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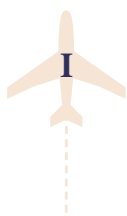
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The principal author of the study was Ian Bertrand, who served as the short-term technical air transport consultant to PA consulting Group. McHale Andrew, PA Consulting's long-term Research and Development Advisor at the CTO, was responsible for editorial and technical supervision of the assignment.

Special thanks for their views, guidance and comments are due to Douglas R. Andrew (Lead Infrastructure Specialist) and Stephen J. Brushett (Lead Transport Specialist) both of the World Bank; Vincent Vanderpool-Wallace, CTO Secretary General; Arley Sobers, Director of Research & Information; Luther Miller, Director of Finance and Human Resource Management; and Rochelle Gooding, administrative assistant, who provided valuable assistance in the formatting of the document.

The report embraces the results of targeted meetings with key stakeholders in four (4) CARICOM countries between February and July 2006; a stakeholder symposium that was held in Barbados, June 1-2, 2006; presentation and discussion of findings at the Small Island Developing States (SIDS) Tourism Conference held in the Bahamas from June 7-9, 2006; and presentation of findings, conclusions, concepts and draft recommendations to CTO Ministers of Tourism at their meeting in New York on June 15th 2006.



Foreword



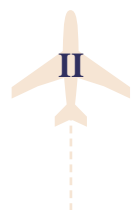
The Caribbean Tourism Organisation is honoured to have had the opportunity to contribute to the research and policy development process geared towards establishing once and for all a reliable, affordable, efficient and value-for-money air transport services regime in the Caribbean. We are therefore quite pleased to provide you with this timely, and hopefully catalytic, summary report on regional air transport.

Notwithstanding previous regional air transportation studies, this study was necessary given the dynamic situation facing the region's air transportation sector, the importance of air transportation to the Caribbean's tourism and business, and the new challenges facing airlines and air transportation globally.

The overwhelming evidence from international experience supports the view that a policy of prudent air services liberalization is effective in securing cost effective, reliable and quality air transport services in most cases. While we have generally embraced such a policy in our international air services Agreements, it seems rather compelling to fully liberalise all intra-Caribbean air services in particular, if we are to have any chance of creating a truly regional market for our goods and services, including tourism, sports and cultural services.

The Caribbean is just a small part of the total aviation market and that part continues to get smaller because other markets have grown faster over the past ten years. I see some enormous opportunities for the first true collaboration of the region on any matter if we were to use this as a catalyst for establishing pan-regional civil aviation rules along the lines of what has happened within Europe. Such rules would essentially create a single Caribbean air space and could open up tremendous possibilities for collaboration and management of our vital aviation resources.

As we write this, the discussions about restructuring two of our intra-regional and one of our international carriers present us with unique opportunities to do something new and effective. More than ever, we need to pool our collective human, natural, financial and technical resources



in order to ensure a much more secure, prosperous and sustainable future for the people of the Caribbean.

Several people in our region claim that this is the most practical and thorough study of its kind in recent years. We are confident that anyone that takes the time to study these recommendations thoroughly and anyone that has the influence to make a difference in our region will save this one from the same dusty shelf of past commissioned studies that never saw the light of implementation. It is our fervent hope that this time will be different and that this study will make a difference.



Vincent Vanderpool- Wallace

Secretary General, CTO



Executive Summary

Introduction

Given the importance of air transportation to the Caribbean's tourism and overall economic development as well as its social and cultural advancement, the region's development prospects, and that of each country therein, depend very much on the provision of reliable, efficient and affordable air transport both within and into the area. Historically, some countries in the region have sought to achieve those desirable objectives through government ownership of airlines as well as through blanket subsidies to privately owned regional airlines and, in some cases, by payment to international carriers for seat guarantees. This has all taken place in a fairly restrictive air services environment, which has made it difficult to achieve the desired quality and reliability of air services in the region.

Empirically, there is evidence that a less restrictive regime- has been associated with expanded airlift, lower airfares, increased investment by private regional and international carriers, and enhanced reliability and efficiency of air services. The evidence is stronger perhaps in the US and EU markets where more extensive analysis has been carried out but the positive impacts are also felt in a number of diverse, developing country settings, both in the region and elsewhere. Therefore, it may now be opportune for regional governments to embrace policy reforms designed to facilitate increased airlift, more efficient and reliable intra-Caribbean air services and greater but fairer competition that promotes more affordable and reliable services into and within the region.

Background

This summary report derives from the recent research studies done in concert by the Caribbean Tourism Organisation (CTO) and the World Bank, which both considered the above issues and came to the conclusion that at the outset the essential purpose of those studies was to provide timely advice on the policy settings and accompanying measures to secure safe, reliable and affordable air services in the region. Specifically, such advice would assist regional governments in determining appropriate policies in support of efficient airline operations, airlift





maintenance and enhancement as well as provide some guidance to regional airline executives in their quest to enhance operational efficiencies and forge strategic alliances geared towards providing more reliable, affordable and sustainable air services throughout the region. It is also well understood that effective air transport services would be a critical underpinning to the successful implementation of the Caribbean Single Market and Economy (CSME) and to exploiting opportunities for regional, multi-destination tourism.

The reports sought to achieve those objectives by focusing on effective risk mitigation strategies that would result in a minimization of airlift vulnerability. The region has variously applied, with different degrees of effectiveness, the traditional risk mitigation mechanisms, namely (a) diversification of airlift providers through liberalised air service agreements and (b) ownership of airlift providers by both public and private sector entities; often in the Caribbean through astronomical demands on the public purse.

Conclusions and Recommendations

While all Caribbean countries are committed to the diversification risk mitigation mechanism only a limited number have effectively embraced the ownership mechanism, usually unsuccessfully and at great cost to the taxpayer. These airlines are undercapitalized and are generally facing serious operational and financial problems, with a consequent negative impact on the quality and reliability of regional services. Of course, it can be argued that the financial losses suffered by those carriers, and by extension governments, must be seen within the context of the provision of guaranteed airlift to their respective countries. However, the evidence from Aruba, Chile, the Dominican Republic and Mauritius, for example, demonstrates that not only does full concentration on the diversification mechanism result in increased and more reliable airlift but also it does that at negligible cost to governments.



