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**Abstract**

This essay briefly discusses the reality that I have experienced in air transport for some time. In this field, the world is still ruled by bilateral air transport agreements. Such bilateral agreements are even in force in Europe. This essay asks several questions. First, what does successful deregulation in Europe really mean? Would deregulation be successful if many low-cost carriers flew throughout Europe and carried mostly point-to-point traffic from point A to B? I personally think that very few routes are suitable for this point-to-point traffic.

# DEREGULATION OF AIR TRANSPORT AGREEMENTS

*Dr. Robert Wolfger**

Thank you for making it possible for me to take part in this Symposium. Normally, it means trouble for an airline when it is surrounded by so many lawyers. It means trouble because for many airlines, economic considerations, in whatever form, come first, and then competition law may hit.

I represent a national airline here. Austrian Airlines is fifty-one percent owned by the Austrian state, a small state. Within this small state, there is limited competition. On the other hand, Austrian Airlines is a very small airline with only a two percent market share in Europe. In absolute size, Austrian Airlines ranks forty-ninth in the world. Austrian Airlines has a limited number of aircraft, and has shown positive results for a couple of years now.

Shortly before this meeting, Dr. Romina Polley asked me if I was offended after reading her presentation. I told her that I was used to the arguments she used in her Essay. Having been with Austrian Airlines for almost twenty years, I know about the past fairly well, and I follow present developments closely. I started with market research, worked in personnel administration for some time, and have been with international relations for fourteen years, which means, in the first instance, care for government relations. I must admit that we have very good relations with the Austrian government. I have to admit as well that when Lauda Air—now our daughter company—was owned by Lufthansa, Lauda Air had even better relations with the Austrian government.

Let me talk briefly about the reality that I have experienced in air transport for some time. In this field, the world is still ruled by bilateral air transport agreements. Such bilateral agreements are even in force in Europe. For example, there is still a bilateral agreement between Germany and Austria, which has not been canceled but has, to a great extent, been overruled by the three European liberalization packages and the declaration of applicable competition laws to air transport within the Euro-

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pean Union ("EU"). Not much more than ten years ago, traffic between Germany and Austria was nearly reciprocally allocated to Lufthansa and Austrian Airlines by means of a so-called pool agreement. We sat together every other month in a relaxed atmosphere, talked about figures, talked about costs, and how to allocate the revenues between us. There was an agreement to share the revenues—in principle, half and half. Of course, Lufthansa had much more revenue than we did, as we were a small airline, and therefore the payments resulting from that pool agreement flew in our direction. Although the pool payments had a limitation of one percent of the revenues of the paying partner, we received about seven million Austrian shillings every season for conceding that Lufthansa was allowed to offer some more seats to Austria than we did to Germany. That is over. That is finally over within the European Economic Area.

It is still the case, however, between the EU and other countries of the world. Not long ago, I returned from bilateral negotiations with Israel. There is a bilateral agreement between Austria and Israel, just as one is in effect between Germany and Israel—an air services agreement of a rather pre-deterministic type. This agreement stipulates that every airline that is designated on each side has, on principle, the right to offer fifty percent of the capacity, but only one airline on each side should be designated for offering this capacity. This agreement also stipulates that both designated airlines must agree on their capacity to be offered in advance, and if the airlines agree, then the respective governments would give their consent. Within this bilateral agreement, Austrian Airlines transports more passengers than El Al. Within this environment, adding frequencies between Austria and Israel is hardly possible. For years, there has been a pool agreement between El Al and Austrian Airlines. Even if code sharing is offered, or eventually the pool payment might be raised, one never takes for granted that the partner will agree to that capacity increase. That is air traffic under a bilateral agreement, especially one with a predetermination clause.

The same scenario goes for Russia, with the new Eastern European countries, and still with almost all Central European countries. It is also the case for most of the air traffic between Europe and Latin America, and between Europe and Asia. Between Austria and Tokyo, one cannot offer the capacity according to market needs. There is a limitation to the capacity the other partner, or the other party, is ready to grant to you. It is a built-in limitation, as it is not only the one party in Europe that can liberalize or deregulate. There is also the other party that has a say in bilateral agreements. If the European Commission ("Commission") obtained an unlimited mandate to negotiate with these countries, then I fear that from some countries, which are not as liberal regarding air traffic as in our part of the world, we would get much less than we have now.

