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Industry Issue Paper

The United States–European Union Open Aviation Area: The American Perspective

by Christian Hofer and Martin Dresner

This paper presents a comprehensive analysis of current United States–European Union (U.S.–E.U.) aviation relations. Following a brief historical review, the proposed North-Atlantic Open Aviation Area is discussed. Specifically, the associated economic benefits are assessed, and the causes of the current deadlock in U.S.–E.U. negotiations are analyzed. Particular attention is paid to the interests and actions of U.S. stakeholders, most notably U.S. airlines, labor organizations, the Department of Transportation and Congress.

INTRODUCTION

The United States and the European Union are the world's largest economies. In 2003, the combined gross domestic product of the United States and European Union was nearly US$24 trillion, with direct investments from U.S. investors to the European Union and vice versa totaling over $1.8 trillion (Calleja 2004). The size of the U.S. and E.U. economies, together with the historically strong ties between the two regions, result in the world's largest international air transport market. In 2000, 419,961 billion revenue passenger kilometers were generated between North America and Europe (Button 2002). Aviation, thus, is an important and economically significant element in transatlantic relations.

While commercial exchange and trade relations have prospered due to progressive trade agreements, international aviation, to some extent, has lagged behind. Although a number of "open skies" bilateral agreements have been concluded between the U.S. and European countries, certain aspects of the transatlantic aviation market continue to be restricted, such as access to key airports (most notably, London Heathrow), fifth freedom and cabotage routes, and foreign ownership of airlines.

The "Open Aviation Area" (OAA) between the United States and the European Union has been proposed as a way to reduce restrictions in the transatlantic aviation market, thus contributing to increased efficiencies, greater airline profits, lower prices, and better route choices for consumers. Between 2001 and 2004 alone, U.S. airlines accumulated losses of US$36 billion.[1] While there are many reasons for the industry's poor performance, it has been suggested that the opening of international aviation markets could help strengthen the aviation industry. According to the International Air Transport Association (IATA), the liberalization of the transatlantic aviation market would affect approximately 105,000 seats each day and could add US$12 billion to the profits of American and European airlines (Bisignani 2006). However, opposition to the Open Aviation Area remains strong, and talks to conclude an agreement creating the OAA are currently stalled. This article sheds light on the reasons for this deadlock and evaluates the prospects for the successful deregulation of the U.S.–E.U. aviation market.

A BRIEF HISTORY OF U.S.–EUROPEAN AVIATION RELATIONS

Ever since the failure of the Chicago Convention of 1944 to agree on a multilateral regulatory regime for international air transportation, the regulation of international air transportation has been governed, primarily, by a system of government-to-government bilateral agreements. The bilateral

system requires two governments to agree on such factors as the routes to be served between the two countries, the approval process for pricing by the carriers, and any fifth freedom route rights.[2] The primary model for these bilateral agreements has been the Bermuda I bilateral, signed by the United States and the United Kingdom in 1946. The Bermuda I agreement specified the routes between the United States and the United Kingdom that could be served by the carriers of both countries, while limiting fifth freedom rights. Carriers were free to set capacities and determine flight frequencies within the limits of the agreement. Finally, carrier prices were set through the International Air Transport Association (IATA) subject to approval by both governments.

The Bermuda I agreement was replaced in 1977 by the Bermuda II agreement, which had more restrictive provisions. Instead of allowing airlines to freely determine capacities and flight frequencies on permitted routes, the Bermuda II agreement allowed governments to determine capacities for the carriers. This process involved U.S. and U.K. representatives meeting on a regular basis to divide capacities between their respective carriers.

Partly as a backlash to this restrictive agreement, and partly to arrive at an international policy that was in keeping with domestic deregulation of air transportation, the United States changed course with respect to international air transport bilaterals in 1978 and began to sign liberal bilateral agreements. These liberal agreements, which served as precursors to the open skies agreements of the 1990s, differed from the Bermuda I and Bermuda II agreements in a number of significant ways. First, they undermined the price-fixing authority of IATA by allowing individual carriers to set prices with minimal government oversight. Second, they specified a much wider system of routes permitted between the two signatory countries, typically allowing any possible third or fourth freedom route.[3] Third, they permitted carriers to fly extensive fifth freedom routes, subject to third country approval (i.e., fifth freedom routes begin or end in a third country and this third country's approval is required for the route to be operated). In five years, 1978-1982, the United States signed 23 of these liberal (or partially liberal) agreements, several with European countries (Dresner and Tretheway 1992).