It is with this in mind therefore that the following recommendations are offered to regional governments:

* Adopt a “regional open skies” regime that would remove all non-technical/non-safety and security restrictions on carriers, equipment, routes, schedule and airfares. Indeed “regional open skies” is the aviation corollary to the CSME and would allow more efficient and profitable operation of regional airlines by giving them *the freedom to find the optimum mix of destinations to fly as well as the framework for fairer competition*. It could also allow other specialised carriers to use the most appropriate equipment for efficiently servicing certain routes as currently obtains in Montserrat. Unserviced or “unprofitable” routes could then be specifically subsidized within agreed parameters as opposed to the current practice of blanket subsidization even where airlines have the opportunity to operate quite profitably.

* The CARICOM Multilateral Air Services Agreement (MASA) should be amended and upgraded to reflect the decision to adopt a regional open skies regime. The current MASA does not now conform to the requirements of the Revised Treaty of Chaguaramas – it is not as liberal as regards removal of restrictions and creation of a single economic space between member countries and must be amended accordingly if it is to remain a useful Agreement for ordering air services between CARICOM countries. *It may be useful to extend the MASA to non-CARICOM regional countries where feasible*. The Agreement should allow for the CARICOM Competition Commission to have jurisdiction over unfair competition disputes. This will ensure full compliance with the Revised Treaty of Chaguaramas. It will also signal to the international community that the Caribbean wishes to apply to itself that which it may be prepared to negotiate with the international community.



* CARICOM and other Caribbean countries are strongly urged to negotiate ‘open skies’ agreements, or comparable liberal arrangements for international air service, with the USA, UK and other relevant developed countries using the Multilateral Agreement on the Liberalization of International Air Transportation (MALIAT) Agreement as a model and incorporating the ‘community of interest’ designation for those CARICOM airlines whose host countries are party to such Agreements. The evidence is soundly supportive of the view that this brings increased services and generally lower prices and better quality through competition. This, of course, should be subject to regional airlines having the reciprocal opportunity to compete and to the “community of interest” principle being accepted.

* Caribbean countries should adopt clear and suitably devised policies for supporting regional airlines; in particular those in which governments may still have a role as shareholder. The sustainability of inter-island air services, especially in the Eastern Caribbean, in a liberalised market is a legitimate concern. Many countries adopting liberal air services policies have recognized the importance of their public service obligation in situations of market failure. There are a number of working schemes in place for addressing this need and their applicability to the region would have to be studied carefully. Nevertheless, there should be no generalized financial subsidies. Rather, Caribbean nations would be well advised to adopt appropriate policies as regards their public service obligation, which would see, where necessary, the granting of subsidies to airlines for selected routes and services where competition in the market cannot be sustained. The policy should clearly establish objectives, target beneficiary groups or communities, payment arrangements, timelines and performance monitoring. Governments must however remove any artificial obstacles to the achievement of competition and where conditions change, necessitating a removal of subsidies, they



should be removed forthwith.

* There is a golden opportunity, with the transformation of BWIA into Caribbean Airlines from January 2007 and the current LIAT/Caribbean Star merger talks, to establish a new regional airline or airline holding company based on commercial principles and the best applicable model of a successful airline. Of course, the consolidation and integration of regional airlines, or at least effective functional cooperation among them, would make that business proposition even more viable. A properly capitalized, new unencumbered airline (s) would be able to share reservations, maintenance, staff, equipment, etc to achieve an efficient low cost operation. However, the airline (s) would need competent market-driven management whose tenure and the compensation of all staff must be performance based. To the extent that the shareholder(s) wish additional flights to be performed, the level of funding and the related service expectations would be agreed and the Board of Directors and management must be judged against this agreement as well as against set performance criteria as set forth in their business plans. The point is that once governments agree to own airlines then they should give them the best chance of success by ensuring that both the operational and policy framework facilitates such success. It is much more prudent to subsidize a specific route from the proceeds of a successful airline than it is to subsidize a perpetually non-performing airline from the public purse.





1. Introduction

This summary report follows the official dissemination of two regional air transport studies, which both seek to develop a set of implementable recommendations and good practices for operation of the Caribbean's air transportation sector. This includes an attempt to rationalize the role of government in ensuring adequate airlift into and within the region. The studies are the results of a coordinated effort by the World Bank and CTO's component of the European Union (EU) financed Caribbean Regional Sustainable Tourism Development Programme (CRSTDP).

There was some overlap in the objectives of a planned World Bank study, the concept of which had been approved in September 2005 and a CTO/CRSTDP proposed study (The Study). The World Bank study had been initiated in response to a call from stakeholders in the OECS countries and had been agreed with the OECS governments as a deliverable. The CTO / CRSTDP study was part of the activities of the programme's research component and was mandated by CTO Tourism Ministers who appointed a Ministerial sub-committee in June 2005 to review the draft Terms of Reference (TOR) for the Study.

The CTO/ CRSTDP Study's TOR had necessarily to restrict its primary geographical focus to those member countries of CARIFORUM, namely Antigua and Barbuda, The Bahamas, Barbados, Belize, Dominica, the Dominican Republic, Grenada, Guyana, Haiti, Jamaica, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Suriname, and Trinidad & Tobago. However, strategies in other member countries of the CTO have been taken into consideration in analysing the various aviation policies and practices in the region.

1.1 Objective of Study

The main objective of The Study, as outlined in the TOR, is to 'assist the region in rationalizing international and intra-regional air transport as a means of ensuring the sustainable development of the tourism sector'. This has been translated to 'how to develop and maintain regional airlift capacity consistent with the sustainable development of the tourism sector'. It



is assumed that each Caribbean country has determined the components and scope of its own sustainable tourism sector and therefore is able to shape the general recommendations of The Study to meet its own specific needs.

In addressing this objective the TOR raised a number of issues to be reviewed including the following:

- Low Cost Carriers (LCCs) and their relevance to the region
- Air Transportation cost structures in the region
- Government subsidies
- Hub & Spoke operations in the Eastern Caribbean
- The CARICOM Multilateral Air Services Agreement (MASA)
- Open Skies Agreements of regional countries with the USA
- Consideration of previous studies:
 - I. The 2001 ‘Study of Critical Issues affecting the Regional Air Transport Sub Sector’
 - II. The 1993 ‘Caribbean Regional Airlines Functional Cooperation Study’

1.2 Approach to the Study

The approach to The Study sought to mitigate the historical implementation inertia of the region (formal approval of the report but failure to implement). It was agreed that an attempt to gain stakeholder commitment be the core component of the approach to the Study using the mechanism of regional workshop(s). Further, the final report would be marketed (as opposed to mere submission) by the CTO to the validating stakeholders across the region.

