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TRANSATLANTIC AIR TRANSPORT: ROUTES TO LIBERALIZATION

MARTIN STANILAND

Professor of International Affairs
Graduate School of Public and International Affairs
University of Pittsburgh

UNIVERSITY OF PITTSBURGH

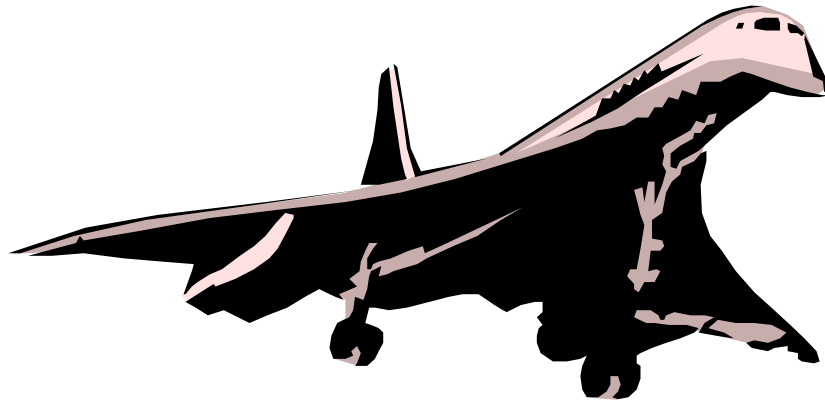
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MARTIN STANILAND

**GRADUATE SCHOOL OF PUBLIC AND INTERNATIONAL AFFAIRS
AND
EUROPEAN UNION CENTER
UNIVERSITY OF PITTSBURGH**



Addresses for correspondence:

3J34 Forbes Quadrangle,
University of Pittsburgh,
PITTSBURGH, PA.15260

E-mail: mstan+@pitt.edu

Phone: (412) 648-7656 (home: (412) 371-5964)

Fax: (412) 648-2605

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Introduction:

The air transport industry, for all its imperfections and peculiarities, represents perhaps the greatest achievement of technology and organization in the twentieth century – an achievement which should inspire admiration comparable to that of Dr Samuel Johnson’s observation about the dog walking on its hind legs – “Sir, it is not done well; but you are surprised to find it done at all.”¹

But commercial air transport is also an intensely paradoxical industry. Cosmopolitan by its very nature and daily operations, and dedicated to increasing opportunities for mobility, this industry is also one that has been notorious for cloaking itself - or being cloaked - in the mantle of nationalism. Air transport was, to no-one’s surprise, the one topic that participants in the original negotiations about the General Agreement on Trade in Services unanimously agreed to exclude from their agenda.² The nationalism and protectionism endemic in this industry are, indeed, a serious brake on the globalization that observers have discerned in recent enterprise alliances such as Star and Oneworld.

Two examples will illustrate the archaic and cramping character of the regulatory regime currently governing the industry – the so-called “Chicago regime”. One is offered by the standard language of international bilateral agreements on aviation (taken in this case from the recent U.S.-France bilateral agreement of June 1998). Article 1 of this agreement prescribes that the names of airlines authorized by their respective governments to fly between the two countries shall be “transmitted... in writing through diplomatic channels.”³ Thus, in order to fly passengers between Paris and New York, Air France (a firm that in 1998 carried 33,169,000 passengers and had an operating revenue of \$9,694,981,000) and United Airlines (the leader of an alliance that in 1998 carried 233,936,000 passengers worldwide and had an aggregate operating revenue of \$52,948,100,000) have first to be formally designated by “their” governments as authorized to engage in trade.⁴ Imagine the reaction if similar requirements were imposed on, say, United Colors of Benetton or McDonalds.

¹ A first version of this paper was given at a conference on “Creating a Transatlantic Marketplace: Government Policies and Business Strategies,” organized by Dr. Michelle Egan and Dr. Dieter Wolf for the American Institute for Contemporary German Studies, The Johns Hopkins University, Washington, D.C., on 4-5 November 1999.