After a pause during the Reagan Administration, when there was comparatively little activity by the United States in signing liberal bilateral agreements, a number of new open skies agreements were signed in the 1990s. The open skies agreements were largely modeled on the liberal agreements of the 1970s and 1980s, including liberalized route rights and minimal government oversight over pricing. The signing of these open skies agreements coincided with the privatization of many flag carriers, leaving foreign countries more willing to allow their carriers to compete in a liberalized marketplace. Between 1992 and May 2006, the United States signed open skies agreements with 76 countries, including 15 member countries of the European Union,[4] although the more restrictive Bermuda II agreement between the United States and the United Kingdom (1977) remained in force.[5] Other E.U. countries without open skies agreements include Greece, Ireland, and Spain.[6]

THE CURRENT STATUS OF U.S.–E.U. AVIATION RELATIONS

From Open Skies to the Open Aviation Area

As a result of the open skies agreements, United States airlines enjoy largely unrestricted access to most transatlantic aviation markets. European airlines, in contrast, are at a distinct competitive disadvantage. Unlike their United States counterparts, they have permission to fly to the United States only from their respective home countries, and not from other countries within the European Union. Further deficiencies in the current regulatory regime include limitations on investments in foreign airlines and the prohibition on cabotage flights (Moselle et al. 2002).[7]

Recognizing that the fragmentation of E.U. member states puts European airlines at a competitive disadvantage relative to U.S. carriers, the European Commission repeatedly attempted to obtain an exclusive mandate to negotiate air transport agreements on behalf of the European Union. As the Council of the European Union declined to bestow this responsibility upon the

commission, the latter decided to take legal action before the European Court of Justice against those member states that had signed bilateral open skies agreements with the United States (Warden 2003). The European Commission argued that the individual member states did not have authority to sign commercial pacts with non-E.U. nations. Moreover, the commission noted that the open skies agreements were in violation of European law. The latter prescribes that all E.U. firms be granted the right of establishment and the privilege of national treatment in all E.U. member states (Warden 2003). In the context of the airline industry, this implies that an Italian carrier, for example, is subject to the same rules and enjoys the same rights as a German airline when operating services between Germany and any other country.

In its 2002 ruling,[8] the European Court of Justice partially voided the existing open skies agreements due to, most notably, their "nationality clauses" that prevent European airlines from operating between the United States and third countries within the E.U. Some argue this ruling effectively suspended all open skies agreements (Warden 2003), while others—such as the U.S. administration—insist that the agreements remain essentially intact. Three days after the E.U. court ruling, Jeffrey N. Shane, then associate deputy U.S. secretary of transportation, signaled openness to partial renegotiations of existing open skies agreements by noting that "the United States is prepared to look creatively at nationality clauses. We certainly do not treat the traditional formula as sacrosanct,"[9] The European Commission, however, envisioned more fundamental changes and suggested abandoning the existing open skies agreements altogether in order to create an Open Aviation Area between the United States and the European Union. In June 2003, the member states of the European Union mandated the European Commission to conduct negotiations with the United States with regard to the Open Aviation Area.

The Open Aviation Area: Objectives and Potential Results

The Open Aviation Area is designed to be a comprehensive agreement between the United States and the European Union, governing air services between and within the two territories. The European Commission specifically hopes to agree on a set of rules "governing market access (routes, capacity, and frequency), how air fares are set, how to ensure effective application of competition rules, and how to ensure maintenance of high standards of airline safety and aviation security."[10] While not formally a part of the OAA, issues of foreign ownership and control are also included in the agenda. The vision is to create an economic area spanning both the United States and the European Union in which carriers, regardless of their country of origin, operate and cooperate freely both in domestic and international route markets.[11] The expected results would be more competition, a greater choice of services, and lower fares. The total impact of the OAA on consumer surplus, for example, is estimated to be in the order of 3.1 to 3.8 billion Euros per year (Moselle et al. 2002).[12] To understand the origins and drivers of these economic benefits, a review of the effects of air traffic deregulation in general, and in the United States–European context in particular, is provided below. A more technical economic analysis of air transport liberalization is provided in the Appendix.

Competition

Liberalized market access provides for greater competition. Many research studies have shown that increased competition implies greater consumer choice and lower prices, all else equal (Brueckner 2001, Morrison 2001, Windle and Dresner 1995). In a United States –European open aviation area, an airline from one European country could offer transatlantic services to the United States from another E.U. member state, thus providing additional competition. By the same token, American carriers could serve European markets where access may have been previously restricted. Access to London's Heathrow Airport, for example, is a priority for U.S. carriers. To the extent that slots at Heathrow are made available, U.S. carriers not now serving London Heathrow from the United States could add that service.

Consolidation

It is likely that the formation of the OAA would lead to industry consolidation. Since the bilateral regulatory regime would be replaced by a comprehensive U.S.–E.U. agreement, large, consolidated, European carriers could serve the United States from any point in the European Union. Small European carriers may go out of business or be purchased by larger airlines.