The interest by the World Bank in assisting primarily the OECS countries in developing sustainable aviation policies influenced the detail but not the structure of the approved approach.

1.2.1 Collaboration with World Bank on Conduct of Study

In January 2006, the CTO/CRSTDP and the World Bank exchanged information and following



discussions, agreed on a joint approach to the study of air transportation in the region but with separate final reports consistent with the separate mandates of the two (2) organisations. Further, it was agreed that, for logistical and current airline ownership/domicile reasons, the geographic focus of the joint approach would be the Eastern Caribbean (OECS, Barbados, and Trinidad & Tobago) and Jamaica, with initial concentration on those countries and then application and adaptation of the lessons and conclusions, where feasible, to the wider Caribbean.

The World Bank was interested primarily in the reform agenda for regional air services policy and regulation but shared the concerns of the proposed CTO Study for the issues relating to (a) support for regional carriers, (b) ensuring air access for all countries at affordably priced airfares, (c) airport infrastructure and regional cost structures, and (d) rationalising hub and spoke operations.

The common objective of the joint approach would be the provision and presentation of policy advice to the respective regional governments on reliable, safe and affordable value-for money air service, which could be provided cost effectively and consistent with medium and long-term economic development objectives.

1.2.2 Desk Research

Apart from its own desk research covering the key issues identified in the TOR of The Study, the CTO/CRSTDP had access to further desk research conducted by the World Bank and its consultants covering:

- * Demand, supply and fiscal analyses of current regional air transportation markets
- * Specialised examinations of relevant issues and comparative analyses of air transportation regimes in other regional destinations
- * Case studies of tourism performance and nature of international air



service agreements (ASAs) in Aruba, Bahamas and Barbados

Two reports have been presented to date. The first was submitted on October 09, 2005 and focused on the approach to the Study, an analysis of the Study TOR and the core characteristics of the LCCs. It recognized that the LCC strategy was not a panacea for airline success and that indeed many LCCs had failed across the globe.

The second report, “An Assessment of the Air Transport Sector in CARIFORUM”, was submitted on April 17, 2006. This report covered an overview of CARIFORUM air transport, the state of its competitiveness and the implications of the findings for the proposed regional workshop. It addressed the financial and operational status of the major CARIFORUM airlines, international and regional regulatory air transport policy of the CARIFORUM states and the level of air transport integration and coordination in CARIFORUM.

These reports as well as the review of the 2001 report and that of the 1993 report were included as appendices to the official Study report. Those reviews found that to a very large extent the concepts and strategies of both reports were still valid today. Detailed recommendations, however, needed to be updated to ensure consistency with the current operations of the regional airlines.

1.2.3 Consultations

The World Bank and CTO/CRSTDP consultants conducted a series of stakeholder visits from February 2006 apprising key officials, including regional airline CEOs and senior personnel, on the approach to The Joint Studies, getting their views and input on same, and gathering information on the key issues to be dealt with in The Study. Countries visited were Antigua & Barbuda, Barbados, Jamaica and Trinidad & Tobago, which were chosen mainly for their principal roles as owners or hosts of the major domiciled regional airlines. The World Bank team also visited St. Vincent & The Grenadines in October 2006. Additionally, the views of both public and private sector regional stakeholders were sought at a number of regional



forums.

i. The World Bank/CTO/CRSTDP Symposium

As part of the consultation process, the World Bank and the CTO held a stakeholder/air transportation specialists' symposium on June 01 – 02, 2006, aimed at getting reliable information, views and support for the initial findings of the ongoing two studies. The symposium focused on (i) policy issues, including air services agreements and tourism & economic development; and (ii) regional airlines including ownership challenges and choices for governments.

While all CARIFORUM member countries were invited, thirty-seven (37) persons representing seven (7) Caribbean countries, namely Antigua and Barbuda, Barbados, Dominican Republic, Grenada, Guyana, Jamaica and Trinidad and Tobago; four (4) regional airlines, Air Caraibes, BWIA, Caribbean Star and LIAT; and seven (7) regional organizations, specifically the Association of Caribbean States, CARICOM Secretariat, Caribbean Development Bank, Caribbean Hotel Association, Caribbean Tourism Organisation, Eastern Caribbean Civil Aviation Authority and Eastern Caribbean Central Bank attended.

The primary objectives of the symposium were to:

- Present progress achieved and tentative conclusions reached on regional air transport services emanating from the complementary work streams of the World Bank and CTO/CRSTDP.
- Share new information and the results of new analyses carried out on the issues.
- Interact with and listen to the views of key Caribbean stakeholders on the issues and how they might be resolved.
- Discuss the possible solutions that could apply in the changing global and regional environment.
- Build support for some of the key changes in policy that need to be undertaken.
- Devise appropriate implementation strategies for change.



ii. The SIDS Bahamas Tourism Conference

CTO/CRSTDP took advantage of the June 07 – 09, 2006 conference ‘Building Tourism Resilience in Small Island Developing States’ sponsored by the Bahamas Ministry of Tourism, United Nations World Tourism Organisation, United Nations Environment Programme/ Global Programme of Action, and University of the West Indies to consult further with regional stakeholders.

A panel chaired by McHale Andrew, CTO/CRSTDP Research & Development Adviser and comprising Vincent Vanderpool-Wallace, Secretary General, CTO, Jean Holder, LIAT Chairman and Ian Bertrand CTO/CRSTDP short-term air transportation consultant addressed the topic, ‘The Role of Local and Regional Airlines in Building Tourism Resilience: The Open Skies Agreement and the Maintenance of Regional Airlift Capacity’. The main presentation focused on the preliminary findings of the CTO Study and the kernel of subsequent discussions and feedback was incorporated into the final report.

iii. The CTO Ministers’ Caucus

The caucus took place on June 15, 2006. Limited time was available for the presentation of the conclusions and recommendations of The Study. However, concerns were raised about the relevance of The Study to the wider membership of the CTO and the need for ownership of airlift was emphasised by Ministers.

