Authority.

3. U.K. Civil Aviation Authority.

THE SINGLE AVIATION MARKET

The EU's internal aviation market is based on a framework of three 'pillars' or 'packages', which ensure the smooth functioning of the trade in aviation services across the EU Member States.

The first package, introduced in 1987, covered intra-EU traffic, limited the right of governments to reject the introduction of new fares, and gave some flexibility regarding seat-capacity sharing.

The second package, introduced in 1990, further expanded the market, allowing greater flexibility over fares and capacity sharing. This package permitted EU airlines to ferry an unlimited number of travelers and cargo between the home country and another EU State.

The third package, introduced in 1993, removed all the remaining restrictions on airline operators in the EU, creating the concept of a 'Community Carrier' to replace national airline carriers. 'Community Carriers' could access any intra-EU route and offer services to customers without seeking prior approval from the regulatory authority of the Member States. Correspondingly, an airline based in the U.K. can offer routes between other EU Member States (without having to fly via U.K.), and domestic routes in other Member States, in addition to routes served between the U.K. and EU Member States.

In order to be a 'Community Carrier', airlines have to comply with the following requirements:

- They have to be owned (greater than 50 percent ownership) and effectively controlled by an EU Member State, and their principal place of business has to be located in a Member State.
- They have to ensure the safety of their operations in accordance with the EU's safety regulations by obtaining an 'air operator's certificate'.⁴

Common EU rules have also been adopted in areas spanning competition, safety, security and environmental protection in aviation, such as those relating to the Single European Sky and the European Aviation Safety Agency (EASA).

EU membership also forms the basis of U.K. airlines' access to aviation markets in third countries. At present, the U.K. has 111 bilateral air service agreements, which are complemented by EU level agreements, including those with the U.S. and Canada.⁵

4. European Union Committee, Brexit: Trade in non-financial services, March 2017i.

5. Ibid.

FREEDOMS OF AIR AND BREXIT

In 1944, the Convention on International Civil Aviation, known as the 'Chicago Convention', was established as the most important primary source of public international aviation law. The law outlines 'freedoms of the air',

defined as traffic rights granting an airline of one country the privilege to enter another country's airspace and land in its territory.⁶ These freedoms of air form the backbone of airline movement between the U.K. and the EU.

Exhibit 1

Freedom of Air	Description	Affected by Brexit?
First Freedom	Right or privilege granted by one Member State to another State to fly in its territory without landing	No
Second Freedom	Right or privilege granted by one Member State to another State to land in its territory for technical and maintenance purposes without picking up or dropping off passengers	No
Third Freedom	Right or privilege granted by one Member State to another State for passage of traffic coming from the home State of the carrier	Yes
Fourth Freedom	Right to fly from a foreign country to one's own country	Yes
Fifth Freedom	Right to fly between two foreign countries in a carrier originating or ending in one's own country	Yes
Sixth Freedom	Right to transport traffic between two foreign countries via the home State of the carrier	No
Seventh Freedom	Right to transport traffic between the territory of the granting State and any other State without any requirement for the service to connect to or be an extension of any service to/from the home State of the carrier	Yes
Eighth Freedom	Right to transport cabotage* traffic between any two points in the territory of the granting State which originates or terminates in the home country of the carrier or outside the territory of the granting State	No
Ninth Freedom	Right to transport cabotage traffic on a service operating entirely within the territory of the granting State	Yes

*Cabotage is defined as a not-for-hire flight between two points within a foreign country, carrying residents whose travel begins and ends in that country, and is not remunerated.

Source: EU Parliament Briefing 2016; WNS DecisionPoint™ Analysis

Out of the nine freedoms of air, U.K. airlines stand to lose five freedoms which allow them to operate services between the EU and U.K. without any disruption.

6. EU External Aviation Policy, European Parliament Briefing 2016.

OTHER LEGAL CONSIDERATIONS AND BREXIT

In addition to the loss of majority of the freedoms of air, U.K. airlines are confronted with a host of other legal and regulatory issues that ought to be considered carefully.

