COMMISSION OF THE EUROPEAN COMMUNITIES

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COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND THE COUNCIL

A Framework for Developing Relations with the Russian Federation in the Field of Air Transport

1. INTRODUCTION AND SUMMARY

The overall importance of the relationship between the EU and the Russian Federation as key strategic partners and neighbours, and the significance of our respective aviation and aeronautical sectors, argue strongly in favour of agreeing on a new framework for the organisation of our aviation relations.

In parallel to this Communication, the Commission therefore recommends that the Council authorise the Commission to negotiate, on behalf of the European Community, a comprehensive air transport agreement with the Russian Federation. This initiative builds on developments in the Community's role in external aviation following the European Court of Justice's November 5th 2002 Judgements in the "Open skies" cases, which recognised exclusive Community competences with regard to important aspects of external aviation, and on the Commission's White Paper "*European transport policy for 2010: time to decide*"[1], which stressed the need for the Union to speak with a single voice on the world arena in defence of its industrial, social and environmental interests.

Following these judgements, the Commission indicated that it intended to submit proposals for further authorisations to allow it to enter into negotiations covering a broad range of air transport issues with selected third countries of strategic importance.

There are substantial economic and political reasons for the Community to define a coherent aviation policy towards its major trading partners, notably Russia, with whom the EU is developing a close economic and political partnership under the framework of the Partnership and Cooperation Agreement (PCA)[2] and the four "Common Spaces" called for at the EU-Russia Summit in St. Petersburg in May 2003, and in particular the Common Economic Space (CES).

The EU-Russia partnership has been reinforced following the accession to the EU on May 1st 2004 of ten new Member States, eight of which have historically experienced particularly close economic and political ties with Russia. The EU is Russia's main trading partner, accounting for over 50% of its overall trade, whilst Russia is the EU's fifth trading partner (behind the US, Switzerland, China and Japan) and accounts for around 5% of the EU's overall trade. Russia is the second most important trading partner of the ten new Member States of the EU.

The integration of transport systems is a precondition for productive co-operation. Aviation is a particularly dynamic transport sector and is indispensable to link the European Union with its neighbours and the Russian Federation in particular. The establishment of an aviation policy towards Russia is therefore an important policy objective within the overall framework of the EU's developing partnership with its large eastern neighbour.

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1 COM(2001) 370

2 Article 43 of the PCA opens the possibility to conclude specific transport agreements with the aim of improving the conditions of mutual market access and of services

Russia offers good prospects for growth for airlines, aircraft manufacturers and service providers in Europe. Russian international passenger traffic is largely concentrated on European destinations. Around 75% of all Russian passenger traffic is directed towards European destinations and this is forecast to grow annually at a rate of 5.8%[3] in the years to 2007. For the EU, the Russian Federation is currently the fourth largest foreign aviation market[4].

The Russian aviation market has long been characterised by a restrictive approach. Market access is strictly limited and the State continues to play an important and influential role in the aviation industry. However, confronted with increased demand and foreign competition, the Russian government has announced substantial reforms in the sector including gradual liberalisation of the domestic market and airline privatisation aimed at increasing competition, attracting more investment and bringing about consolidation in the industry.

EU-Russia aviation relations have been dominated in the past by the contentious issues of Siberian overflight payments and Russian concerns with respect to EU noise and safety standards. The issue of Siberian overflight is of major importance for European air carriers as it affects services between Europe and the growing and lucrative markets in the Far East, in particular China. These difficulties have jeopardised opportunities for constructive cooperation and progress in such important areas of mutual interest as aviation safety and security.

Today, relations are fragmented, notably with respect to the traffic rights and market opportunities available to Community carriers. Member States acting individually have neither been able to bring bilateral agreements into conformity with Community law nor resolve such crucial issues as Siberian overflight payments, nor achieve significant progress in market access. Different approaches to safety and noise are a constant source for potential misunderstandings in aviation relations.

A comprehensive EC-Russia air transport agreement would aim to bring about the broadening of aviation relations and establish a framework in which both the industry and users can benefit from improved market conditions, a stable and consistent legal environment between the two markets, and mechanisms through which differences can be avoided or effectively resolved.