A second example is the odd situation that arose in August 1999, when British Airways (BA) announced that it would cease its nonstop service between Pittsburgh and London. BA had operated this service exclusively since 1985 under authority provided by the 1977 “Bermuda II” bilateral agreement between the UK and the US. BA took this decision on purely commercial grounds (because of its new strategy of concentrating on high-yield business traffic (discussed below)): it had reportedly said that it would not oppose adoption of the route by USAirways which (with control of 86.1% of flights at Pittsburgh International Airport) was well placed to run the route profitably and was anxious to add a London service to its existing daily international services (to Frankfurt and Paris) fed by a 72-point hub-and-spoke system centered at Pittsburgh.

Despite evidence that the route was viable, the British government transferred the route authority from BA to Virgin Atlantic, to enable the latter to fly vacation travelers between London and Las Vegas.⁵ The British government was acting entirely legally in transferring the authority and Virgin Atlantic was, in effect, at the head of the waiting list for new authorities, having lost to BA in a recent contest for transatlantic service.⁶ But this decision prevented USAirways from taking over the Pittsburgh-London route and led to great resentment in western Pennsylvania, culminating in the holding of a Congressional hearing (beside the international gates at Pittsburgh International Airport).

This episode (which was described by a US DOT official as “a poster child for the evils of Bermuda II”) revealed the potential under the current regulatory regime for denial of international service by national governments to cities abroad.⁷ Absent surrender of an existing authority by USAirways or another US carrier under the US allotment of such authorities or some kind of special deal, airlines were subsequently prohibited from flying between Pittsburgh and London. The regulatory regime in international aviation is probably unique in that, while other regulatory regimes may restrict or channel demand, this one can actually suppress it.

Optimists believe that procedures and decisions of the kind illustrated above are doomed by an irresistible tide of liberalization. They point to the sheer size of (in this case) the EU-US market and to the proliferation of “open skies” agreements to suggest that aviation is about to burst out of its regulatory chrysalis to emerge as an exceptionally beautiful free-trading butterfly. This chapter will examine the character and present structure of this industry and will then explore the actual prospects and routes for liberalization of transatlantic air transport. The discussion is divided into the following sections:

Transatlantic air transport:

- Air transport as an industry;
- The transatlantic market;
- The regulatory regime;
- The regulatory regime and airline strategies;
- Airline strategies I: market share or shareholder value?
- Airline strategies II: enterprise alliances

Routes to liberalization:

- Route I: “Open skies” agreements?
- Route II: A transatlantic common aviation area?
- Route III: The General Agreement on Trade in Services?
- Route IV: Multilaterals or plurilaterals?

Conclusions

TRANSATLANTIC AIR TRANSPORT:

AIR TRANSPORT AS A SERVICE INDUSTRY:

The airline industry, in common with many service industries, likes to talk about its “products”. Such language suggests a suspicion that customers might be reassured by the notion of something solidly manufacture-like - something that, as *The Economist* has put it, you can drop on your foot - rather than the still rather unnerving business of flying seats through the air and selling paperless tickets in which it is actually engaged. But it does itself a disservice by using this language, opening itself up to ridicule of its marketing practices (as in the paint shop story, reproduced in Appendix 1).

For, in truth, the airline industry does not sell “products” in anything like the traditional sense. It is a service industry, in the sense that when you buy a seat on a plane, you are not normally allowed to take the seat with you when the plane lands. Marketing of air transport is, consequently, different in crucial respects from selling pots of paint, though both industries do have differentiated “products”, with differentiated prices, as well as limited-time sales.

The airline industry is surely better described as one selling something much more perishable, like bananas – produce, in fact, rather than a product.⁸ Such produce has, in a sense, to be consumed before it can be unpeeled. Once the aircraft succeeds in leaving the ground, any unconsumed produce - empty seats - immediately and irretrievably goes rotten. The same dilemma does face other service industries such as theatre and hotel managements. But the special problem of the airline industry is the very large capital investment that it has to make in order to persuade its rather fickle customers to consume. Few hotels, theaters or fruit stalls cost the \$144 million that is the current price of a new Boeing 747-400.⁹

So, if we had to make a comparison with paint shops, we would have to say that air transport is an industry in which the cans are incredibly expensive, the paint has no shelf-life worth measuring, and inventory doesn't exist. (Also, very few people die as the result of a can of paint leaking or bursting) With such high costs, high risks and dire economics, it is not surprising that this is an industry that has been both highly protected and closely regulated. Without the first, it might not have survived; without the second, many of its customers might not have survived.