In order to operate as full-fledged community carriers in the EU, U.K. carriers will have to ensure that 50 percent of their ownership is by EU nationals. Once Britain leaves the union, low-cost airlines such as Ryanair and EasyJet are set to breach a strict condition of their European licenses and flying rights. Dublin-registered Ryanair is 60 percent owned by EU nationals, but this will drop to 40 percent once the U.K. shareholders are excluded.⁷ EasyJet is now 84 percent owned by EU nationals, but this will fall to 49 percent after Brexit, provided the shares of founder Stelios Haji-Ioannou – a dual U.K. and Cypriot national – are categorized as EU-owned.⁸ Mr. Haji-Ioannou's shares have been accorded a U.K.-owned status to meet the airline's own restrictions on ownership. But if this continues, EasyJet's shares will be just 16 percent EU-owned.⁹

Both Ryanair and EasyJet have outlined extraordinary provisions in their articles of association to force investors to sell up, should they fail to lift their shareholder base above the 50 percent threshold. International Airlines Group (IAG), the parent company of British Airways, also has provisions to force non-EU shareholders to divest within 10 days in the event of their license coming under threat. Under their company rules, Ryanair, EasyJet and IAG can issue a 'restricted share notice' to non-EU shareholders, depriving the

holder of the right to attend, vote and speak at general meetings, and requiring the holder to sell the shares to an EU national within a set number of days.¹⁰ The prospect of such mandatory share sales is one of the many legal problems facing the industry in the wake of Brexit as Britain attempts to reframe its access to the EU and other international aviation markets. The divestiture clause exists because non-compliance with EU ownership rules will result in the suspension of the carrier's operating license. This would imply loss of rights or privileges to operate services carrying passengers, mail and cargo in the EU single market.

Other pressing issues include whether type (airworthiness) certificates for aircraft, engines and other airline parts issued by the Civil Aviation Authority will be recognized by the EASA as equal. One of the pillars that forms the basis of the Brexit referendum is complete independence from a common EU legal regulatory framework across sectors. Hence, once the U.K. is formally out of the EU, U.K. carriers will no longer be under the jurisdiction of the EASA.

Another aspect to be considered is the Wet Lease agreement. Under the agreement, the aircraft is operated under the Air Operator's Certificate of the lessor. Will U.K. airlines be able to continue to wet-lease aircraft to other carriers into the EU freely? The license to wet-lease aircraft to other carriers in the EU is dependent on the final aviation deal the U.K. strikes with the EU.

7. Financial Times, 'Airline investors face forced share sale after Brexit', January 2017.

8. Ibid.

9. Ibid.

10. Ibid.

ASSESSING OPTIONS FOR U.K. AVIATION INDUSTRY UNDER BREXIT SCENARIOS

With the U.K.'s imminent departure from the EU, what options does the U.K.'s GBP 60 Billion aviation industry have? The table below outlines the framework that could take shape under each Brexit scenario.

Brexit Scenario	Implications for U.K.	Implications for U.K. Aviation Industry
Soft Brexit	<ul style="list-style-type: none"> U.K.'s full participation in one of the key areas of the single market and European Common Aviation Area (ECAA) Free movement of people, goods, services and capital between the EU and U.K. Continued jurisdiction of the European Court of Justice 	<ul style="list-style-type: none"> Acceptance of the EU aviation acquis, which is against the basic principles of the Brexit referendum ECAA membership might not grant continuing access for U.K. services to third countries No direct say over the ECAA's ongoing policy formulation or future development Membership of the EASA Management Board without voting rights
Hard Brexit	<ul style="list-style-type: none"> U.K.'s complete departure from the single aviation market Restricted movement of people, goods, services and capital Independence from the jurisdiction of the European Court of Justice and other single regulatory regimes 	<ul style="list-style-type: none"> Creation of a U.K.-EU Bilateral Air Services Agreement EU's agreements with third countries, including the U.S., would cease to apply to the U.K., thereby requiring U.K. to negotiate a whole new set of bilateral air services agreements with the U.S. Alignment of the laws of the Civil Aviation Authority with those of the EASA

Source: WNS DecisionPoint™ Analysis

According to the Airport Operators Association, only one EU multilateral air services agreement has been extended to the European Economic Area (EEA) countries – the EU-U.S. Open Skies Agreement – and that too only by mutual consent of both the

signatories. This grants the right to operate services between any point in the U.S. and any point in the European country with no restrictions on intermediate and final points of destination. The Irish subsidiary of Norwegian Air had been blocked from access to the

U.S. aviation market even though access should have been allowed under the Open Skies agreement. Hence, negotiating a separate agreement with the U.S. and other countries looks far from easy for the U.K. aviation industry.