Let me discuss, as an example of an air transport agreement that had some importance for Austrian Airlines in the past, the air transport agreement between Austria and Spain. Normally, the annex to a rather liberal agreement says that the designated airlines of Spain are allowed to fly from any point in Spain to any point in Austria, and the designated airlines of Austria are allowed to fly from any point in Austria to any point in Spain. This air transport agreement, however, was not that liberal. It said that the designated airlines of Spain could serve any point from Spain to Vienna, and the designated airlines of Austria could do so from any point in Austria to Madrid. One can already see from this formula, however, that the chances are not evenly distributed because Spain has so many interesting points for an airline, while Austria has, at most, only Vienna and Salzburg to offer. Graz, Klagenfurt, and Linz might not have been so attractive for new air services within these agreements. Even with such an air transport agreement the points are limited, and in this situation, they were even more limited. The designated airlines of Spain flew from two limited points in Spain—Madrid and Barcelona—to Vienna, while the Austrian airline was allowed to fly from points in Austria (the only economically reasonable point was Vienna) to Madrid. I do not think that this was fair, but it was, let us say, a reciprocal formula and logically clear: from points here to one point there—the reciprocal way. So Iberia was allowed to fly from Madrid to Vienna, from Barcelona to Vienna, from Malaga to Vienna, from wherever in Spain they wanted to Vienna, and we were allowed to fly from Vienna to Madrid, from Graz, Klagenfurt, Linz, and Salzburg to Madrid. If, under a pre-determinative type of agreement, one finds such a situation, then the small country normally, through repeated negotiations, can negotiate more points in the other, larger country. So, after a while, we were allowed to get Barcelona, to get Malaga, and even a fourth point. We got a little bit more than a logical formula of reciprocity would permit. Now, if one takes all the European countries, especially the small ones, negotiating in the same way with Spain, they often got more rights than they deserved out of these reciprocal agreements. I think this is still the case between smaller countries in Europe and larger third countries, where the governments still show a rather restrictive attitude.

This conclusion is even valid if we consider the relations between single European countries and the United States. Many European countries have concluded Open Sky agreements with the United States, which mainly offer every European country such an Open Sky agreement. I must say that for Austria, this Open Sky agreement might be the optimum it could get. I suppose that for the German carriers, the Open Sky agreement between Germany and the United States might also offer the best available chances. I don't know if the Dutch agreement is sufficient for the Dutch carriers, but for the Spanish and Portuguese carriers, I also suppose that such an agreement would be enough. For most of the European carriers, an Open Sky agreement with the United States might be the best they could get. Why the best? Because most European carriers operate from or to one single hub, and they try to build up, maintain, or expand this single hub. The more spokes they add to this hub, the better their competitive advantage is, and the cheaper the fare they can offer to the public. If some spokes are taken out of these hubs, however, as the Commission thinks they must be in the case of British Airways/American Airlines and maybe Lufthansa/SAS/United Airlines, then the cost of the network operation would naturally go up, and the prices for the public would increase. So, if the European carriers build hubs in their own countries they need not, in the first instance, build second or third hubs in other countries if there is no severe capacity constraint at their main hub. Lufthansa, in my opinion, need not to build up a hub in Madrid. Lufthansa need not build a hub in Rome or in Milan, because, with their hubs in Frankfurt and Munich, and their cooperation network, they can serve the whole of Europe. Europe is not the United States, where the situation is completely different, and carriers possibly need more hubs because the country is so much larger.

So, *cui bono*, what happens if the Commission negotiates for the whole European air traffic—if single countries, in the long run, could gain more, vis-à-vis more restrictive countries, and if the single countries are rather happy with their Open Sky agreements? I doubt that it would bring about an added value for existing carriers, in case the Commission negotiates.

In general, one could ask, what does successful deregulation in Europe really mean? Would deregulation be successful if many low-cost carriers flew throughout Europe and carried mostly point-to-point traffic from point *A* to *B*? I personally think that very few routes are suitable for this point-to-point traffic. I might offer you an example. Just at the time Austria joined the EU, there was a Belgian entrepreneur who wanted to fly with his low cost airline between Vienna and Brussels, between Brussels and Rome, and between Brussels and Barcelona. He started this operation between Vienna and Brussels. The airline's name at that time was Eurobelgium, although now it is Virgin Express, as the entrepreneur sold the airline to Mr. Richard Branson. At that time we made the following calculation: Eurobelgium operated with a 737, and offered a price of DM130 from Vienna to Brussels one way. No frills were included. The airline, which offered its services daily, needed a break-even of seventy percent just to cover its cost. The managers of this airline thought there was more than enough point-to-point traffic on this route. There was not enough, however, and there is still not enough. If airlines operate between two hubs—in the case of Vienna and Brussels, these airlines have been Sabena and Austrian Airlines for years—then almost fifty percent of the traffic, or even more, is hubbing traffic. It is network traffic, not point-to-point traffic. So, if an airline goes into such a route and wants to have only the point-to-point traffic, it can only gain a very limited number of passengers from the incumbent airlines.

After two years of making losses, Mr. Hasson, who was the owner of that airline, called us. We went to Brussels to have talks with Mr. Hasson. He told us the following:

> Look, I tried, but have not been successful in my way. I offer you one thing. Give me, let's say, 70 seats from your midday flights at a price of 80 Deutsche marks. In such a case I will put these passengers on your planes, they will get no service, except an apple from time to time, but the passengers will know, that they are on my no-frills part of the plane, not yours.