Alliances, mergers, and acquisitions have proven to be powerful strategies in the aviation business. A study by Oum et al. (2004), for example, suggests that (horizontal) alliances in the airline industry result in significant productivity gains (see Button 2002 for a discussion of the benefits of transatlantic alliances). The profitability effect of mergers is highlighted by the cases of US Airways with America West Airlines, and Air France with KLM. In both cases, the merged firm posted substantial profit increases following a merger (Buyck 2006, Straus 2006). By the same token, with fewer airlines operating in the transatlantic market, there may be price increases as carriers exercise their market power.

Efficiency

Efficiency gains in deregulated markets are predominantly derived from increased market and firm size. The U.S.–E.U. Open Aviation Area unites the world's largest aviation markets, and, as noted above, large airlines or airline alliances would likely emerge as the key players in this market. Large firms exploit size-related economies, such as economies of scale (increased scale of operations), scope (increased network size) and density (increased passenger throughput) (Moselle et al. 2002, Oum et al. 2004).

The increased scale of airline operations may also lead to improved customer service in terms of network coverage, reliability, and frequency of services (Button 2002). From an airline's perspective, further productive efficiencies arise from improved access to capital markets (Moselle et al. 2002). U.S. airlines, for example, could benefit from foreign investments to a greater extent than current regulations permit,[13] thus attracting urgently needed fresh capital. Moselle et al. (2002) point out that closer cooperation and integration between American and European carriers leads to a more efficient pricing regime and the elimination of double marginalization[14] (see Buehler 2005, Cameron and Done 2006, Park and Ahn 1999 for a discussion of the effects of double marginalization in network industries). It is also conceivable, however, that further consolidation within the airline industry results in an increase in firms' market power. Dominant airlines may then be able to exploit their market power and charge higher fares.

Growth

Improved operating efficiency and increased competition may result in a decrease in prices and to an increase in passenger traffic on liberalized air routes. Based on the markets that were liberalized in the 1970s and 1980s, Dresner and Tretheway (1992) showed that the discount prices in these markets were 35% lower than the discount prices in markets regulated by Bermuda I or II agreements and equated this price drop to annual welfare gains of about $325 million.[15] Dresner and Tretheway (1992) further showed that traffic in the liberal markets was, on average, 46% greater than the traffic in the Bermuda markets, after controlling for all other factors. They also calculated that the average passenger growth rate in the liberal markets was 11% higher than the average growth rate in the Bermuda markets.

More recently, the consulting firm Inter*VISTAS*-g[2] analyzed the impact of deregulation by conducting a series of case studies (Anonymous 2006). Examining air traffic between the United States and the United Kingdom, for example, the following conclusions were presented:

> "A simulation of full liberalization of the United States – United Kingdom market as a result of a Comprehensive First Step Air Transport Agreement between the

> U.S. and the European Union would result in a 29 percent increase in traffic. The increase would derive in part from lower fares, and in part from allowing any U.S. city to obtain nonstop service to London's Heathrow or Gatwick airports." (Anonymous 2006, ES-14)

The report estimates the incremental GDP impact for both the United States and the United Kingdom to be about of $7.8 billion.

Moselle et al. (2002) estimate direct employment effects and indirect revenue effects of air traffic deregulation. They project that the implementation of an open aviation area would create between 3,800 and 16,200 new airline and airport jobs in the United States and the European Union (Moselle et al. 2002, Table 6-3). The increased volume of air travel both between and within the United States and the European Union would result in rising demand for aircraft, parts, maintenance services, fuel, advertising, and computer equipment (Moselle et al. 2002). Focusing on suppliers of these products and services only (and thus ignoring further indirect effects on the transportation and tourism industries), Moselle et al. (2002) estimate that the revenue effect on directly related industries ranges between 3.6 and 8.1 billion Euros (Moselle et al. 2002, Table 6.4).

The Current Status of U.S.–E.U. Negotiations

Preliminary talks between the U.S. and the E.U. on the Open Aviation Area started in 2004, and several rounds of negotiations have taken place since then. The provisional results have been recorded in the text of a First-Stage Comprehensive Air Transport Agreement[16] and the related Memorandum of Consultations. The key points of the latter include, most notably, the willingness of the United States to abandon the nationality clauses of previous open skies agreements and to embrace the concept of a "European carrier" (Waterfield 2005). Moreover, the agreement envisions an adjustment in the U.S. foreign ownership threshold to European levels (i.e., 49% of equity). Accordingly, the U.S. administration has attempted to relax its restrictive foreign ownership rules. This initiative, however, has sparked vociferous opposition in the U.S. Congress, by key U.S. carriers, and by labor organizations (Anonymous 2006, U.S. Senate 2005). The government of the United Kingdom, in turn, has made it clear that it will not accept any U.S.–E.U. aviation deal unless the United States makes concessions with respect to foreign ownership and cabotage, the right of European airlines to offer domestic services within the United States, and vice versa.