Further, the interest of the Member States in any bilateral agreement is contingent upon the U.K.'s share in their respective domestic aviation markets. In Ireland and Cyprus, the U.K. represented 50 percent of the seats, whereas in France and Germany, it was less than 10 percent.¹¹ The International Air Transport Association (IATA) noted that Swiss Airlines, despite a series of bilateral air services agreements granting them the right to operate services between two Member

States, couldn't operate carriers on domestic routes within a Member State.

A number of U.K. airlines are now looking to set up EU-based subsidiaries which would enable them to carry on their European operations after Brexit. In July 2017, EasyJet announced that it will establish a new Vienna-based airline to carry on its European operations after Brexit. The establishment of EasyJet Europe

will allow the low-cost airline to keep running flights across the continent and within European countries regardless of the outcome of talks on a future U.K.-EU aviation agreement.¹² It also stated that it was in the advanced stages of receiving an Austrian Air Operator Certificate and airline operating license, and expects to secure them in the coming months.¹³

11. European Union Committee, Brexit: Trade in non-financial services, March 2017.

12. Financial Times, 'EasyJet to set up Austria-based airline to run EU flights after Brexit', July 2017.

13. Ibid.

POTENTIAL RISKS AND SCENARIOS IN CASE OF A 'NO DEAL'

In the event of the U.K. leaving the EU without any bilateral agreement in place with third countries such as the U.S., the U.K. has the option to fall back on the Bermuda II agreement (which predated the Open Skies agreement) with the U.S. In simple terms, the agreement imposed restrictions on the number of entry points, or 'gateways', in the U.S. which could be served from London.¹⁴ However, this agreement is extremely restrictive and both the U.K. and the U.S. will try to secure a liberal bilateral agreement fairly quickly.

The issue of Gibraltar is also a potential deterrent to Brexit negotiations. Spain has repeatedly pushed for Gibraltar to be excluded from the Single European Sky II agreement. The Gibraltar airport has expressed concerns about being potentially excluded from current and future arrangements between the U.K. and the EU. However, the U.K. is an important aviation destination market for Spain and, hence, it will have an interest in ensuring that negotiations on air trade services between the U.K. and the EU take place as smoothly as possible.¹⁵

Leaving the EU without a bilateral agreement in place with Member States would disrupt important trade and tourism links for the U.K. The IATA has highlighted that these bilateral agreements could take 'longer than 2 years' to negotiate, with the European Commission still struggling with a backlog of incomplete mandates

with countries such as China and India.¹⁶ In contrast with other sectors, the aviation sector is not covered under the World Trade Organization rules, and hence, there is no 'fall -back' option for the U.K. aviation industry. It is also questionable whether any bilateral agreements concluded with individual Member States in the past would still remain valid, since these were in place before the EU extended its hold on aviation matters and, hence, are at a risk of being considered outdated and not fit for purpose. In case of Spain, there is no right to fly as the bilateral agreement between Spain and the U.K. has been repealed.

14. U.K. Parliament, Select Committee on Environment, Transport and Regional Affairs.

15. European Union Committee Brexit: Trade in non-financial services, March 2017.

16. Ibid.

OUTLOOK FOR PASSENGERS CARRIED FROM U.K. TO EU: HARD BREXIT VS. SOFT BREXIT

The U.K.-EU passenger traffic has risen drastically in recent years owing to booming inter-regional trade and leisure and tourism services in both the regions, with the distance between the two facilitating movement of passengers for both business and leisure. However, in the last one year, the total number of passengers carried by all major airlines from the U.K. to the EU grew at a rate lower than that of 2015, declining to 3.6 percent in 2016 from 6.6 percent in 2015.¹⁷ Depreciation of the sterling against the euro since the Brexit referendum is one of the prime factors behind this decline, creating an upward pressure on passenger fares on flights originating from the U.K. and landing in the EU. The euro has risen by 5.03 percent against the sterling in the last one year since the referendum, exerting further pressure on the U.K. currency.

It is expected that the number of passengers carried in the near term, from 2017 to 2018, will grow at a steady rate, albeit a slow one in comparison to previous years, primarily due to a weak sterling. Continued uncertainty in the wake of the Brexit negotiations will impact the sterling's value against the euro over the next two years. Burgeoning passenger air fares due to a weak sterling will discourage outgoing passenger movement from the U.K. to the EU.