2. TRENDS IN RUSSIAN CIVIL AVIATION POLICY - MODERNISATION, CONSOLIDATION AND LIBERALISATION

2.1. A growing and evolving market

Air transport is one of the most dynamic transport modes in Russia. Civil aviation is a significant sector in the Russian economy as a whole employing around 223 000 people. According to the Russian Ministry of Transport, passenger air transport grew by 9.9% in 2003, cargo by 2.7%.

3 Source: IATA

4 Source: European Commission: data on seats available, 2004

While the Russian air traffic market is developing rapidly, it remains in certain respects relatively immature with strong potential for growth in both passenger and cargo sectors. IATA forecasts indicate that between 2003 and 2007 Russia's civil aviation market will experience annual growth rates of 5.8% - above the more mature markets in Western Europe and the US.

Only four commercial airlines – Aeroflot, Sibir, Pulkovo and UT Air – carry more than one million passengers a year. Aeroflot dominates the international market whilst in the domestic market it faces competition from the others (Sibir is the leading Russian domestic passenger carrier). Aeroflot provides 37.7% of the total seats supplied in the overall Russian-EU market, with Lufthansa the next nearest carrier with 12.6%[5].

2.2. A new strategy for air transport – towards privatisation and liberalisation

In October 2003, the Russian government announced its new "Transport strategy for the Russian Federation".

As regards air transport, a principal objective of the Russian government is to develop domestic air transport through major restructuring in order to increase efficiency and quality of services. Russia has currently 215 registered airlines (267 in 2000), including 55 state-owned carriers, a number which is expected to decrease in the years to come with increased competition, more stringent governmental licensing procedures and the enforcement of higher safety requirements.

The Russian government has announced plans to significantly improve the overall competitiveness of Russian carriers by adapting to international commercial, environmental and service-related standards and progressively liberalise the market.

Growth in passenger traffic in recent years is the main factor behind the move to speed up the liberalisation of the domestic air transport market. In 2002, the liberalisation of the domestic market began with abolishing the existing quota system. The Russian government envisages to further remove quotas and to thus rapidly bring about the full liberalisation of domestic air transport.

The government aims to encourage strategic alliances at both a domestic and international level to contribute to preparing Russian carriers for competition. Indeed, competitive pressures between Russian airlines on both domestic and international routes are likely to bring about significant changes in the Russian airline industry in the years ahead. An early sign of the developments to come was the signing on 24th May 2004 by Aeroflot of a Memorandum of Understanding preparing the ground for the Russian airline to join the *SkyTeam* alliance. There have also been announcements regarding the possible privatisation of Aeroflot.

2.3. Modernisation of infrastructure

Most Russian airports need refurbishment and modernisation. The transport strategy adopted by the Russian government envisages further privatisation of airports as well as an "optimisation" of the airport network in the whole country. Improving the

5 Source: OAG

functioning of airports will be critical to the successful development of the civil aviation sector in Russia. Security questions and procedures play an increasingly important role since the dramatic terrorist acts in summer 2004. A new law on transport security has been prepared.

Just as the Russian government envisages deep reforms in the domestic aviation sector, it has also announced plans to restructure the aeronautical industry.

Today, the availability of efficient and modern aircraft is the single most important growth-limiting factor for Russian airlines. Estimates suggest that airlines will have to replace a third of their ageing fleets (around 95% of existing aircraft were designed between 1960 and 1980) over the next five years. Over 1 600 aircraft in service do not comply with existing ICAO noise standards.

Russia has traditionally possessed a sizeable aviation industry. Today it employs around 500 000 people in about 300 companies and research and engineering institutes. However, the industry is in desperate need of investment, modernisation and restructuring.

This process seems to be underway following proposals put forward by the Russian Aviation and Space Agency (Rosaviakosmos) in the context of Russia's new transport strategy. It proposes radical measures to create a single aerospace consortium (OAK – Unified Aircraft Manufacture), apparently following the example of EADS. The consortium would be controlled by private capital (with government participation of 25.5%) and its objective would be to achieve a 10% share of the global aviation market.