The feedback at the symposium, the conference and the caucus, especially the points of disagreement, was stimulating and influenced the content of this final report. In summary, the broad views of the regional stakeholders who participated in those consultations were:

- * Liberalisation of international air transport policy was accepted and practiced to different degrees across CARIFORUM. However, many of the states believed that any further benefits of ‘open skies’

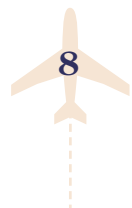


agreements were outweighed by the resulting minimal ability to influence competitive behaviour of airlines

- * 'Community of interest'¹ airline designation should be an integral part of any 'open skies' agreements
- * Countries that were shareholders in regional airlines were committed to the continued existence of these airlines as instruments of regional socio-economic development and believed that the current benefit/cost was positive despite the endemic losses of these airlines. These countries were however open to strategies that would improve the benefit/cost of the operation of the airlines.



¹ CARICOM succeeded in getting the International Civil Aviation Organisation (ICAO) to support the principle of 'community of interest' for airline designation of airlines of countries in an economic grouping of developing states. In the Caribbean context, it applies, to date, only to full members of CARICOM. It can be requested by a CARICOM state but its applicability is not mandatory but voluntary on the part of the 'other party' in air service agreements. To date it has only been successfully implemented on a 'case by case' basis by some of those Eastern Caribbean member states of CARICOM that do not have a domiciled airline providing international service.





2. Situational Analysis

Both the geography and the economic structure of the Caribbean region demand *effective airline service* and the countries generally feel a strong sense of vulnerability in this regard. This vulnerability is greatest in the tourism sector.

2.1 The Concept of Risk Mitigation

The essential underlying requirement of this and previous studies is therefore to minimize if not remove this airlift vulnerability i.e. *effective risk mitigation*. Caribbean countries have applied to varying degrees (and with varying degrees of success) the traditional risk mitigation mechanisms, viz:

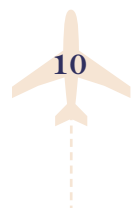
- I. Diversification of airlift sources i.e. *liberalised air service agreements/practices* (but with the Caribbean focusing on international air service)
- II. Ownership of airlift capability i.e. *domiciled airlines*, preferably through private sector funding (but in the Caribbean usually through public sector funding)

In a number of countries there is a sense of conflict between these two mechanisms. However, it must be emphasized that neither will be successful unless:

- a. There is sufficient demand to support airlift capacity to the country (in this context *the quality and relevance of the tourism product*).
- b. There are *effective partnerships* established between the tourism sector of the country and the individual airlines.

2.2 Current Status of Risk Mitigation

CARIFORUM, the main focus of this study, is a grouping of fifteen (15) sovereign states that jealously guard such sovereignty. It comprises all of the full members of CARICOM, save Montserrat, but includes the Dominican Republic. All members of the CARICOM Single



Market (CSM) are members of CARIFORUM. The 32-member country CTO encompasses all CARIFORUM countries.

Within CARIFORUM there are four (4) countries (27%), each of which has a domiciled public sector owned airline, providing international service but with a heavy emphasis on service to the United States; indeed one (1) airline serves only the Atlantic Seaboard of Florida. All four (4) airlines, Air Jamaica, Bahamasair, BWIA and Suriname Airways, provide limited intra-regional service.

One country, Antigua & Barbuda, is the domicile of two (2) airlines providing regional service. One (1) of these is privately owned (Caribbean Star) and the other (LIAT) is substantially owned by three (3) regional governments. Both serve primarily the Eastern Caribbean and encouragingly have begun formal talks aimed at exploring the possibility of a merger between them.

Less than 50% of CARIFORUM is therefore committed to the ownership risk mitigation mechanism while all are committed to the diversification mechanism for international air service. The Dominican Republic, generally recognized as the most successful stayover tourism destination in CARIFORUM, depends only on the diversification risk mitigation mechanism, thereby demonstrating that the ownership mechanism is not a necessary condition for the sustainable development of its tourism sector but that the quality and relevance of the tourism product is such a condition.

Only one country, Jamaica, is committed to full diversification, ‘open skies’² for international service, and to the ownership mechanism. Ironically, it is also one of the few countries that has not to date signed the CARICOM Multilateral Air Services Agreement (MASA). Since the MASA is currently limited to CARICOM members, Dominican Republic cannot now participate in this Agreement. Given that:



- Membership in MASA is, to date, confined to members of CARICOM
- The Bahamas (not a participant in the CSME), Jamaica and Montserrat are yet to sign the MASA
- St. Vincent (a significant shareholder in LIAT) and Suriname have signed but not yet ratified
- There is no service by any of the regional airlines to Belize;

The MASA is therefore defacto applicable only to the Eastern Caribbean membership of CARICOM.

In summary, to date:

- All members of CARIFORUM are committed to liberalisation of international air service agreements with two (2) extending this to 'open skies'²
- Four (27%) are committed to ownership of airlines providing international service even though such service may be very limited
- Three (20%) are committed to ownership of airlines providing regional service even though such service has been limited to the Eastern Caribbean
- Ten (67%) are committed to a somewhat liberal intra-regional air service agreement that is de facto confined to the Eastern Caribbean



² "Open Skies" (OS) bilateral air service agreements usually have the following characteristics:

- * unlimited airline designation, provided the airlines have at least their principal place of business in the designating state;
- * an open route schedule;
- * open traffic rights;
- * open capacity;
- * airline investment provisions which focus on effective control and principal place of business, but protect against flag of convenience carriers;
- * third-country code-sharing;
- * a minimal tariff filing regime;
- * application of normal competition law



2.3 CARIFORUM Airlines

Only a minority of CARICOM states practices the ownership mechanism. These airlines have provided support to the tourism sector in CARICOM at significant, consistent financial losses. These losses have occurred pre- and post-liberalisation, pre-and post-9/11, whether private sector or public sector owned, through management with a previous record of success and through management without any such record. Such financially challenged airlines do not have the capability to provide the sustained quality service that tourism economies need. Moreover, given the limited scale of their service, both international and regional, they at best provide the equivalent of limited airlift insurance cover at very high premia.

These airlines have however never been effectively capitalised and they have not been able to generate major cost savings due to diseconomies of scale arising from their relatively small size and that of their market. Further, the owners (whether public or private sector), board of directors and executive management of these airlines have consistently since 1993 refused to effectively participate in regional airline functional cooperation that would have gone some way to achieving some of the benefits of economies of scale. Their current public sector owners have nevertheless decided to keep them functioning, as instruments of socio-economic development, notwithstanding the continuing financial losses.