The number of passengers carried in the forecast period from 2019 to 2021 will depend on the form Brexit takes. A hard Brexit, resulting in the U.K.'s departure from the EU single aviation market and ECAA, will slow down the growth in the

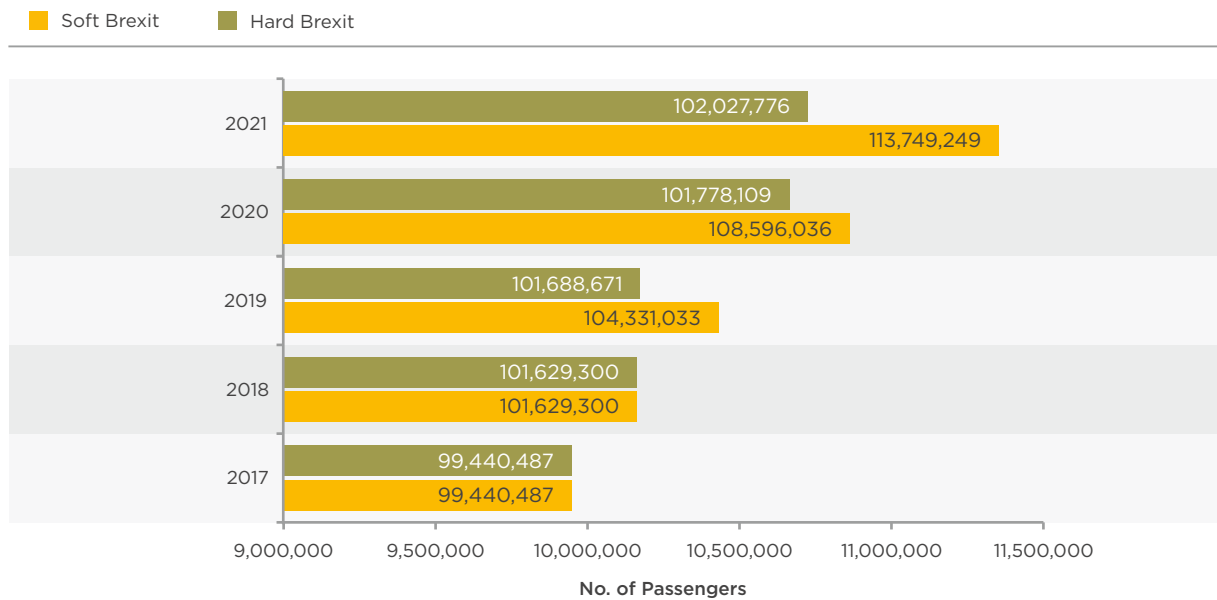
outbound passenger movement from the U.K. to the EU. Many airlines will lose the right to operate across EU Member States and from the U.K. to the EU. The situation will be made worse if the departure were to take place without any bilateral air services agreement or a temporary arrangement in place to help the U.K. aviation industry transition from the EU regime. The first half of 2019, when the formal process of Brexit is expected to be complete, can witness a drastic slowdown in passenger movement from the U.K. to the EU. Depending on how fast the U.K. aviation industry can transition itself from the EU aviation regime, passenger movement from the U.K. to the EU is expected to pick up slowly in the period 2020–2021.

A soft Brexit, on the other hand, will be favorable for the growth of outbound passenger movement from the U.K. to the EU in the forecast period 2019–2021. Continued access to air traffic routes from the U.K. to the EU, both domestic and intra-EU, will facilitate passenger movement for the purposes of business and leisure. We expect a steep rise in outbound passenger movement from the latter half of 2019 till 2021, once the final direction of the Brexit negotiations is determined and the U.K. formally departs from the EU.

17. U.K. Civil Aviation Authority, Passengers uplifted on all scheduled and non-scheduled EEA passenger services 2015 and 2016.

Exhibit 2

Passengers Carried, U.K. to EU



Source: WNS DecisionPoint™ Forecast based on data from U.K. Civil Aviation Authority and Eurostat. Passengers carried refer to all passengers uplifted on all major U.K. carriers from U.K. airports to the EEA. Includes both scheduled and non-scheduled services from U.K. to EEA.