With a 40% share in the E.U.–U.S. transatlantic market and the "crown jewel," London Heathrow (Waterfield 2005), the United Kingdom has a particularly high stake in the ongoing negotiations and is likely to block any U.S.–E.U. agreement that does not provide European airlines greater access to the U.S. domestic market (Done 2006, Knight 2004, Sevastopulo 2004). Foreign ownership and cabotage, however, remain the very issues on which the United States appears unwilling and/or unable to compromise. As of summer 2006, U.S.–E.U. negotiations have been put on hold as "the U.S. has extended its internal decision-making process" (AEA 2006).

Contentious Issues

As noted previously, the concept of a U.S.–E.U. Open Aviation Area originally envisioned a wholly integrated and deregulated aviation market. For various reasons (discussed below), the U.S. administration has ruled out granting cabotage rights to European airlines, and the topic has effectively been deleted from the OAA agenda (Sevastopulo 2004). The remainder of the Open Aviation Area has since been termed the "Trans-Atlantic Common Aviation Area" (House of Lords 2003, Warden 2003)—a designation that more appropriately describes the regulatory realm that is the subject of ongoing negotiations.

Foreign Ownership: The most contentious issue remains that of foreign ownership, which is also directly related to the issue of cabotage.[17] European law currently allows overseas investors to own up to 49% of a European carrier's equity. While the European Commission's objective is to lift foreign ownership restrictions altogether, the minimum requirement is reciprocity. U.S. laws, however, continue to limit foreign ownership to 25% of the voting stock (and 49% of non-voting stock[18]) (Pustay 1992). The European side argues that such restrictions serve no purpose but to hinder competition and "the normal development of the industry" (Calleja 2004) and exclude U.S. airlines from foreign capital markets (Havel 2003). The European Union and the government of the United Kingdom, in particular, are adamant that ownership constraints be lifted to facilitate the integration of U.S. and European air carriers (Done 2006).[19] The associated efficiency gains and resulting improvements in airline competitiveness are seen as key incentives for further deregulation.

While the liberal, pro-competitive, European stance is argued from an economic perspective, political concerns have dominated the discussion within the United States. The so-called Citizenship Purity Test was implemented in the 1920s (Adams 2006) and is applied to all U.S. airlines to verify that ownership and control remain with U.S. citizens. This rule was put into place for "reasons of national security" (Havel 2003) and to protect the U.S. domestic airline industry from international competition (hence the link to cabotage). Both rationales are reviewed below.

Security Concerns: The Civil Reserve Air Fleet (CRAF) program provides the United States with military access to commercial aircraft in the case of "defense emergencies" (House of Lords 2003). Under this program, U.S. commercial carriers pledge to provide transportation services to the military in return for exclusive access to U.S. government peacetime business (Moselle et al. 2002). Given the scale of the CRAF program[20]—commercial airlines provide 90% of military passenger air transportation and 40% of military cargo air transportation during military activation (Havel 2003)—it has been argued that foreign ownership might jeopardize military operations as foreign owned airlines may be unable or unwilling to provide reliable transportation services in support of U.S. military operations (Grossman 2006). While it is true that the U.S. government has greater legal leverage over U.S. airlines than over foreign carriers, there is no reason to suggest that U.S. airlines under foreign ownership would provide less reliable service (Moselle et al. 2002). In fact, the U.S. government relies on foreign-flagged ocean carriers to provide much of the country's sealift capacity during wartime.

The security concerns, however, are persistent, and proponents of foreign ownership restrictions insist that critical infrastructure services and installations must remain under direct control of the U.S. government and U.S. citizens. The experience of the "Dubai Ports deal"[21] and the ensuing national-security debate bear testimony to the strong political weight associated with the foreign ownership issue (Barnard 2006, Cameron and Done 2006).

U.S. Protectionism: Aside from protecting national security, the United States is also concerned with protecting U.S. airlines and U.S. workers. U.S. airlines accumulated of about US$ 36 billion[22] between 2001 and 2004. Excess capacity, rising operating costs, and cut-throat competition have been blamed for the industry's poor performance. Concerns have been voiced that a relaxation of foreign ownership requirements might result in further U.S. domestic capacity increases and put more pressure on U.S. airlines (Mazor 2006).

The case of Virgin America has shown the resoluteness of the opposition to foreign ownership in the U.S. domestic aviation market. In late 2005, Virgin America filed an application for an operating certificate with the U.S. Department of Transportation. While Virgin America claims to meet nationality requirements (i.e., no more than 25% of the voting stock and no more than 49% of all stock is held by foreigners), its affiliation with the British Virgin Group has been subject to close scrutiny by U.S. airlines and other interest groups (Lott 2005). Continental Airlines and American Airlines, among others, filed objections to Virgin America's application with the Department of Transportation in an attempt to block the carrier's certification. In its monthly magazine, the Air Line Pilots Association (ALPA) contains an article titled "Virgin Invasion" with "The British Are

Coming! Only this time, they're not after your tea taxes, they want your jobs and your paying passengers" (Mazor 2006, 26).