To make matters worse, air transport is an industry in which, while fixed investments are very substantial and costly, demand is quite unpredictable and is subject to dramatic reduction because of events beyond its control (such as an economic downturn or a war). It has to purchase (or lease) extremely expensive equipment and hire highly skilled and expensive labor without any adequate assurance of reasonable or sustained returns. Moreover, it does not sell flight by the single seat-unit (as a paint store might buy one or two cans of paint).

Though airlines have made great efforts to acquire varied fleets and, by techniques of “yield management”, to adjust the supply of seats to predicted demand on specific routes and at specific times on specific days, the challenge of “putting bums in seats” (as Eddie Rickenbacker,

the veteran aviator and CEO of Eastern Airlines defined the air transport business) is exacting and few planes (whatever the cramped passengers may think) ever fly completely full.

Air transport is thus different, at least in degree, from other service industries because of the exceptional perishability of its “product” and the exceptionally high costs of offering it. It is also different because of the industry’s long history of protection (originally stimulated by concerns about national security) and because of an equally long history in which a heady mixture of romanticism and desire for national prestige has created chronic oversupply and equally chronic deficits.

THE TRANSATLANTIC MARKET:

The North Atlantic market possesses all of the general characteristics of the airline industry and, indeed, is the supreme example of the problems and strategies encountered in international aviation. Historically, it is actually a more recently developed international market, compared to both the routes between Europe and Asia and Africa, which developed before World War II as a matter of imperial strategy, and those within the western hemisphere developed by Pan American and other US carriers. True commercial service to the United States only began after World War 2: even as late as 1949, fewer than 300,000 passengers a year were crossing by air and it was only in 1957 that the number flying the Atlantic by air exceeded those travelling by sea.¹⁰

The introduction of jet airliners (and eventually large widebodies such as the 747) increased reliability and productivity further, leading in turn to lower fares yet more passengers.¹¹ In 1980, over 16 million passengers flew across the North Atlantic: by 1990, this figure had jumped again to 30, 430,000, with a forecast of 51, 800,000 by 2001 - a fiftyfold increase in passenger traffic since 1957.¹² Passengers carried on transatlantic flights now represent approximately fourteen per cent of all passengers carried by air worldwide, partly because transatlantic flights connect the world’s two largest domestic air transport markets – the European and the U.S. markets (with 28.4% and 41.35%, respectively, of the world’s air traffic).¹³

Revenue from transatlantic routes is substantial - in 1998, \$20 billion from services between the EU and the US (with \$10 billion of the total coming just from routes between the UK and the US).¹⁴ The revenue - and the profits - of several EU airlines depend substantially on transatlantic routes: in 1992, for example, KLM Royal Dutch Airlines obtained 33.9 per cent of all its revenue from transatlantic services, followed by BA with 30.7 per cent and Swissair with 24.9 per cent (see Table 1).¹⁵ Figures for profits for particular markets and routes are hard to obtain, but it has been reported that Lufthansa in the early nineties was deriving some thirty per cent of its profits from transatlantic services.¹⁶

TABLE 1: Derivation of revenues from markets, 1992

CARRIER	EUROPEAN MARKET (%)	EXTRA-EUROPEAN MARKET (%)	EXTRA-EUROPEAN, ATLANTIC (%)
KLM	28.9	65.3	(33)
BRITISH AIRWAYS	42.2	57.8	(30.7)
SWISSAIR	47.6	52.4	(24.9)
AIR FRANCE	50.1	49.9	(16.7)
<i>EU AVERAGE</i>	<i>50.7</i>	<i>49.3</i>	<i>(18.4)</i>
LUFTHANSA	52.8	47.2	(20.6)
ALITALIA	55.6	44.4	(16.6)
IBERIA	70.1	29.9	(25.6)
SAS	80.9	19.1	(10.2)

Source: Lehmann Brothers, *European Airlines: A Turbulent Decade*, 14 September 1993, n.p.

