



2016 Q3 Report

Perceptions from the Middle Kingdom

New CAAC Internal Policy Rule Makes Market Entry More Difficult For Domestic Startup Airlines

Perhaps the most significant Q3 development for the PRC domestic aviation industry was the issuance of CAAC Internal Rule #96 dated August 29, 2016 governing the process for market entry by new startup airlines (hereinafter "the Rule"). The three-page internal policy guidance memo was issued to all domestic airlines, major aviation suppliers, and local CAAC branch offices. It doesn't affect foreign airlines serving the Chinese market.

The Rule addresses concerns raised by the PRC government aviation industry "watch dog" organizations relating to safety, service quality and schedule reliability. It also includes some interesting key parameters, such as: the current domestic RPK growth rate is 9.6%, and; there are currently 57 airlines operating in the PRC domestic market, including 51 passenger and 6 cargo carriers. The Rule also predicts that the combined total domestic airline fleet will grow from 2800 aircraft today to 4500 by the end of the current (13th) Five Year Plan, which ends in 2020. It indicates that this growth will adequately serve both the national needs and those of the traveling public, and that care must be taken to avoid having "too many, too small, too sparse and too weak" domestic airlines going forward.

In light of these considerations, and to support the objectives of promoting regional aviation, cargo aviation, and the domestic aircraft manufacturing industry, the

Rule imposes strict criteria for entry of new airlines into the domestic market. New startups must begin as either a regional or cargo airline with a sufficiently large fleet (at least 25 aircraft for a regional airline, or 20 for a cargo carrier) and sufficiently high number of monthly flight hours before subsequently transitioning to mainline operation and/or from cargo to passenger service. These prerequisites would seem intended to inhibit, rather than facilitate, the growth of the domestic fleet.

The Rule also indicates that more detailed additional procedural rules and requirements will follow in such areas as aviation resources, airport hub operations and slots, and pilot training and qualifications, with a more restrictive approach to market entry and licensing procedures as well.

Finally, and perhaps most significantly, the Rule directs all CAAC branch offices to re-examine applications of prospective startup airlines for entry into the domestic market, *specifically including those that have already been approved*. Such pre-approved applications are to be returned to the submitting airline for re-evaluation based on the criteria set forth in the Rule, including the 25/20 minimum size threshold for regional and cargo airlines respectively.

The issuance of the Rule is consistent with the outlook we had predicted in our Q2 report, and will of course have a very significant effect on new startup market entry, aircraft OEM order books and the PRC airline industry's forthcoming new round of reorganizations. PGA Aviation does not expect any new domestic PRC passenger airlines to be approved in the near future.

The PRC has an administrative licensing law dating to early in this century, some provisions of which would

seem to overlap with the Rule. Although that has the status of actual law, whereas the Rule is more in the nature of a regulatory procedure, it remains to be seen which one will actually take precedence in case of any conflicts or inconsistencies.

As always, the professionals at PGA Aviation will continue to monitor trends and developments in the Chinese aviation industry from our "ground level" perspective and stand ready to respond to and serve our clients on matters relating to PRC government compliance relating to both domestic and foreign projects.

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