We asked him not to pursue this idea any further, but to use a smaller aircraft, as we offer a different standard of service quality. We want to offer quality service to the passengers on our planes, and such an idea does not fit our flights. He told us that he would to have to give up the route and consult another airline about the idea of cooperating on his other routes. Finally, he went to Sabena. Maybe this suited him better because he—and now Virgin—cooperates with Sabena, though in a slightly different fashion. Sabena accepted his flights to London, Rome, and Barcelona under its umbrella, and operates these flights under its own name.

With this example, I just wanted to mention that even within Europe, we have mostly network operations. The Commission is investigating purely on the basis of routes. On the route, the Directorate General IV officials say that if you have market power, you have market dominance. They argue the same way when investigating third country routes. When they examine the U.S.-Austria traffic, they almost solely look at the New York-Vienna route. A rather limited number of passengers fly on this route; approximately 120,000 passengers a year. With this limited demand, we can hardly operate two frequencies a day. Let us say it is not enough potential to operate two frequencies a day, but we must operate them in order to have connections from and to the United States via Vienna. So you have to operate two frequencies, but the load factor does not justify them if you operate on your own. If we did not have our partner Delta Airlines cooperating on this route, which contributes substantially to the route, then we would have to bear losses. The Commission says, however, that by cooperating you have a dominance on this route, and they have to see if they might have to take something away here—slots, frequencies, the cooperation vis-à-vis travel agents, companies, etc. Although the route is open to competitors, nobody else in Europe is interested in operating this route.

There is a difference, of course, between small airlines and big airlines. If there is a very big airline on the very west end of Europe, then this airline could have a dominance, as no passenger would be interested in going eastwards first in order to continue westwards. In this connection, one must say that the Commission is investigating business traffic, in the first instance, because the Commission considers this kind of traffic as having no other choice than going on the direct flight. We made a study together with the Roland Berger company, however, and this study shows that from Austria—or from Germany—to the United States, this is not true, because only thirty to forty percent of the business traffic goes on the direct flights to the United States. Seventy percent of the business traffic, at least from Austria, is going via other European points. Traffic, including business traffic, which the Commission considers time-sensitive, to or from the United States, is network traffic. It is not purely third and fourth freedom route traffic. It is network traffic, and you have to investigate the traffic flows within networks. This result is also true in case of business traffic.

One last remark, maybe a short one about prices in air transport. Fifteen years ago, we had real networking in prices. There were the International Air Transport Association agreed fares, and there was a world wide network in fares. Small Austrian Airlines had a world wide network offer. What does that mean? When we sold a ticket from Vienna to Los Angeles—we did not even fly to New York in those days—any airline accepted this ticket, any airline. So the passenger had the choice to fly via Frankfurt, via Paris, via London, via Madrid, wherever he wanted, because there were agreed tariffs around the world, and so-called interlining between all airlines was granted. I do not say this was good in all aspects, because this mechanism in some cases kept the fares at high levels. But, on the other side—and let us say, under the table—for travel agents and for big companies, there existed other, and, in all cases, lower prices. So, for example, if the official gross tariff to Los Angeles was, let us say, 12,000 shillings, big companies got a rebate, and then the net rate might have been, for them, let us say, 8000 Shillings. Airlines that had on-line connections to Los Angeles—via Frankfurt, Paris, London, Amsterdam, etc.—could sell at 8000 shillings because they pro-rated this fare internally over their own flights. If we sold this 8000 shilling fare via our connecting flight to Amsterdam, then KLM would have taken from us a pro-rated Amsterdam-Los Angeles fare based on the 12,000 shilling fare, and this might have been the 8000 shillings in all. Now it is possible to sell the 8000 shilling fare with our partners, because if we sell at these 8000 shillings, we are able to keep 4000 shillings for the New York route, and Delta takes 4000 shillings for the New York-Los Angeles route. If we did not have these internal agreements, then we could not even interline with our partners. So pricing agreements and interlining agreements are good for the passengers, as well as for the interlining partners, because they create new products. If, for example, we have a low tariff, now we can offer this low-tariff together with all our partners, but we cannot offer this low tariff on Lufthansa, on KLM, or on other alliances—they have their own low internal tariffs. This result keeps the alliances apart, and it keeps them apart while, in other fields, there necessarily remain connections between alliances, especially if small airlines are concerned. When we could no longer afford to operate to Düsseldorf—we experienced a loss of twenty million shillings within one year—then we had to ask Lufthansa if they could be so kind as to offer us some seats on its flights in order continue feeding our hub in Vienna. The other alternative was to go out of this route. Lufthansa kindly agreed. We offer our prices there, Lufthansa offers its prices on this route, and there is competition on this route. With the Commission, however, we still might have a problem. The Commission might say that there should be absolutely no cooperation between alliances, whatever cooperation it might be. This rule cannot be the case for small airlines, however, because if it were so, the diversity of route offers would be killed in favor of an oversimplified theoretical construct.