Despite its spectacular growth, the North Atlantic market has been chronically afflicted by what has been described as “profitless growth syndrome”.¹⁷ Ironically, in 1976, when ocean liners were left with only five percent of the passengers they had carried twenty years earlier, a book was published about the capacity and pricing problems of the North Atlantic air transport market subtitled *Saving an Endangered System* and describing this market as in a “sick condition” with losses “chronic and widespread.”¹⁸ Though airline alliances have recently offered a way of controlling capacity, the problem of overcapacity and the profit-destroying fare wars they engender have continued to afflict air services across the North Atlantic, as well as other popular, high-volume sectors of the industry.

The problem of overcapacity is common to both EU and US airlines. But in order to understand American policy and European responses, it is important to remember that the division of traffic on transatlantic routes underwent a dramatic change during the nineteen-eighties. Before 1978 (and deregulation in the US), the share of transatlantic traffic carried by the two main American international carriers (Pan Am and TWA) declined continually, partly because of the revival and re-establishment of European airlines after the war and partly because, with decolonization, the flag carriers of European imperial powers began to concentrate on transatlantic routes to compensate for the routes and traffic lost with the collapse of their empires.¹⁹

But this trend was reversed after deregulation in the US led (ironically) to the reconsolidation of the American industry and aggressive international expansion by US majors

(notably “the Big Three” – American, Delta and United) which had previously been inactive on international routes. By 1993, the European airlines’ share of the market had shrunk from 68% (in 1962) to 48% and European airlines were clamoring for protection against “the American invasion”(an invasion that was possible because many bilaterals (negotiated in the post-war years) were generous in allowing “unrestricted capacity increase and the ability to open new routes almost at will”).²⁰

By offering low fares and frequent service, US airlines were able to capture some 61% of traffic between the US and Germany and 71% of traffic between the US and France (respectively, the second and third largest transatlantic markets).²¹ Both France and Germany demanded renegotiation of their bilaterals with the US (and France actually renounced its bilateral in 1992, transatlantic services continuing on the basis of annual agreements). Both countries felt obliged to resist pressure for liberalization until Air France and Lufthansa had undergone drastic restructuring preparatory to privatization and were better able to compete with the “Big Three”, especially given the simultaneous pressures created by liberalization of air services within the European single market.

THE REGULATORY REGIME:

Regulation of air travel between Europe and the US still rests on the foundation provided by the 1944 Chicago Convention on International Civil Aviation and the 3000-plus bilateral Air Service Agreements (ASAs) concluded within the framework of this Convention. The agreements (such as “Bermuda II”) stipulate what routes may be flown between airports on the territories of the signatories and with what frequency: they may also contain limits on capacity and provisions for authorizing fares. Perhaps even more importantly, the Convention and the arguments and laws derived from it contain strict provisions about nationality, stipulating that in order to use the rights assigned to a country, the designated airlines must be “substantially owned and effectively controlled” by nationals of the countries concerned. These nationality provisions stand directly in the path of any international liberalization and, indeed, any consolidation of the airline industry.

For many years, bilateral ASAs provided for comfortable duopolies exercised by the respective state airlines of contracting states, even allowing for a pooling of revenues on shared routes (a practice that, interestingly, the more integrated of the current airline alliances intend to revive). For many years, too, (indeed, at the Chicago Convention itself), the US has been seeking to liberalize bilateral agreements, arguing that liberalization will lead, via greater competition, to lower fares and a dramatic expansion of traffic. Both consumers and airlines will thus benefit (though, as critics point out, not all the airlines will necessarily survive to reap the benefits). Since 1978, the US has consciously and aggressively tried to apply to international markets the principles of deregulation applied in that year to the US domestic market. The outcome has been a series of so-called “open skies” agreements which permit, without restriction, airlines registered in the countries concerned to fly between any points in their own countries and in the other countries.

