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COMMUNICATION FROM THE COMMISSION

**A Community civil aviation policy towards the People's Republic of China
- strengthening co-operation and opening markets.**

1. INTRODUCTION AND SUMMARY

- 1.1 The People's Republic of China, the world's most populous nation, has emerged over the past 15 years as a key player in world affairs, reflecting its extraordinary growth and economic development. China is becoming an increasingly important partner for the European Union - and vice versa - both economically and politically.

China is making continued progress in the reform of its economy. China's accession in December 2001 to the World Trade Organisation was significant and will pave the way for further market opening and foreign direct investment. In 2003, China became the EU's second largest trading partner after the US and the EU became China's second largest export market. Following EU enlargement in 2004, the EU is now China's largest trading partner.

- 1.2 The Chinese air traffic market is among the fastest growing in the world. The average annual growth rate of air travellers in China has been approximately 16% between 1958 and 2002 and high growth rates are expected to prevail until 2020.¹

China therefore offers a strong potential for growth also for airlines, aircraft manufacturers and service providers in Europe.

The 2008 Olympic Games in Beijing and the 2010 World Expo in Shanghai will provide major impetus to the restructuring and investments in the aviation sector to allow China to use these events to demonstrate an efficient and modern image to the world. However, China is facing significant challenges in this respect, notably in matching continued safety developments with the spectacular growth rates in air traffic.

- 1.3 China is taking a gradual and selective yet determined approach to market opening in civil aviation. As a consequence of the "open skies" judgements of the European Court of Justice on 5 November 2002, the bilateral agreements between Member States and China are unsustainable and need to be amended. The Commission has been given a "horizontal" mandate to negotiate with third countries such necessary corrections to bilateral agreements.

However, in view of (i) the growing importance of the Chinese aviation market, (ii) the difficulties encountered by individual Member States in seeking to bring bilateral agreements into conformity with Community law and (iii) the benefits of replacing the fragmented European approach in its relations with China with a co-ordinated and liberal approach, the Commission is of the view that it is now time to develop a wider range of opportunities between China and the Community in air transport.

- 1.4 In parallel to this Communication, the Commission therefore recommends that the Council would authorise the Commission to negotiate, on behalf of the European Community, a comprehensive Open Aviation Agreement with China. Positive exploratory contacts between the General Administration of Civil Aviation of China

¹ *The General Administration of Civil Aviation of China (CAAC), 2004*

(CAAC) and the services of the European Commission were initiated in May 2004, which may serve as a good basis for entering into formal negotiations with China.

2. THE GROWING IMPORTANCE OF EU-CHINA POLITICAL AND ECONOMIC CO-OPERATION

- 2.1 In recent years, the Chinese economy has performed spectacularly well with economic growth rates above 7% in 14 consecutive years. In 2003, China's economy grew by 9.1%, the highest level for seven years. Economic growth in some of the large urban centres, which leads China's economic development, even far out-strips the average economic growth rates.

It is generally recognised that the demand for air transport is closely linked with the development of GDP. Against this background, and in view of the improved spending basis of the growing urban middle class representing an important potential for tourist travelling, continuously growing demand for air transport in China is expected.

- 2.2 EU-China trade is growing faster than China's trade with its other two main trading partners (Japan and the US). Total trade for 2003 between China and the EU was estimated to be worth a total of €135 billion, up more than 15% on 2002. Following EU enlargement in 2004, the EU is now China's largest trading partner.
- 2.3 Buoyed by its sheer size and its nearly 1.3 billion population (22% of World population), extraordinary economic growth rates and immense potential in general, China's economic weight and political status in the world today is very different from what it was as recently as in the 1990s. A broad political dialogue between China and the EU was formally established in 1994.

Enhancing China-EU relations is an important component of China's foreign policy. In its first-ever "*EU Policy Paper*", the Chinese Government outlined in October 2003 its priority areas and plans for strengthening the China-EU political, economic and trade relations.

Improving market access and investment conditions in China is a key objective for the EU. In particular, further reform and liberalisation will help China attract foreign investment and technological know-how, and to sustain economic growth. This is true for any sector of the economy but for civil aviation in particular.