Given the *raison d'être* for The Study and the current realities, the fundamental issues to be examined are how to:

- I. *Optimize the value of the diversification of air services (liberalisation including 'open skies')*
- II. *Strengthen the CARICOM domiciled airlines so that they can provide the sustained quality of service that the tourism sector needs*

It is worthy of note that the Dominican Republic, the only non-CARICOM member of



CARIFORUM and the largest tourism destination in the region, already practices 'open skies' on its international services and does not have any domiciled airlines.

2.4 Non-CARIFORUM CTO Members

An examination of seventeen (17) non-CARIFORUM members of the CTO (Anguilla, Aruba, Bermuda, Bonaire, British Virgin Islands, Cayman Islands, Cuba, Curacao, Guadeloupe, Martinique, Montserrat, Puerto Rico, St. Barts, St. Eustatius, St. Maarten, Turks & Caicos, and U.S. Virgin Islands) indicates the following:

- Each has the tourism sector as a significant component of its economy
- Only one (6%) is a sovereign state and so the remainder would not have total control over their air service agreements but in a significant number of cases the controlling state supports 'open skies'
- Only one (6%) is a full member of CARICOM but five (29%) are associate members
- Eleven (65%) are situated in the Eastern Caribbean
- All but one (94%) are committed to liberalisation of air service agreements with ten (59%) extending this to 'open skies'
- Three (18%) have domiciled airlines providing international service and limited intra-regional service, two (2) of which are public sector owned. One (1) of these airlines flies internationally to the USA only; another is banned from flying to the USA
- Two (12%) have between them three (3) domiciled airlines providing regional service focused on the Eastern Caribbean; two (2) of those airlines are private sector owned and one (1) public sector owned.
- American Eagle, based in Puerto Rico (the main hub for US traffic to the Eastern Caribbean), has an effective capital structure and enjoys economies of scale from being part of a large airline, American Airlines, that has a strategic



alliance with other international airlines (“One World Alliance”). It is consistently profitable.

- Aruba, which is heavily dependent on tourism and which refused to continue to support a loss making airline, negotiated an ‘open skies’ agreement with the USA and is generally considered to be able to ensure the sustainable development of its tourism sector; once again demonstrating that ownership of airlift is not a necessary condition of success. On the other hand, the Cayman Islands with tourism arrivals in 2004 totaling just 36% of Aruba’s arrivals and closer geographically to the USA, which is the principal visitor generating market for both countries, insists that preservation of its endemic loss-making Cayman Airways is indispensable to its tourism sector.

When compared to the CARICOM members of CTO, these countries, with a few exceptions, exercise less sovereignty, are more likely to exploit the diversification mechanism to include ‘open skies’ and are less likely to use the ownership mechanism. When the latter is used, the funding is more likely to be from the private sector. The Dominican Republic’s air transport policy is more akin to that of the non-CARICOM CTO members than it is to CARICOM’s. Given this analysis, the recommendations of The Study will be of significance to the CARIFORUM states other than The Dominican Republic (i.e. the full members of CARICOM) but should have some resonance among all the other CTO member countries.



*3. Optimising
the Liberalisation
Mechanism*



There has been gradual liberalisation of the CARIFORUM air service environment, both international and regional over the years, yet, as the need for The Study shows, there is some discomfort with its ability to ensure sustained airlift capacity for the tourism sector.

It must be emphasized that this mechanism will not work where temporarily there is no tourism product or where the product is poor. The impact of natural disasters can lead temporarily to no product and the inability to contain crime when trying to sell ‘paradise’ (as opposed to reality), for instance, would lead to a poor product. The failure of liberalisation to meet expectations should not fall on the mechanism but on the environment.

The only step to go beyond the status quo in CARICOM is the adoption of ‘open skies’ but there is a marked reluctance by a number of countries to so do. Caribbean countries wish to retain ultimate control, even though in some current agreements the reality is the *appearance of ultimate control*, over pricing. The fear is that pricing could be used as a weapon to create monopolies. This fear is more pronounced among countries that exercise the ownership mechanism. The very comprehensive June 2006 InterVISTAS study entitled, “Economic Impact of Air Service Liberalisation”, sponsored by a number of institutions including IATA and the World Travel & Tourism Council, concluded that:

“Traffic growth subsequent to liberalization of air services agreements between countries typically averaged between 12 percent and 35 percent, significantly greater than during the years preceding liberalization. In a number of situations growth exceeded 50 percent and in some cases reached almost 100 percent of the pre-liberalization rates”.

The report also states that:

“An examination of 190 countries and 2000 bilateral air service agreements suggests that there are still a number of countries that place a priority on protecting their flag carrier (s) rather than enhancing the overall welfare of the broader public interest”.



Moreover, it is fully accepted by Caribbean States that sustainable development of the tourism sector in the Caribbean requires effective partnerships between that sector and airlines.

Effective partnerships are based on trust, mutual benefit and a sense of welcome and openness between the partners. Air Service Agreements, though negotiated between countries, can be viewed as gateways facilitating on-going access to the designated airlines of the signatory countries. An 'open skies' agreement, more than a mere liberal agreement, demonstrates that sense of welcome and openness to the airlines of the other party thereby creating a positive environment for effective and multiple airline partnerships.

In this regard, it is interesting to note that Aruba, which lies deep in the Caribbean and has no large non-resident national market, has been able to attract the LCC, Jet Blue, to start service from the USA. Aruba has a highly demanded tourism product, an 'open skies' agreement with the USA and a USA immigration and customs processing facility at its airport.

3.1 The Latin American/Caribbean Experience

But what has been the experience in Latin America and the Caribbean? The USA has 'open skies' agreements in force with the South American countries Chile and Peru, the Central American countries Costa Rica, El Salvador, Guatemala, Honduras (provisional), Nicaragua and Panama and the Caribbean countries Aruba and Netherlands Antilles. All but the two Caribbean countries have domiciled airlines providing both international and regional service.