3. EU-RUSSIA AVIATION RELATIONS – THE NEED FOR A COMMUNITY APPROACH

3.1. Growing markets of major mutual commercial interest

Well-developed aviation links to the European Union and to the main international destinations are essential for the development of the Russian economy and for its trade relations with the EU.

Russian international passenger traffic is largely concentrated on European destinations. In 2002, 4.3 million passengers travelled between Russia and Western Europe and 1 million passengers between Russia and Central and Eastern Europe. Around 75% of all Russian passenger traffic is directed towards European destinations and is forecast to experience annual growth of 5.8% in the years to 2007[6].

Air traffic between EU and Russia rose significantly in the last ten years. Weekly frequencies between EU Member States to Russia rose from 279 in 1992 to 465 in 2003, at the same time the number of available seats in EU-Russia air traffic increased from 44 880 seats in 1992 to 65 663 seats in 2003. The growth potential of the Russian market is widely recognised.

[6] Source: IATA

The highest proportion of EU-Russia air traffic is between Russia and Germany (39% of EU frequencies with Russia)[7], followed by traffic with Spain (12%), France (11%), UK (8.5%) and Finland (7%). Among new Member States, Poland and the Czech Republic have significant traffic with the Russian Federation.

Together with China, Russia is one of the largest "high potential" tourist markets in the world. The overall number of tourists to the Russian Federation grew by 7.3% in 2002 (Europe average 2.3%). European travel companies have started co-operation and joint-ventures with companies in Russia. Russian tourism is of increasing importance to the EU tourist industry. Russian tourists are among the world's top spenders in international tourism (12 billion US Dollar in 2002).[8]

3.2. Bilateral aviation relations between the EU Member States and Russia

3.2.1. A fragmented and restrictive market environment

The Russian Federation has bilateral air services agreements with 23 of the 25 Member States regulating in particular traffic rights and related issues of bilateral importance (designation of airlines, aviation safety, tariffs, customs etc.). This fragmentation results in greater complexity than needed for the regulatory framework applicable to air services between the EU and Russia.

Moreover, Member States' bilateral air service agreements with Russia usually regulate market access heavily, not only in terms of limited designation of carriers or points which may be served, but also in terms of frequency or of capacity, which the designated airlines may operate.

Beyond the illegalities identified by the European Court of Justice in the "Open Skies" judgements, there also exist legal issues in the area of European competition law, which will need to be addressed in the context of a future EU-Russia air transport agreement.

3.2.2. Clouds in the sky – the major outstanding issues

3.2.2.1. Siberian overflights

EU airlines flying over Russian territory have to pay special royalties to their Russian competitor, Aeroflot, which are not related to normal payments for Air Traffic Control services. These payments, which are imposed by Russia in the bilateral agreements with Member States through mandatory commercial agreements between EU airlines and Aeroflot, constitute an unacceptable charge for transit, contradict universal practice and are considered to be incompatible with international law, including Article 15 of the Chicago Convention of 1944. In 2003, these payments were estimated to have cost European airlines a total of approximately €250 million. Russia is the only country in the world where such payments have to be made. In addition, these payments are applied neither in a transparent manner nor to all Russia's trading partners. The transit over Siberia is essential for EU airlines to gain

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7 Germany is Russia's biggest single international aviation market. Lufthansa, Aeroflot, Pulkovo and Air Sibir operate each more than 100 weekly frequencies between the Russian Federation and Germany.

8 Source: World Tourism Organisation (WTO), Tourism highlights 2003

commercially viable access to the growing aviation market in the Far East, including China. Far-East operations are essential for the economic profitability of EU airlines.

Most EU cargo operators operating between Western Europe and the Far East avoid paying overflight payments by flying around Russian territory. Russian cargo operators, in particular Aeroflot, have therefore a significant advantage by offering cargo services from Western Europe to the Far East directly via Russia.

3.2.2.2. Environmental and safety standards

Russian airlines still operate a significant number of old aircraft, which are non-compliant with international and European environmental (aircraft noise) and safety standards. This remains an obstacle for improving EU-Russia aviation relations that needs to be addressed with the help of a comprehensive approach at EU level.