- 2.4 The Sixth EU-China Summit held in October 2003 clearly demonstrated that China now recognises the Community as such as a primary interlocutor for Europe. With EU enlargement and the process of European integration, Community-level contacts and co-ordination with the EU will become increasingly important for China as well as for the Union. This also applies to civil aviation in relation to which the EU and China agreed at the Sixth Summit that co-operation should be widened and deepened. This was confirmed in May 2004 during the visit of Chinese Prime Minister Wen Jiabao to the EU Headquarters in Brussels and further emphasised during the Seventh EU-China Summit held in December 2004. At the Seventh Summit, the possibility of a future EU-China Civil Aviation Agreement was envisaged.

3. CHINA'S GROWING IMPORTANCE IN INTERNATIONAL AVIATION – A MARKET PROFILE

China – a strategic civil aviation market in rapid growth

- 3.1 Over the past decade, the Chinese air traffic market has been among the fastest growing in the world. The average annual growth rate of domestic and international air traffic in China has been around 16% between 1958 and 2002. Total number of air traffic passengers was expected to exceed 100 million in 2004 while cargo was forecasted to reach 2.5 million tons.

Since 1990, the number of seats available on scheduled non-stop flights between the EU and China has increased from 250,000 to nearly 3 million in 2003 (+1150%).² The growth in available seats on scheduled non-stop flights to Japan, which is still the EU's largest air traffic market in Asia, "only" grew by 378% over the same period.

- 3.2 Until as recently as 10 years ago, Beijing was the only destination for European flights to China. Since then and until 2003, all flights to China have been to Beijing and Shanghai with Shanghai experiencing an extremely rapid growth now receiving more than 35% of all air passenger traffic from Europe. New routes are now being opened to a number of other Chinese cities.

Eight EU carriers currently fly passengers to China on scheduled routes while all three main Chinese airline groups (Air China, China Eastern and China Southern) fly to Europe. A total of 21 routes are now operated between China and the EU. The largest share of the non-stop traffic between the EU and China is with Germany with 38% of the total traffic, while France has 23% and the UK 9%. Of a total number of weekly frequencies between the EU and China of 141 in April 2004, Air China had a share of 28% while Lufthansa had a share of 17% and Air France 15%.

Looking forward

- 3.3 While future growth rates in Chinese air passenger traffic may be less spectacular than in recent years, they will still be impressive. The International Air Transport Association, IATA, forecasts an average annual growth of 8.6% in passenger traffic in China over the period 2003-2007. This is nearly three times the world average growth rate forecast by IATA. Cargo is generally expected to grow faster than passenger traffic.

The CAAC expects even higher growth rates for air traffic with an expected average annual increase until 2020 of 15%.

China is therefore expected over the next 10 years to become the largest Asian market and leading hub for air passenger traffic as well as for international cargo traffic thereby taking over Japan's current leading position. China's total passenger traffic is expected to increase from approx. 100 million passengers in 2004 to 215

² Source: OAG schedules

million passengers in 2014 thereby increasing its total share of Asian-Pacific air passenger traffic to 25% up from 10% in 1985.³

Approved destination status

- 3.4 One of the key drivers in Chinese air traffic demand and development will be tourism. International tourist arrivals to China grew by 11% in 2002, making China the fifth largest recipient of tourists in the world. Chinese outbound tourism amounted to 20 million tourists in 2003 (+22% year-on-year) overtaking Japan to become Asia's largest source of tourists. It is estimated that by 2020 the number of Chinese outbound travellers will have reached 100 million.

To facilitate and attract visits of Chinese tourist groups to Europe, the Community and the Chinese government signed in February 2004 a Memorandum of Understanding under which the Community will enjoy an "Approved Destination Status" (ADS). Chinese tourist groups are only allowed to travel to countries which have been granted ADS by China. Until now, private tourism from China to the EU has not been possible.

The ADS scheme will ease the process of visa applications for Chinese tourist groups wishing to visit Europe.

The implementation of the ADS scheme is expected to generate significant numbers of new Chinese tourists visiting Europe. This will have profound implications on airline and airport capacity with airlines already adding capacity to China to meet increasing demand.