To date there has been no such experience in the Caribbean since no country with a domiciled airline has implemented the 'open skies' regime. However it is to be noted that Chile and its major airline LAN have been strong proponents of 'open skies' agreements (probably even more so than the USA) and LAN has prospered in this environment. LAN is a properly capitalized non-LCC airline, with a customised business plan and effective market-driven management operating in a strong demand environment. It provides a high level of service and controls its costs. It generates record profits in the current high fuel environment at a time when the US legacy airlines and some of the key Low Cost Carriers (LCCs) have been very unprofitable. LAN's management is on record that 'open skies' is beneficial to it. *'Open Skies' gives it the*



freedom to find the optimum mix of destinations to fly. COPA and TACA in Central America have had similar experiences. Moreover TACA was the result of the application of functional cooperation to a number of loss-making airlines seeking to benefit from economies of scale. In Asia, Singapore Airlines also prospers in an ‘open skies’ environment. It is to be noted that while LAN is a private sector company, the Government of Singapore owns Singapore Airlines. In the Middle East, Emirates Airline, based in Dubai and public sector owned, also prospers, attracting pilots from the cash-strapped CARICOM airlines. One can conclude then that: *It is not the nature of the ownership but the willingness to operate under commercial principles that matters.*

3.2 International ‘Open Skies’

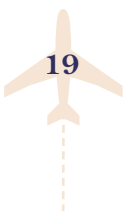
Key Provisions of the USA international ‘open skies’ agreements include:

- * No restrictions on international route rights, number of designated airlines, capacity, frequency or type of aircraft
- * Double disapproval pricing and only for certain specified reasons intended to ensure competition
- * Fair and equal opportunity to compete
- * Permission for cooperative marketing agreements such as code-sharing
- * Provision for dispute settlement and consultation
- * Choice by carriers to operate under the charter regulations of either country
- * Observance of the highest standards of safety and security
- * Optional 7th Freedom all-cargo rights

3.3 The CARIFORUM Status

The Dominican Republic negotiated an ‘open skies’ agreement with the USA in December 1999. CARICOM attempted to negotiate a similar agreement as a group but negotiations have been suspended for lack of progress. The USA has since indicated that it wishes to negotiate separately with each country.

Since then Jamaica has negotiated an ‘open skies’ agreement that is still subject to ratification. It is understood that in that agreement the USA has agreed to recognise ‘community of interest’



designation of CARICOM airlines on a ‘case by case’ basis.

The OECS countries may still want to negotiate an ‘open skies’ agreement with the US as a group but it is not clear from our consultations that all members want to conclude this type of agreement. It is also apparent that Trinidad & Tobago, Barbados and The Bahamas do not want to negotiate an ‘open skies’ agreement with the US in the near future.

3.3.1 Recommendation

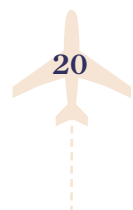
It is recommended that CARICOM countries proceed to negotiate ‘open skies’ agreements with the USA using the MALIAT Agreement³ as a model and incorporating the ‘community of interest’ designation for those CARICOM airlines whose host countries are party to such Agreements⁴. The principles used by the USA to regulate domestic predatory pricing issues can form the basis of negotiation for the inclusion of similar procedures in the ‘open skies’ agreements.



³ The *Multilateral Agreement on the Liberalization of International Air Transportation (MALIAT)* provides for:

- * an open route schedule
- * open traffic rights
- * open capacity
- * designation based on effective control and principal place of business but protection against flag of convenience carriers
- * multiple airline designation
- * third country code sharing
- * minimal tariff filing regime retention of cabotage

⁴ A country can request to participate in MALIAT once it has acceded to the following international security agreements, the 1963 Convention on Offences and Certain other Acts Committed on Board Aircraft, the 1970 Convention for the Suppression of Unlawful Seizure of Aircraft, the 1971 Convention for the Suppression of Unlawful Acts against the Safety of Civil Aviation and the 1988 Protocol for the Suppression of Unlawful Acts of Violence at Airports Serving International Civil Aviation. Current signatories to MALIAT include Brunei, Chile, New Zealand, Singapore, Samoa, Tonga, and USA. The New Zealand Government is the depositary state for the Agreement. The text of the Agreement can be found on www.maliat.govt.nz/agreement. With the Agreement now in force, any state that is a party to the aviation security conventions listed above may accede to the Agreement by deposit of an instrument of accession with the Depository



3.4 Intra-Regional ‘Open Skies’

The current CARICOM MASA is in reality confined to the Eastern Caribbean. The less liberal ACS version is yet to come into effect. The current MASA does not now conform to the requirements of the Revised Treaty of Chaguaramas – it is not liberal enough and must be amended. But how far should the liberalisation go?

It must be noted that the aviation corollary to the CSM would be ‘open skies’. Indeed the concept of ‘open skies’ goes hand in hand with the single markets of the USA, Canada and Europe. It is in effect in Central America and the South American countries are now pursuing it. Numerous studies have shown the positive impact of intra-regional ‘open skies’ regimes on countries in the same economic grouping. The most comprehensive to date, the June 2006 InterVISTAS ‘Economic Impact of Air Service Liberalisation’, determined that,

“The creation of the Single European Aviation Market in January 1993 led to an annual growth rate in traffic between 1995 and 2004 that was almost double the growth rate in the years 1990 to 1994, producing about 1.4 million new jobs”.

Further, pushed by the CTO secretariat, its members are now realizing the relative value of intra-regional tourism – it is no longer the ignored poor kin of international tourism. Its unit financial contribution is generally higher, its impact on Gross National Product (GNP) greater and it is more tolerant of natural disasters and issues such as crime. Intra-regional tourism (and indeed the nascent multi-destination tourism) would respond positively to an ‘open skies’ environment.

3.4.1 Recommendation

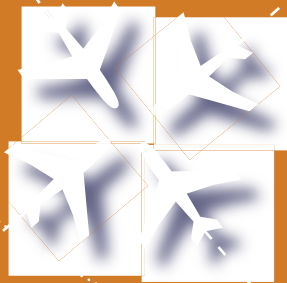
It is recommended that the CARICOM MASA be amended to an ‘open skies’ agreement based on the MALIAT model but retaining designation of CARICOM airlines only. The Agreement should allow for the CARICOM Competition Commission to have jurisdiction over



unfair competition disputes. This will ensure full compliance with the Revised Treaty of Chaguaramas. It will also signal to the international community that the Caribbean wishes to apply to itself that which it may be prepared to negotiate with the international community. Once the Agreement comes into force it could be open to accession by any full member of the CTO or the Association of Caribbean States.