Concerns about the impact of foreign ownership on U.S. employment have been expressed elsewhere (Warden 2003), but independent studies have concluded that there is little evidence relating foreign ownership to a decline in U.S. employment (Moselle et al. 2002). As Warden (2003) points out, however, there may be differences and loopholes in labor laws and labor protection standards that may require closer examination before comprehensive aviation agreements, including revisited foreign ownership regulations, can be concluded.

Access to London Heathrow: A second contentious issue is access to London Heathrow. As is discussed in more detail below, there are currently only two U.S. carriers (United and American) and two U.K. carriers (British Airways and Virgin Atlantic) that can serve the U.S. market from London Heathrow. The OAA would, theoretically, open the London Heathrow–U.S. market to other U.S. and European carriers. However, London Heathrow is slot-restricted, and slots are not currently for sale. It has been proposed that a certain percentage of slots at Heathrow that are "grandfathered" with existing carriers be withdrawn from these carriers and made available to other carriers through market sales. Although the U.K. government is agreeable to a secondary market for Heathrow slots, it has not agreed to the withdrawal of slots from current holders (House of Lords 2003). Without access to slots at Heathrow for additional U.S. carriers, it is doubtful that the U.S. government will agree to the OAA.

Other Issues: Further concerns pertain primarily to third-country relations, aviation safety, and subsidization of airlines. As to the first issue, it is unclear how a potential U.S.–E.U. agreement would affect aviation relations with third parties. Would Mexico, for example, permit a French carrier to operate flights between Italy and Mexico with a stopover in the United States? Provisions in the U.S.–Mexico bilateral agreement could allow the Mexicans to refuse these flights raising the fear that third countries, in general, might withdraw such traffic rights (Havel 2003). Others, however, have suggested that "the E.U. and U.S. jointly persuade the third country to accept the airline concerned irrespective of its ownership and control" (Calleja 2004). Safety concerns have been expressed but quickly dismissed, as both U.S. and European airlines (as well as any other international airline) must abide by the safety standards and procedures defined by the International Civil Aviation Organization (ICAO), which, in turn, are enforced by national aviation authorities (Moselle et al. 2002). Subsidization, finally, remains a sensitive issue in commercial transatlantic relations. Government subsidies to European airlines,[23] such as Air France (3.15 billion Euro since 1991), Iberia (1.4 billion Euro), and more recently, Olympic Airways (1.1 billion Euro since 1991), are illegal under Article 92 of the European Community Treaty (Scharpenseel 2001). At the same time, European airlines have complained that many U.S. carriers drastically cut ticket prices on transatlantic routes following the Bush Administration's announcement of government aid for U.S. airlines in 2001 (Guerrera 2001). A common understanding of the government's role in the aviation industry would be required to eliminate anti-competitive subsidization practices in an open aviation area.

THE AMERICAN PERSPECTIVE

The key U.S. stakeholders in aviation negotiations with the European Union are U.S. airlines, unions and other labor organizations, the Bush Administration and the Department of Transportation, as well as Congress. Their positions, interests, and actions with respect to the OAA are reviewed below.

U.S. Airlines

U.S. carriers are divided into two camps, those that support the Open Aviation Area and those that do not. FedEx and United Airlines are the most ardent defenders of the OAA (Meckler and Michaels 2006). FedEx is keen on establishing hub operations in Europe that would provide the

cargo carrier with greater access to markets in Europe and beyond. United Airlines, in turn, strives to further integrate with its European partner airlines, most notably Lufthansa. Hawaiian Airlines, Delta Airlines, and Atlas Air/Polar Air Cargo have also voiced support for the OAA (Anonymous 2006, Hughes 2006). At the same time, Continental Airlines seems determined to stop any U.S.–E.U. aviation agreement. Jeff Smisek, president and CEO of Continental, argues that "[i]f the deal is approved, British Airways can start flying between Heathrow and Houston with as many flights as it wants to, but Continental won't be able to operate any flights between its Houston hub and Heathrow" (Meckler and Michaels 2006). In theory, all U.S. airlines would gain access to Heathrow, but it would be difficult for carriers, such as Continental and Northwest, to obtain slots without their reallocation by the U.K. government or through market mechanisms (Karantzavelou 2005, Meckler and Michaels 2006). Moreover, if the OAA materializes, some U.S. airlines may face increased competition on flights between the United States and Europe, possibly resulting in lower fares and lower market shares. Consequently, Continental Airlines has been lobbying vociferously against the OAA and to changes to foreign ownership rules, a likely prerequisite to the successful conclusion of U.S.–E.U. aviation negotiations.