4. TRENDS IN CHINESE AVIATION POLICY - OPENING SKIES

- 4.1 China's civil aviation sector is undergoing considerable change these years. The transformation of the Chinese civil aviation sector appears to be a gradual move away from central planning towards a combination of decentralisation and globalisation.

Aviation developments and policies in China are characterised notably by the following key features:

- Consolidation of the airline industry into three main airline groups
- Emerging liberalisation and market opening both internally and externally
- Development of new airport infrastructure and air traffic management technology

Each of these features will briefly be examined in the following.

³ "Asia/Pacific Air Traffic – Growth and Constraints", Air Transport Action Group (ATAG), 2001

Consolidation

- 4.2 In the mid 1990s, Chinese aviation industry was characterised by poor safety records with serious accidents. In addition, over-capacity led to intense price-cutting and fierce competition in the domestic market which restricted international expansion. This led the government to pursue a policy of consolidation and price control of the largely state-controlled airline industry. Following only modest progress in the restructuring in the late 1990s, the CAAC announced in July 2000 that the 10 carriers under its direct administration would be merged into the three main airline groups. As a result of this, three airline groups with similar numbers of aircrafts (ca. 100) and assets (ca. USD6bn) have emerged centred around three main geographical centres: Air China (Beijing), China Eastern Airlines (Shanghai) and China Southern Airlines (Guangzhou).
- 4.3 The three main airline groups account for about 80% of flights in China. The consolidation of the airline industry has created profitable operators with strong balance sheets, which have been able to expand and compete internationally and attract foreign investment and partners. Chinese airlines have traditionally had a domestic focus with only 13% of total passengers carried by the top 5 Chinese airlines in 2002 being international traffic.
- 4.4 The once fully state-owned airlines are now listed on the stock markets and being partly privatised. The direct control over the state shareholding in the airlines has been transferred from the CAAC to other government agencies and the CAAC is now solely focusing on its regulatory role.

Market opening

- 4.5 China is clearly signalling its intention and willingness to open its domestic and international air transport markets to more competition. The CAAC has announced that it will progressively open mainland China air traffic rights to foreign carriers including more cabotage rights and encouragement of more foreign carriers to fly to China and more mainland carriers to serve foreign cities.
- 4.6 CAAC intends to liberalise the Chinese aviation market in three phases which by 2010 should have led to an opening of 70-80% of the air transport industry.

CAAC is also progressively deregulating air fare pricing to give airlines greater flexibility in setting fares according to market demand.

Reports that the CAAC is also welcoming low-cost airlines as a strategy for boosting middle class tourism and economic development in Western China is a further significant sign of liberalisation.

As a result of its new policy, CAAC has signed a series of increasingly liberal air services arrangements with third countries including Singapore, Thailand, Australia and most recently the US. Often the cargo services are leading the way in liberalisation but are followed by similar moves in passenger traffic.

- 4.7 China is also liberalising rules for foreign investment in civil aviation. In 2002 a new Decree on “*Provisions on Foreign Investment in Civil Aviation*” entered into force designed to reinforce the opening of the civil aviation industry of China and stimulate foreign investment both in airports, airlines and other projects and services. Foreign investors can, however, not take control over Chinese airports or airlines.

Infrastructure - airports, aircraft and air traffic management

- 4.8 In order to meet the growing demand for air transport services in China, massive investments in air transport infrastructure are required both in airports, aircrafts, air traffic management technology and supporting facilities.

Since 1990, China has built more than 25 new airports and had in 2002 a total of 160 civilian airports. The number of airports is expected to increase to 260 by 2015.

The new projects include a new airport in Guangzhou; expansion of Beijing’s Capital International Airport including a new runway for planned completion in 2007 in time for the 2008 Olympic Games; and expansion of Shanghai’s Pudong airport with a new runway for planned completion by 2005-2006. Total investments at these three designated international hubs alone are estimated at more than 5 billion USD over the next four years.

Ownership and control over airports has recently been decentralised to the provincial and municipal authorities, which now have a strong incentive to develop their regional aviation market and attract private capital to support this.