OUTLOOK FOR FLIGHTS FROM U.K. TO EU: HARD BREXIT VS. SOFT BREXIT

The long-term forecast for the number of flights from the U.K. to the EU is dependent on the shape Brexit takes in 2019. In the near term, we expect the number of flights to grow at a steady rate. However, the period 2019–2021 will be tricky for flight carriers, since any decision on the number of flights and the domestic and intra-EU routes to follow will be made only when the Brexit deal is in the final stages.

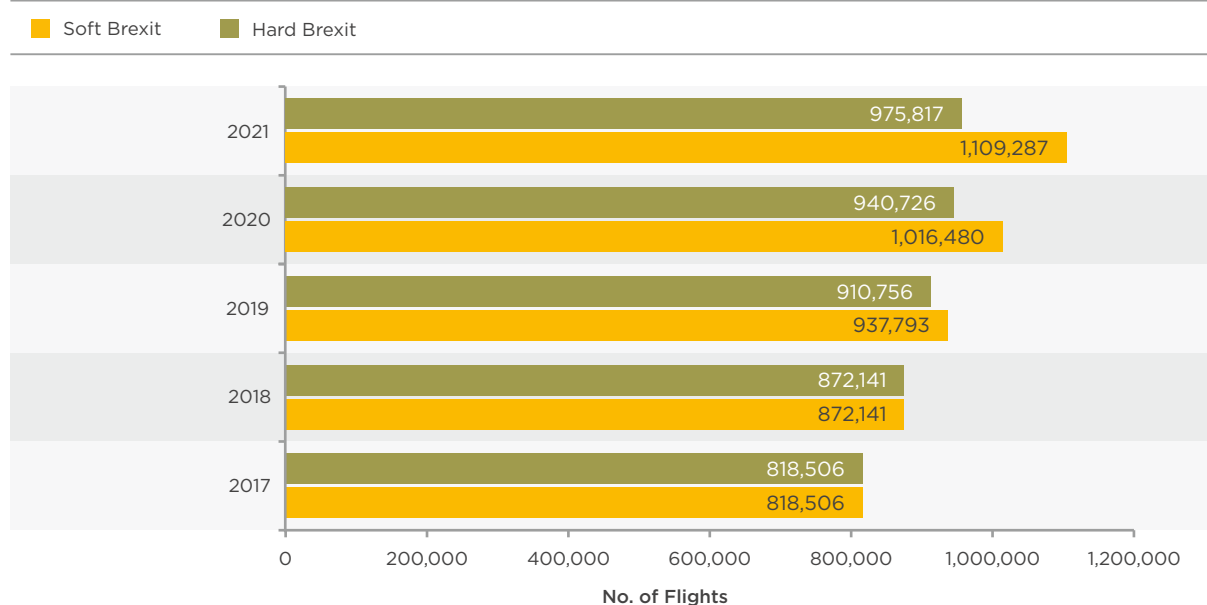
A hard Brexit, without a bilateral air services agreement or a transition arrangement, will disrupt major traffic routes and result in the loss of operating licenses and suspension of U.K. air carriers' rights to ply on intra-EU routes and within the domestic territories of the Member States. The initial few months of 2019 will be more testing for these air carriers, since

most of them will have to cancel their services from the U.K. to intra-EU territories. It is expected that a majority of these carriers, having foreseen such a scenario, would have set up EU-based subsidiaries and obtained EU-authorized operating licenses, resulting in a reduction of flight carriers originating from the U.K.

A soft Brexit, on the other hand, will ensure continuity in terms of the routes that flight carriers take, both intra-EU and within the domestic territory of a Member State. We expect the number of flights to rise at a healthy rate, albeit a slow one due to the uncertainty that will plague Brexit negotiations till 2018. The forecast period from 2019 to 2021 will witness a robust pick-up in the number of flight carriers once formalization of Brexit is complete.

Exhibit 3

Flights, U.K. to EU



Source: WNS DecisionPoint™ Forecast based on data from U.K. Civil Aviation Authority and Bank of England. Number of flights refer to total number of flights of major U.K. air carriers from all U.K. airports to EU. Includes both passenger and cargo services.

CONCLUSION

In the last few decades, the U.K. has emerged as a world leader in air services. Partnership with the EU, cemented over the years, has played a major role in contributing to the U.K.'s image as a global front runner in air services.