*4. Strengthening
the Domicile
Airlines*



Given that the Dominican Republic currently has no airline providing scheduled intra-regional or international service, the focus in this Study is on the airlines domiciled in CARICOM. The airlines in CARICOM are the international service airlines Air Jamaica, Bahamasair, BWIA and Suriname Airways and the intra-regional service airlines Caribbean Star and LIAT. Caribbean Star is private sector controlled while the others are controlled by the public sector – albeit reluctantly. All these airlines regularly lose money. Their owners firmly believe nevertheless that they should keep flying.

An analysis of Caribbean airlines indicates that they are generally undercapitalised and lack economies of scale, inclusive of demand. *A review of successful airlines indicate that they are well capitalised, operate in an environment of high demand and enjoy economies of scale. It is also generally recognised that endemic loss-making airlines are unable to provide the sustainable high quality of service that tourism economies need.* Since the owners of these airlines want them to contribute effectively to the socio-economic development of the tourism-driven economies of the Caribbean, it is incumbent on them to provide the environment and tools to give the airlines a reasonable chance of success.

It should be noted that Caribbean Star appears to be effectively capitalised and is attempting to generate economies of scale by expansion and by close functional cooperation with its sister airline Caribbean Sun. Air Jamaica, Bahamasair, LIAT and Suriname Airways continue to be poorly capitalised while BWIA may be about to be effectively capitalised as it metamorphoses into Caribbean Airlines. Certainly Air Jamaica, Bahamasair, and BWIA have had access to recent advice from consultants of international repute and are in the process of re-engineering. LIAT and Caribbean Star are in the process of exploring a possible merger of operations, albeit while admitting that they are both hemorrhaging financially. Such a merger would, among other benefits, provide an enhanced opportunity, given the Category 1 status of the OECS, to gain feed from international airlines serving the Eastern Caribbean. Generally, however, the



requirements of proper capitalization lack of strong demand and diseconomies of scale remain. The lack of strong demand, worsened by the typical small island state characteristics of the region, reinforces the diseconomies of scale.

4.1 Recommendations

The recommendations presented in this section take account of these realities and are focused on the public sector controlled airlines. *It is important to stress that the recommendations be treated as a cohesive whole and not be 'cherry-picked'.*

4.1.1 Improving Demand

The core demand for airlift capacity is driven by the extent to which the tourism product is of quality and relevance to the defined target markets. Creating this demand is a function of the tourism sector and the governments of the Caribbean, including those that own the airlines. In addition, demand is boosted by intra-regional and multi-destination tourism and this demand can best be serviced by the Caribbean domiciled airlines. In that context, it is recommended that Caribbean governments seek to strengthen the regionally domiciled airlines by:

- I. Maintaining the International Aviation Safety Assessment (IASA) Category 1 status of the domiciled airline countries and encouraging those other countries that are Category 2 to achieve Category 1 in the shortest time possible. These countries include Belize, Dominican Republic, Haiti, and Guyana. This graduation may be more easily effected if the concept of the ECCAA can be applied to CARICOM and even to the wider region, where feasible. The Revised Treaty of Chaguaramas requires the “implementation of uniform regulations and procedures in areas such as transport operations, safety, licensing and certification”. The Regional Aviation Safety Oversight System (RASOS) in which all CARICOM countries but The Bahamas are members can be converted into this regional authority. With Category 1 across



CARICOM/CARIFORUM/Wider Caribbean, the domiciled airlines will be able to fully exploit code-sharing opportunities with one another and with international airlines thereby increasing demand for their services.

- II. Adopting 'open skies' regimes across CARIFORUM for intra-regional and international service. This not only creates additional opportunities for the domiciled airlines since they are no longer route constrained but it also allows for the optimization of 'community of interest' designations since the 'other parties' would be more inclined to allow this form of designation if the country of domicile of the airline adopts the 'open skies' regime.

- III. Improving hub airport-client country relations, (see 'Hub & Spoke' Systems below) thus facilitating service and encouraging demand to countries without airports capable of handling passenger jet service. The regional service airlines will benefit from such an improvement since they are the ones that serve the client countries. The domicile international service airlines can also benefit to the extent that they too structure preferential marketing alliances with the regional service airlines.

4.1.2 Generating Economies of Scale

Responding to increased demand requires expansion of the operations of the airline thus providing the potential for internally generated economies of scale. Pursuing the following measures could further generate economies of scale:

- I. Functional cooperation among the regionally domiciled airlines; owners and managers of Caribbean airlines have generally not seen this concept as a useful component of airline re-engineering. Their formal position is that internal airline re-engineering must first take place before regional functional cooperation can



be considered. The result of this approach is that (a) it never seems to happen; (b) its contribution to internal re-engineering is at best reduced; and (c) it puts the staff of the airlines through two separate sets of trauma. Its success has however been evident in Latin America and is being employed by Caribbean Star and Caribbean Sun in the Eastern Caribbean

- II. Strategic alliances with international airlines; this approach seems to be preferred over regional functional cooperation by Caribbean airlines even though the two (2) mechanisms are not mutually exclusive. The potential for these alliances is enhanced by the current Category 1 status of the host countries of the CARICOM airlines and can be further improved with both 'open skies' (allowing for more transfer airports) and improved hub airport-client country relations.

4.1.3 Hub & Spoke Systems

Airlines adopt 'hub & spoke' systems as one mechanism for creating economies of scale when it is in their interest to so do. However, passengers tend to prefer same plane non-stop service unless the price premium for such service is significant, loyalty programmes are not available or flight times are grossly inconvenient. Further, 'hub and spoke' systems are complex logistical arrangements that place increased burdens on airline operations, especially the engineering and maintenance function, and subject airline schedules to increased adverse impacts from forces outside the control of the airline e.g. weather and air traffic control delays.

Moreover, 'hub and spoke' systems will accentuate the 'peak and trough' of service at the hub airport and may lead to a need for increased resources (higher costs) by the airport, the airline and ancillary support services (immigration and customs) that will only be used for relatively short periods of the day.

However, when operated efficiently, 'hub and spoke' systems can be of financial benefit to airlines and of service benefit to passengers. When operated inefficiently, which is all too easy



to do, these systems can significantly increase the operating costs of an airline and its hub airport and be powerful disincentives for passengers to use the airline. LCCs tend not to adopt 'hub and spoke' systems. In the Eastern Caribbean the effective adoption of 'hub and spoke' systems can:

- * Facilitate service to low demand generating islands
- * Allow such islands to attract international visitors without the capital and operating expense of providing airports capable of supporting trans-continental service
- * Generate increased service for the hub airports thus allowing capital and operating costs to be spread across a larger number of flights

This strategy demands a more effective level of planning at both the developmental and operational phases of the hub airport(s). It requires a higher level of on-time performance by the participating airlines, better inter-airline connecting systems (e.g. BA -LIAT) and a greater degree of trust among them for the effectiveness of their security systems. It also needs more efficient support systems at the hub airport(s).