- 4.9 The CAAC forecasts that Chinese airlines will need to add nearly 1800 new passenger aircraft to their fleets over the next two decades. This offers the European aerospace industry significant business opportunities, particularly in the important market segment of large civil aircraft.

China will also require new air traffic management technology to manage the steadily increasing air traffic. It is expected that China will need to invest more than 1.1 billion USD over the next decade in improving its air traffic management (ATM) infrastructure. Virtually all of this equipment will need to be imported and European industry is well placed to provide this technology.

In addition, China will need to modernise a wide range of support facilities and services such as ground handling, refuelling etc. China should make efforts to remove obstacles to market entry in these sectors including in relation to fuel supply and computer reservation systems, where current practices are discriminatory against foreign suppliers.

Key challenges facing China’s civil aviation sector

- 4.10 The spectacular growth in Chinese civil aviation has its own negative side effects and matching the rapid growth in demand for air transport with aviation safety developments and the implementation and management of modern technology is proving very demanding.

CAAC has therefore identified the following main challenges for further developing safe and market-driven civil aviation in China:

- Improve safety and security regulation and oversight capabilities
- Further expansion of infrastructure
- Optimise utilisation of air space
- Better training of personnel
- Develop market mechanisms and competition laws
- Adapt airlines and airports to become more competitive

In view of these challenges, there is a very strong Chinese interest in learning from the European experiences in developing safe and competitive air transport services. In this context, the EU co-financed “EU-China Civil Aviation Co-operation Project” has been seen by the Chinese as a very valuable project. The project started in 1999 and has enjoyed a total of more than 15 million € in Community funding. Both the Chinese authorities and industry as well as European industrial interests have expressed a strong interest in a continuation on a longer-term basis of this project or similar co-operation structures.

5. WHY A COMMUNITY APPROACH IN EXTERNAL AVIATION RELATIONS?

- 5.1 Since the 1960s, EU-China relations in civil aviation have been based on bilateral air services agreements between individual Member States and China with little, if any, coordination at Community level. 19 out of the 25 EU Member States have bilateral air services agreements with China (all except Cyprus, Ireland, Lithuania, Malta, Portugal and Slovenia). All these bilateral agreements are based on national designation at Member State level of a single (or in a few cases more) national carriers which are allowed to operate on routes to China. Moreover, traffic rights allowed under the bilateral agreements are also limited hence restricting the scope for competition.

Following the judgements of the European Court of Justice on 5 November 2002, existing bilateral air services agreements based on national designation urgently need to be amended to include Community designation clauses permitting designation of any Community air carrier established in a Member State.

- 5.2 A dialogue between the Chinese civil aviation authorities and the services of the European Commission was initiated in May 2004 during which the Commission services informed CAAC about the need to amend existing air services agreements. Both sides expressed their interest in continuing discussions with the aim of resolving this matter as soon as possible.

The two sides agreed to continue the dialogue and to further develop co-operation with the objective of reaching a comprehensive agreement between China and the Community. The services of the European Commission informed the Chinese side of their intention to take the necessary steps to request a mandate from the Council authorising it to negotiate such an agreement with China.

During the May 2004 meeting, CAAC presented a wide range of proposals for closer technical co-operation and EU assistance in civil aviation including in relation to safety management, air traffic control, airworthiness certification, regulation of market access and application of competition law and flight standards.

- 5.3 This Communication requesting a mandate for negotiating a Community-wide air services agreement with China follows naturally from the judgements of the European Court of Justice and the political agreement reached by the 5 June 2003 Transport Council. It also reflects the acceptance of the Community as negotiator of international agreements in many economic sectors including in air transport.

The Commission is currently negotiating air transport agreements under the “horizontal mandate” with a number of countries and has initialled agreements with some countries already. Such agreements could be the first step towards a more comprehensive open aviation agreement between the Community and these countries. In 2004, the Commission issued a Communication on a “*Community aviation policy towards its neighbours*”⁴, which recommended further more comprehensive Community negotiations with a number of neighbouring countries. In December 2004, the Commission was given a comprehensive mandate for negotiating with Morocco and the Western Balkans.