4. THE BENEFITS OF A COMMUNITY APPROACH TO EU-RUSSIA AVIATION RELATIONS

4.1. Overall economic benefits

The aviation and aeronautical industries of the EU and the Russian Federation are fundamental components of our economic cooperation contributing to the mobility of our citizens and to industrial development. The importance of the Russian Federation and EU aviation relations increased with the enlargement of the EU and traffic between the markets of the EU-25 and the Russian Federation grew significantly.

Over the past decade or so, the EU has developed a truly single European market for air transport. Consumers are also benefiting from more choice and lower air fares, in particular with the emergence of new low-cost carriers. The EU is also developing common standards for safety, security and air traffic management for the Single Sky.

Nevertheless, the full potential of the internal market is unlikely to be achieved until the Community acts as a single coordinated entity in its aviation relations with third countries wherever such co-ordinated efforts can create added value in the interest of the European aviation industry and users. According to the results of a recent study carried out on behalf of the Commission, a fully open market between the EU and Russia could create benefits of up to €680 Million per annum for both sides, derived from job creation in the aviation industry, expenditure by tourists and travellers and from support services to the wider aviation industry.

Closer aviation relations between the EU and Russia that would be derived from an aviation agreement might encourage the integration of Russian civil aviation with the existing network of global alliances.

The development of closer ties between the European and Russian aerospace industries and the strengthening of industrial cooperation have been identified as among the priority actions within the roadmap for the EU-Russia Common Economic Space. The reinforcement of this cooperation could be envisaged in the overall framework of negotiations on an aviation agreement between the Community and Russia and would also bring about new market opportunities resulting in major economic benefits.

The substantial savings (approximately $250 million per annum) that would be made by European airlines following the phasing-out of Siberian overflight payments, as well as the benefits of a more liberal environment in which to expand services to the Far East over Russia, should also be taken into account.

The opening and integration of markets must be undertaken in a balanced manner that takes into account other important policy objectives and mitigates potential adverse impacts, be it in competition, environmental protection and sustainable development or other areas.

4.2. Traffic rights - creating new opportunities, opening the skies

With respect to traffic rights, as described above the current environment is very restrictive with respect to designation, frequencies, capacity, and routes. This is hampering the expansion of air services in spite of growing demand. The agreement would therefore aim to allow for the gradual opening up of access to the two aviation markets with a view to stimulating investment and competition and improving services for passengers and cargo.

The current market and regulatory conditions are such that the creation of an Open Aviation Area, whilst remaining a longer term goal, is unlikely to be a realistic immediate objective. Such a goal might best be achieved in stages to allow a smooth and balanced transition.

4.3. Ensuring compliance with Community law

In accordance with the case law established by the European Court of Justice (ECJ) in its judgements of 5 November 2002, the existing bilateral air services agreements between the Member States and the Russian Federation must be deemed in breach of Community law to the extent that they contain designation clauses which discriminate against the carriers of other Member States or other clauses that impinge upon exclusive Community competence. Unless these agreements are promptly amended or replaced with agreements that conform to Community law, they must be denounced by the Member States concerned. This situation deprives the airlines operating between the EU and the Russian Federation from the indispensable legal certainty and risks compromising the future development of our aviation relations.

The outcome of bilateral negotiations between Member States and the Russian Federation have not yet yielded the necessary alignment of existing agreements with Community law.

A key aim of a comprehensive air transport agreement between the Community and the Russian Federation would therefore be to resolve the outstanding legal issues in relation to existing bilateral agreements between Russia and the Member States.

4.4. Siberian overflights – implementing the phase-out by 2013

A comprehensive EC-Russia air transport agreement would provide for a transition period for the modernisation of the current mechanism of payments for trans-Siberian overflights by 2013 at the latest and ensure that charges applied after the end of the transition period will be transparent, cost-based and not lead to discrimination between airlines.

In 1997, the Council welcomed the initiative of the Commission to start direct consultations with the Russian Federation on this issue.