Most of all there must be a sea change in behaviour, overcoming the negative impact of separation by water and sovereignty. It requires the hub airport to consciously recognise that it serves not only its host country but also its surrounding client countries and it requires the client countries in turn to recognise the hub airport as their own even though it is in another sovereign country. It may also require that the client countries contribute to the funding of the hub airport. In fact, it is all about the pooling of regional resources to the benefit of the regional community – an underlying principle of CARICOM. Success requires a rise above the parochial view, necessary in any case if the benefits of the CSM are to be optimized.

4.1.4 Proper Capitalisation

This is probably the area of greatest challenge to owners of CARICOM airlines, whether they



are from the public or private sector. For government owners, the competing demands for limited funds have continually restrained their ability to adequately capitalise their airlines. Yet it is necessary if the airline has to make reduced (preferably none) on-going demands on the public purse and achieve its service mandate of providing sustainable high quality service at acceptable prices to customers.

There is now an influential body of opinion that says that a CARICOM government-owned airline can be likened to a bridge. It is an analogy that has some merit if:

- An effective design is seen as a pre-condition to the proper construction of a bridge
- The effective design of the bridge is seen to be akin to a credible business plan
- The proper construction of the bridge is also recognised as being akin to the proper capitalisation of the airline
- International/regional financial institutions funding of infrastructure would apply to both bridges and airlines.

It appears that the World Bank, the Inter-American Development Bank (IDB) and the Caribbean Development Bank (CDB) have all recognised the importance of effective airlift capacity to the socio-economic development of the Caribbean region. It is also to be noted that government taxes are a significant portion of the passenger airfare and are therefore the antithesis of the low airfares that the tourism sector says it needs.

It is therefore proposed that:

- I. On the basis of credible business plans that have been subject to thorough scrutiny, government owners source adequate funds, either from their own resources, through equity partners or through loans from the development financial institution(s), to provide proper equity capital for the airlines.



- II. Where the capital is obtained through borrowing, such loans should be repaid from the government ticket taxes collected from the airlines. It must be emphasized that the funds will be loaned to the shareholder government (s) and not directly to the airline (s).

- III. Governments should avoid at all cost the practice of granting generalized financial subsidies to airlines, whether domiciled, international or owned by the government or local/regional private sector. Rather, Caribbean nations would be well advised to adopt appropriate policies as regards their public service obligation, which would see, where necessary, the granting of subsidies to airlines for selected routes and services only where competition in the market cannot be sustained. The policy should clearly establish objectives; target beneficiary groups or communities; payment arrangements; timelines and performance monitoring. Governments must however remove any artificial obstacles to the achievement of competition and where conditions change, necessitating a removal of subsidies, they should be removed forthwith.

4.1.5 Maintaining a Commercial Culture

All too often, an environment of continuing government subsidies does not generate effective performance by staff thus leading to lack of creativity and drive. This in turn produces inefficient operations leading to reduced financial outturn. In order to maintain the commercial drive within the airline it is recommended that:

- I. The airline be mandated to develop a financially viable business plan that meets agreed criteria; board and management would be judged against this plan

- II. To the extent that the shareholder(s) wish additional flights to be performed the level of funding and the related service expectations would be agreed and



once again board and management would also be judged against this agreement

III. It is expected therefore that the airline (s) would seek competent market-driven management and that tenure and compensation of all staff would be performance based



5. Conclusion



Efficient, demand responsive air transport services are critical for international trade and economic development. There is a clear recognition that the issue of sustainable and reliable air transportation is extremely important to the region's economic sustainability, particularly in relation to its tourism sector, and needs to be dealt with most urgently in a manner that is implementable. The sustainability of Caribbean tourism and general business competitiveness cannot be ensured without reliable, efficient, easily accessible and affordable air transportation.

The overwhelming dependence of the region's tourism industry on air transportation and the increasing vulnerability of airlines to economic phenomena such as escalating energy costs, high wage rates, overcapacity in major markets and suicidal price wars, necessitate an urgent review of the business models and policy approaches for sustainable operation of the region's vital air transportation sector. This in effect is the rationale for this Caribbean Air Transport Study. While many other studies have been commissioned in the past, the current situation requires a determined effort and commitment from all stakeholders to ensuring the provision of reliable, efficient and sustainable air services into and within the region.

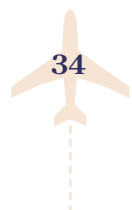
There is vast evidence over the last twenty years that air services markets work best when there is fair and healthy competition. Efficient competitive outcomes in air services markets are possible in terms of services provided in relation to customer demands and requirements. A more liberalised Caribbean air services regime with appropriate safeguards against abuses of dominant market positions and market failure is commended as an essential measure for ameliorating the current unstable condition of the region's air transport sector.

A liberal environment for the provision of air transport services does not obviate the need for effective policy and regulatory capacity. Regional governments must still have the capacity and know-how to effectively manage the opportunities created by competition in order to ensure that policy objectives are met and satisfactory services to the consumer are secured. A good start, for example, has been made in this direction in the Eastern Caribbean in regard to the



management of air safety and security with the establishment of the Eastern Caribbean Civil Aviation Authority (ECCAA). Caribbean nations therefore would be well advised to take the opportunity to generally review and selectively strengthen public sector capacity, in order to ensure effective monitoring of air transport services, to critically assess policy options and their impact on sector performance, and to develop and sustain knowledge of best practices in air transport sector management. International donor agencies such as the World Bank and European Union as well as relevant developed countries could be approached for assistance in that regard.

This summary report and the study on which it was based would be well worth the effort if it succeeded in garnering support for change and devising realizable implementation strategies for ensuring the best possible regimes for the sustainable development of regional air transportation and by extension the sustainable development of Caribbean economies. One must nevertheless have a realistic long-term view as this may take some time to come into effect. However, we do not have the luxury of time as changes are taking place rapidly and the challenges of competition and survival become more acute.



Notes