- 5.4 As the EU has developed a strong Community dimension of its internal aviation market it would be illogical if such a dimension was not pursued also in the EU’s external relations. Moreover, the experiences which the EU has gained in this respect are considered highly valuable by third countries.

The European Commission’s White Paper “*European transport policy for 2010: time to decide*”⁵ stressed the need for the Union to increase its ability to assert itself in international relations and speak with a single voice in international arena in defence of its industrial, social and environmental interests. The EU has demonstrated in several areas that it can obtain and deliver more when it acts in strong unity and as one.

- 5.5 However, the European Union remains - unlike the US - fragmented in its relations with third countries.

The conduct and outcome of bilateral negotiations in recent months between Member States and third countries have not yet led to the necessary alignment of existing agreements with Community law. The Community and Member States therefore must act together to regulate access, ensure the development of industry and achieve compliance with Community legislation.

- 5.6 There is no reason why the benefits of opening market access and investment rules in third countries such as China in principle should not be similar to the benefits of an EU-US Open Aviation Area. Indeed, a recent study commissioned by the European Commission has made an indicative assessment of the potential longer-term economic benefits for both sides involved in a fully liberalised EU-China aviation market, which could be in the order of several hundred million € per year.

⁴ COM(2004)74, “A Community aviation policy towards its neighbours”, 9 February 2004.

⁵ COM(2001)370

Obviously, it will be of paramount importance to ensure that opening and integration of markets is undertaken in a balanced manner that takes into account other important policy objectives and mitigates potential adverse impacts, be it in competition, environmental protection or other areas. Flexibility for the EU to apply the economic or regulatory instruments that are necessary to counter-balance adverse environmental impacts from the expected growth in traffic volumes should also be ensured.

- 5.7 Proposing a comprehensive mandate for the negotiations with China that more adequately reflects the EU's position in the world today would clearly strengthen the negotiating position of the Community and also signal the determination of the Community to resolve outstanding infringements of Community law and competence and demonstrate Europe's commitment to open markets and sustainable development.

6. REQUEST FOR AND SCOPE OF A NEGOTIATING MANDATE

- 6.1 As this Communication has shown, China has embarked on profound changes in its civil aviation sector including restructuring of its domestic aviation industry and gradual market reform and opening.

Significant efforts will continue to be necessary for the development of the Chinese air traffic sector to meet China's aspirations as well as international standards. Closer co-operation between the EU and China is paramount and will be mutually beneficial and be able to contribute to the development of an efficient, robust and safe aviation sector.

The Commission therefore considers it important to offer China a comprehensive scope for strengthened co-operation in civil aviation.

Such co-operation must address and resolve the legal issues in relation to existing bilateral agreements between China and Member States.

- 6.2 However, an agreement with China should not be limited to agreeing on Community designation clauses. It should go further and establish an ambitious framework integrating industrial co-operation and wider aviation issues such as co-operation in the fields of aviation safety, security, air traffic management, technology and research as well as "doing-business" issues.

While ambitions should be high, a fully open aviation area with China may take time to develop and may best be developed in stages to allow a smooth transition and market integration based on a gradual implementation of new rules.

- 6.3 The scope of the mandate that the Commission is proposing is outlined in a proposed separate draft Council Decision.

- 6.4 To the extent that restrictions on traffic rights may remain under a future Community-China agreement, or indeed any other Community-wide agreement with a third country, the Community will need to develop transparent and non-discriminatory procedures for allocation of such limited traffic rights as negotiated at

Community level. Such procedures are under preparation and a proposal will be submitted in the near future.

7. CONCLUSIONS

- 7.1 The civil aviation sector offers significant new opportunities for further strengthening transport sector co-operation and mutual benefits of China and the EU. Efforts should therefore now be made for air transport to become the next key area of closer co-operation between the EU and China in the transport sector.
- 7.2 In the light of this, the Commission proposes the negotiation and conclusion of a comprehensive open aviation agreement with the People's Republic of China and invites the Council to authorise the Commission to enter into negotiations on behalf of the European Community on such an agreement.

The Commission will work closely together with Member States and all relevant stakeholders in further developing and achieving the objectives set out in the proposed Council Decision.