Membership of the ECAA and the single market in air services have been the pillars of this strong U.K.-EU alliance. The U.K. government

needs to clarify its position with regard to the aviation market during the course of the Brexit negotiations. A choice between retaining membership of the ECAA or a bilateral air services agreement with the EU as a bloc or with individual Member States has to be made in order to ensure that the U.K. aviation industry functions smoothly post Brexit. The U.K. will

also need to re-think its aviation strategy with regard to third countries, such as the U.S., which is also its single largest trading partner after the EU. Departure from the EU without a definite plan for U.K. aviation will be catastrophic not only for its own industry but also for international aviation markets spread across the globe.



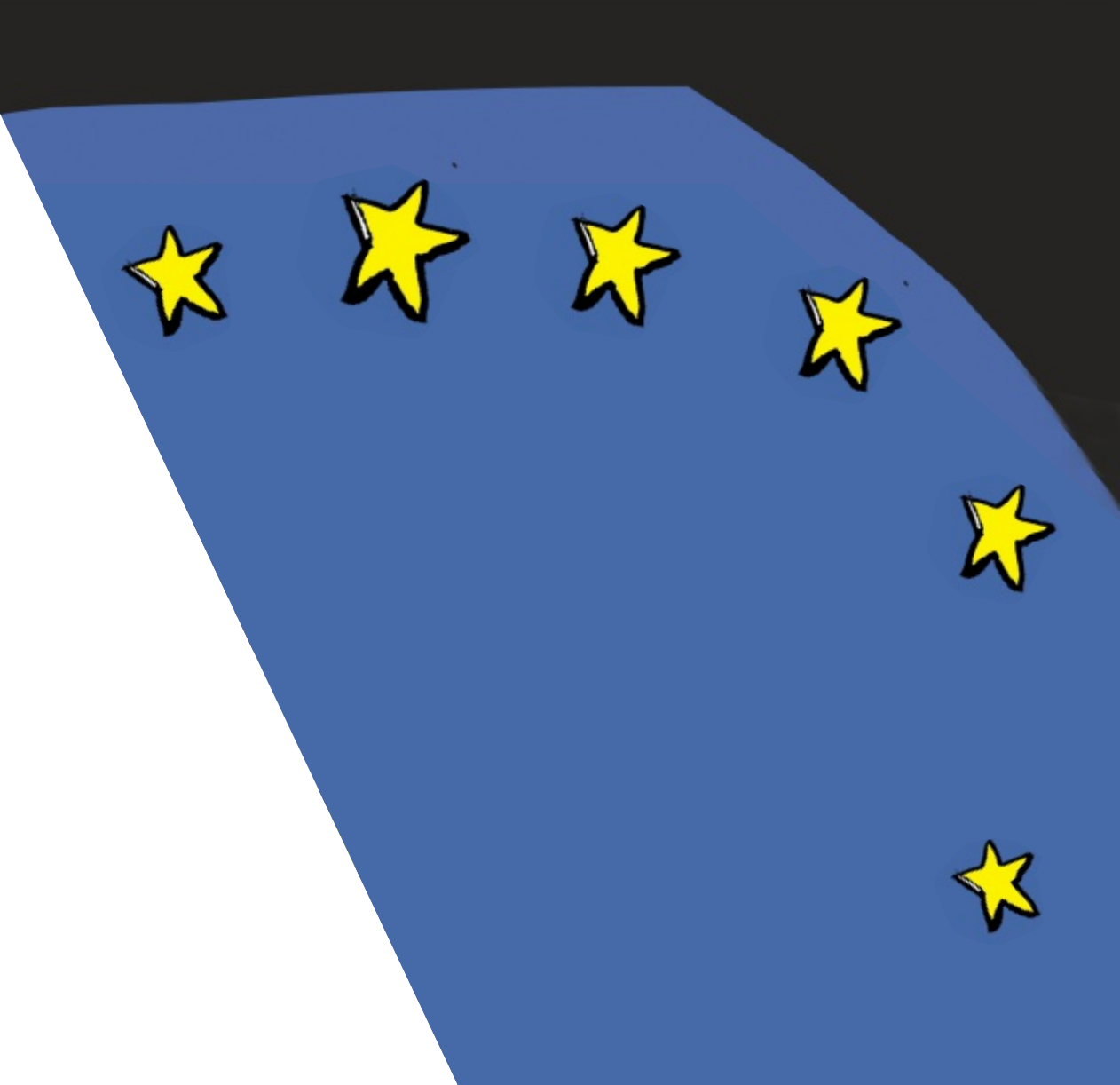
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