The Community was able to demonstrate its strength in negotiating with Russia, culminating in the commitment received from the Russian Government on 21st May 2004 in the context of the negotiations on Russia's accession to the WTO to eliminate the non-commercial elements of Russia's current system of payments for Siberian overflights in order to replace it with a cost-based, transparent and non-discriminatory system by 2013 at the latest. It was also agreed that the modalities for the gradual phasing out of the overflight payments over a transitional period leading to 2013 would be implemented in the context of Russia-EC negotiations on a comprehensive air transport agreement. This offers the best framework within which the EC and Russia can agree on the way forward. The economic benefits for EU airlines of eliminating these payments, in particular for the development of traffic to the lucrative and rapidly growing markets in the Far East, would be significant.

Should further progress on this issue prove difficult, parallel actions, for example within the framework of ICAO and application of Article 15 of the Chicago Convention, may be pursued.

4.5. Allowing closer market integration – safety, security and environmental standards

Against the background of the liberalisation of Russia's domestic aviation market, the Russian government has shown an interest in pursuing a dialogue with the EC on regulatory matters. This might take the form of technical assistance in the regulatory field based on the EC's own experience of a liberalised regulatory framework, or even the approximation of aviation laws. Such an exercise, leading to increased regulatory consistency and certainty, would clearly be in the interest of the Community and those parts of the industry wishing to expand their services in Russia and develop closer commercial ties with Russian companies.

Ensuring stringent aviation security and safety provisions would be of major importance and ensure that market opening is accompanied by appropriate levels of integration and regulatory convergence. The agreement could establish close cooperation to ensure that the highest international security standards can be met, fully taking into account the procedures, standards and developments applicable on or taking place in the territory of the Community. Joint mechanisms and procedures for cooperation in the security field could also be developed under the agreement.

In the context of the new aviation relationship between the Russian Federation and the EC established by the agreement, it would be possible to provide assistance towards the harmonisation, where appropriate, of certification standards, with a view to preparing the ground for closer cooperation between the Interstate Aviation Committee (IAC) and the European Aviation Safety Agency (EASA). A working arrangement between the two bodies was agreed in July 2004.

With respect to environmental issues, the agreement could establish a framework for consultation between the EC and the Russian Federation to *inter alia* facilitate the implementation of improvements in environmental standards in Russia, notably with respect to aircraft noise. In addition, the agreement should safeguard the flexibility for the EU in respect of measures to mitigate the impact of aviation on climate change and other environmental issues.

4.6. Industrial cooperation - exploiting mutual strengths and needs in the aerospace industry

The EU aerospace industry has a major interest in developing collaboration with its Russian counterparts and research centres. A variety of joint projects, including in the fields of design, production, training and safety certification involving the main EU and Russian companies are already underway. In 2003, Airbus opened an engineering centre (ECAR – Engineering Centre Airbus in Russia) in cooperation with the Russian company Kaskol. EU industry is also involved in Russian development projects of new, more environmentally friendly aircraft such as the TU 204 and Russian Regional Jet (RRJ). The agreement could create a new framework for aviation relations between the Russian Federation and the EU under the umbrella of which industrial cooperation could be fostered. Such cooperation would support jointly identified aviation and research projects aimed at accompanying the on-going restructuring and modernisation of the Russian aerospace industry. This might include research on, and development of common standards (safety, security, and environmental standards), training programmes, as well as supporting the modernisation of the Russian air traffic management system and airport infrastructure.

5. CONCLUSIONS

This Communication presents the background and arguments substantiating the need for a comprehensive air transport agreement between the Community and the Russian Federation, which would allow the two partners to establish a clear and coherent framework in which to constructively develop their aviation relations in the coming years.

Such a framework would *inter alia* aim to improve market opportunities for both sides, ensure compliance with Community law, implement a phase-out of trans-Siberian overflight payments, promote the approximation of aviation laws where appropriate, establish joint mechanisms for co-operation on security, safety and environmental standards, and foster co-operation in the industrial field. It would also bring about significant economic benefits.

The current situation whereby each Member State separately, and not the Community, negotiates air traffic rights and access conditions with third countries is a clear handicap. As long as Member States negotiate bilaterally with Russia it will be considerably more difficult to achieve the significant benefits in terms of market access and integration, which the Community would expect to achieve, together with offering substantial opportunities for cooperation in the regulatory, technical and industrial fields.