Unions and Labor Organizations

Unions and labor organizations in the United States have joined Continental Airlines in efforts to block changes to current foreign ownership regulations. The Air Line Pilots Association (ALPA), for example, fears that jobs for U.S. citizens will be eliminated (Meckler and Michaels 2006) at a time when "thousands of airline workers already have been laid off amid heavy losses and bankruptcies" (Grossman 2006). Labor unions[24] are particularly concerned that the best jobs—pilots on transatlantic flights, for example—will go to foreign workers (Adams 2006, Meckler and Michaels 2006). Representatives of labor organizations argue that similar experiences have occurred "when the U.S. maritime industry was taken over by foreign players" (Grossman 2006). In addition to fears of job losses for American airline personnel, the most frequently cited issue is that of labor laws. Duane Woerth, president of ALPA, for example, notes that representational and collective bargaining issues arise as "current labor laws do not deal with labor relations issues that would be created by transnational airline families that operate in multiple domestic markets" (Woerth 2004). Woerth further argues that the benefits to be derived from aviation deregulation are not well balanced among the United States and its partner countries. Referring to the German Open Skies Agreement, for example, Woerth noted that "US carriers grew their German operations […] but their growth paled in comparison to Lufthansa's" (Woerth 2004). Statements such as "[ou]r country already has a dependence upon foreign oil. Are we going to allow the DOT to make air travel dependent on foreign airlines, too?" (Corsi 2006) further illustrate that the labor unions' interests are clearly protectionist in nature.

The Bush Administration and the Department of Transportation

The Bush Administration, and the Department of Transportation (DOT) in particular, firmly support the creation of the Open Aviation Area, believing that the OAA will benefit both U.S. consumers and U.S. airlines (Adams 2006). Lower fares and better service in terms of carrier choice, reach, and frequency are considered the key advantages from a passenger perspective. At the same time, the OAA would enhance U.S. airline access to international routes and capital markets (Meckler and Michaels 2006). DOT officials argue that "the modern economy—and by extension […] transportation systems—are global in nature" and warn that the U.S. might "lose [its] competitive edge" (U.S. transportation secretary Norman Mineta in Karp 2006) if the OAA initiative fails.

Recognizing security concerns relating to the CRAF program expressed by the Department of Defense, and the protectionist sentiment in the United States, the DOT has attempted to find a compromise by "reinterpreting" extant U.S. legislation on foreign ownership. In November 2005,

the DOT issued a Notice of Proposed Rulemaking (NPRM[25]) which may grant non-U.S. citizens greater influence over U.S. carrier operating decisions (including choice of markets, equipment, and pricing) while leaving more sensitive decisions pertaining to safety and security (including CRAF participation) under the control of U.S. citizens.[26] The DOT argues that U.S. citizens would continue to exert “actual control” over U.S. carriers and that current foreign equity ownership limits would remain unchanged. It was hoped that this would partially accommodate the E.U.’s request for relaxed foreign ownership rules while circumventing lengthy and possibly futile law-making processes. Airlines, such as United, Delta, and Hawaiian, as well as U.S. aircraft manufacturer, Boeing, and the airport authorities of Washington D.C. and Orlando, support the DOT’s initiative (Anonymous 2006).

Congress: The House and the Senate

In 2003, John Mica, a Republican congressman and chairman of the United States House of Representatives Subcommittee on Aviation noted that “it would probably take a ‘crisis’ before Congress would consider raising [foreign ownership levels]” (Sevastopulo 2003). In December 2005, Representative James Oberstar (Democrat, Minnesota), proposed a bill[27] that aims at preventing the DOT from issuing a final decision on the NPRM. Oberstar and the bill’s 196 co-sponsors argue that the DOT does not have authority to interpret extant laws on foreign ownership in a way inconsistent with the letter of the law. In December 2005, Senator Daniel Inouye (Democrat, Hawaii) introduced a bill in the Senate to block the implementation of the DOT’s NPRM.[28] The bill has been supported in committee[29] and passed to the full Senate for approval. Even if these initiatives are not successful in blocking DOT’s proposed rulemaking changes, they do demonstrate the extent to which members of the U.S. Congress are opposed to allowing greater foreign control over U.S. carriers.

In his July 2006 farewell address, U.S. Transportation Secretary Norman Mineta commented on the debate surrounding the foreign ownership issue and the related NPRM as follows:

> “Security is, and must always remain, a foremost concern. But it is pure folly to think that economic isolationism is an option in today’s interconnected world. While the rest of the world is building up its infrastructure, the United States can ill afford to close the door on much-needed investments, even international investments, in our transportation network.” (U.S. Transportation Secretary Norman Mineta in Karp 2006).

Meanwhile, the DOT remains committed to making a final rule on the NPRM by late August 2006. This will likely not end the foreign ownership debate, however. Meckler and Michaels (2006) cite a confidential report by Continental Airlines’ legal team as stating that the NPRM on foreign ownership is “vulnerable to judicial review and reversal and uncertainties stretching years into the future.” It is questionable whether the European Union will sign a U.S.–E.U. aviation agreement as long as this issue is not definitively solved (Hughes 2006).

SUMMARY AND OUTLOOK

In 2002, the European Court of Justice heralded the end of the U.S.–European open skies era by ruling that portions of these aviation agreements violated applicable E.U. law. As a consequence, the European Commission and the U.S. Department of Transportation have attempted to agree on a new regulatory regime for travel within and between the United States and Europe. The so-called Open Aviation Area aims at liberalizing United States, European, and trans-Atlantic air traffic to the fullest extent possible. As a result, the aviation industry may become more efficient and competitive, provide consumers with better service and, in many instances, lower fares.

Conflicting interests have hindered the successful conclusion of an agreement. The United Kingdom and British airlines are reluctant to open London Heathrow to additional foreign airlines. Improved access to London Heathrow, however, is what is demanded by some U.S. airlines in return

for allowing additional access to the United States by European carriers. These U.S. airlines are joined by strong protectionist forces within the United States —most notably labor organizations and numerous Congressmen—who oppose changes to U.S. foreign ownership rules and, thus, the idea of a truly liberalized U.S.–E.U. Open Aviation Area. Negotiations have come to a halt until the foreign ownership issue is resolved. This may not happen anytime soon as lengthy legal procedures within the United States loom. The Europeans, in turn, seem determined not to concede ground and sign any agreement until the reciprocity condition with respect to foreign ownership is met.

Security and labor concerns dominate the U.S. foreign ownership debate. More specifically, a relaxation of foreign ownership rules will likely only be achieved if the viability of the Civil Reserve Air Fleet (CRAF), a vital component of U.S. military operations, can be ascertained. While one may argue that foreign-owned U.S. airlines would not forego high-volume, high-margin military business, critics will only be appeased once an appropriate legal regime governing airline participation in the CRAF program is defined. Second, labor issues must be addressed. Independent studies (e.g., Moselle et al. 2002) have not found evidence for negative employment effects, as purported by various labor organizations, but concerns regarding conflicting labor laws and potential legal loopholes, as well as open questions regarding labor relations (e.g., union representation and collective bargaining), must be addressed.

A truly liberalized U.S.–European Open Aviation Area may still be far in the future. In the meantime, it is conceivable that the United States and the European Union will settle on an interim solution that partially deregulates transatlantic traffic (perhaps, with the exception of London route markets), but excludes the issues of cabotage and foreign ownership. An alternative to full cabotage suggested by Warden (2003) involves trading domestic routes. Under this scenario, the United States would grant European airlines the right to operate a specific route in the United States in exchange for access to a specific intra-European route market. Havel (2003), in turn, suggests "experimenting" with the air cargo industry first to better understand the effects of deregulation before opening the U.S.–E.U. Open Aviation Area to passenger operations. Some form of interim solution may be in place as early as mid-2007 according to some analysts. A full-fledged liberalization of the U.S.–E.U. aviation market remains a more distant goal.

Endnotes

1. See www.iata.org/pressroom/pr/2005-10-12-02.htm

2. Fifth freedom rights enable an airline to transport passengers from a country other than the airline's home country to a third country on routes originating or ending in the home country.

3. Third and fourth freedom rights enable an airline to transport passengers and cargo from the airline's home country to another country and vice-versa.

4. As of July 2006, the following countries are member states of the European Union with bilateral U.S. open skies agreements (the dates in parentheses indicate the year in which the respective open skies agreements were concluded): Netherlands (1992), Belgium (1995), Finland (1995), Denmark (1995), Sweden (1995), Luxembourg (1995), Austria (1995), Czech Republic (1995), Germany (1996), Italy (1998), Portugal (1999), Slovakia (2000), Malta (2000), Poland (2001), France (2001).

5. The Bermuda II agreement establishes that only two U.S. airlines (American Airlines, United Airlines) and two British airlines (British Airways, Virgin Atlantic) may offer services between London's Heathrow airport and a restrictive set of U.S. airports (Baltimore-Washington, Boston, Chicago [O'Hare], Denver, Detroit, Los Angeles, Miami, New York [John F. Kennedy], Newark,

Philadelphia, Phoenix, San Francisco, Seattle, and Washington [Dulles]). Further limitations are imposed with regard to air services to or from other London airports, airline pricing, and the number of route markets served.

6. Highly restrictive agreements between the United States and Greece, Ireland, and Spain, respectively, are in place.

7. The term cabotage refers to the transport of passengers and cargo wholly within a country other than the carrier's home country.

8. The ruling was rendered on November 5, 2002.

9. Remarks to the American Bar Association's Forum on Air and Space Law, Hollywood, Florida, November 8, 2002.

10. See http://ec.europa.eu/transport/air/international/dev_en.htm.

11. Subject only to extant antitrust and cartel regulations.

12. These numbers represent estimated gains in consumer surplus that do *not* offset air carrier profits.

13. U.S. legislation restricts foreign ownership of U.S. airlines to 25% of the voting stock and 49% of non-voting stock.

14. The term double marginalization refers to instances where firms charge suboptimal prices to the end customer due to a lack of inter-firm price coordination. Such suboptimal prices may come about when firms successively add profit margins to a product's price as it moves along the supply chain. Higher prices negatively affect customer demand and have been shown to reduce the total producer surplus earned.

15. This number is a specific estimate of welfare gains for the year 1981.

16. This agreement was reached on November 18, 2005.

17. If foreign airlines could acquire or found a U.S.-based airline, that airline could naturally offer U.S. domestic services.

18. In addition, the president and two thirds of the board of directors must be American citizens.

19. Integration through mergers, takeovers, and share swaps, for example.

20. The U.S. military spent $2 billion on transportation services provided by commercial airlines during the 2003 conflict in Iraq alone.

21. Dubai Ports World bought control of British P&O but was later forced to sell P&O's six U.S. container terminals.

22. See www.iata.org/pressroom/pr/2005-10-12-02.htm.

23. Excluding compensation payments for losses following the events of September 11 2001.

24. Labor organizations that oppose changes to foreign ownership regulations include the Air Line Pilots Association, the Independent Pilots Association, and the Allied Pilots Association.

25. The Department of Transportation is charged with enforcing foreign ownership rules in the U.S. airline industry and ensuring that U.S. citizens are in "actual control" of U.S. airlines. The NPRM aims at redefining the meaning of "actual control."

26. The DOT NPRM can be accessed online at http://dmses.dot.gov/docimages/pdf93/ 368719_web.pdf.

27. The proposed bill is identified by the following code: H.R. 4542.

28. The proposed bill is identified by the following code: S.2135.

29. The committee voted 19-6 on July 20, 2006.

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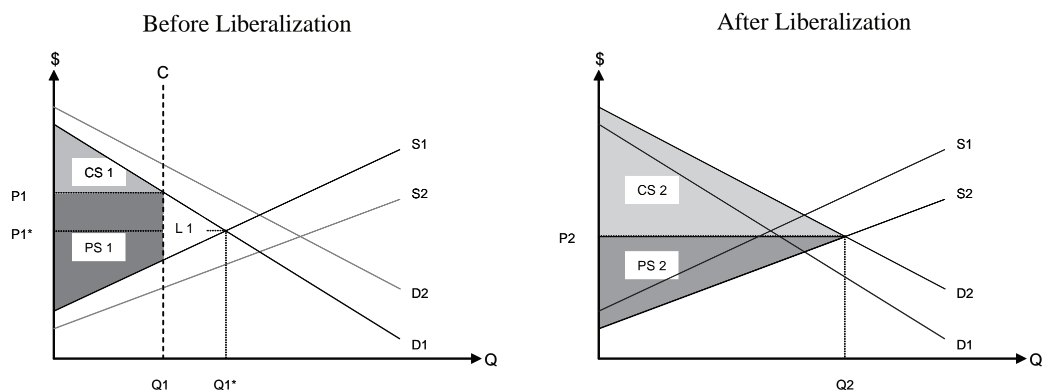
Appendix - Economic Effects of Air Transport Liberalization

Figure 1 summarizes the results of the processes triggered by the signing of an open skies agreement and presents an economic perspective of expected consumer and producer benefits:

Figure 1: An Illustration of the Economic Effects of Air Traffic Liberalization



The left part of Figure 1 illustrates the situation before liberalization occurs. S1 indicates the supply function and D1 indicates the downward-sloping consumer demand. The vertical dashed line (C) represents a capacity constraint imposed by regulatory restrictions; for example the limitation on air services between the United States and London Heathrow. In this scenario, the equilibrium quantity, i.e., the number of passengers, is equal to Q1 and the equilibrium price is P1. The areas denoted CS1 and PS1 mark the consumer surplus and producer surplus, respectively. Note that imposing the capacity constraint prevents the market from reaching the optimal equilibrium (Q1*/P1*) and leads to welfare loss L1. Deregulation results in the abolition of capacity constraints, potentially leading to lower production costs and increased consumer demand. The right part of the Figure 1 visualizes these changes by presenting shifted supply (S2) and demand curves (D2). The new equilibrium is identified by quantity Q2 and price P2. The resulting welfare gains are readily apparent. Social welfare clearly increases, with consumers likely benefiting the most. The effect on total producer surplus is uncertain as profits from efficiency gains may be eroded by added competition and lower prices. While total producer surplus may not change dramatically, it has been suggested that larger, efficient firms and alliances will gain substantially (Button 2002). Moselle et al. (see Table 6 in Moselle et al. 2002) estimate that total consumer surplus may increase by approximately 5.1 billion Euros due to the OAA. Cost efficiencies, pricing synergies, and the abolition of capacity constraints on the transatlantic market account for more than half of this increase. The remainder, about 46%, is credited to cost savings in the intra-European market.