THE REGULATORY REGIME AND AIRLINE STRATEGIES:

An airline's strategy is shaped by regulatory conditions as well as by "pure" demand and supply. Regulation not only determines costs (as, for example, by requiring certain levels of maintenance and training and imposing certain qualities and quantities of equipment), but it can actually determine supply (and usually has done so in this industry). [It can even - as in the Pittsburgh case - suppress demand] British Airways, for example, has traditionally drawn high profits from its services to Africa and the Middle East (routes which are still subject to very strict regulation through bilateral agreements under the Chicago convention. Conversely, BA draws very low profits from its intra-European services and almost none from its services in the UK (where it faces direct competition from rail and road transportation).

The regulatory dimension is bound to be a complicating factor in how airlines regard liberalization and in their choice of strategy. In a highly regulated market (such as all the routes serving London Heathrow), any authorized airline can derive a "rent" (in the strict economic sense) from lack of competition.²² An airline in this situation may prefer to emphasize profit over market share (which – as discussed below – seems now to be the case with BA): it may even prefer the profits to be gleaned in a regulated market to the potentially greater revenue (and the smaller profits) to be earned in a liberalized market.

AIRLINE STRATEGIES I: MARKET SHARE OR SHAREHOLDER VALUE?

The transatlantic market has for many years been plagued, even more than other markets, by overcapacity. Airlines have responded to high and rising personal incomes in both the EU and the US by providing more seats, especially for leisure travellers. But, with so many airlines operating across the Atlantic and competing for market share, overcapacity can easily occur.

Faced with high losses from overcapacity, airlines have several choices. All carriers will try to reduce risk, by fitting capacity very closely to expected demand (sometimes by overbooking). At the same time, airlines will eliminate any costs that can be eliminated (such as unprofitable routes) and will reduce every conceivable cost unavoidably associated with flight. They will also try to attract revenue by adjusting price to the costs of offering different conditions for flying.²³

If overcapacity becomes a serious problem, airlines may appeal to governments to impose or enforce regulatory controls on capacity (as both Air France and Sabena tried to do during the crisis following the Gulf War).²⁴ But such an appeal is only effective where airlines are state-owned, and even before the current wave of privatization, capacity controls were sometimes absent or weak. Without regulatory controls on capacity, airlines face more painful choices. They may simply withdraw from particular, inadequately profitable routes (as in the case of BA and the Pittsburgh-London route). But, at least in liberalized markets, they surrender traffic and goodwill by doing so. In addition (or instead), they may take the "traditional" route of engaging in periodic fare wars so as to increase market share, while at the same time trying to reduce costs (as, notably, Continental and Air France were doing in the summer and fall of 1999 (see Table 2 below). A less traditional and more radical route is deliberately to reduce capacity

and to concentrate on increasing revenue (and thereby please shareholders and prospective investors).

The choice of strategies became particularly acute and transparent in the course of 1999, when dramatic increases in capacity occurred on North Atlantic routes. By August 1999, the number of seats offered on North Atlantic routes was between ten and eleven per higher than in the corresponding month of 1998, while demand, though strong, was only growing at between four and five per cent.²⁵ As Table 2 indicates, in September 1999 at least two major carriers were offering over twenty per cent more seats on North Atlantic routes than in September 1998.

TABLE 2: THE RACE TO THE BOTTOM: TRANSATLANTIC SERVICES, FALL 1999*

AIRLINE	NUMBER OF FLIGHTS PER WEEK	SEATS OFFERED WEEKLY	WEEKLY CAPACITY (Available seat-kilometers)
BRITISH AIRWAYS	+ 6	- 1.0%	-0.7%
UNITED	+ 28	+10.0%	+9.8%
DELTA	+ 23	+ 6.0%	+4.7%
AMERICAN	+ 0	+ 7.0%	+9.2%
LUFTHANSA	+ 26	+ 17.0%	+15.7%
CONTINENTAL	+ 56	+ 24.0%	+22.8%
VIRGIN ATLANTIC	+ 32	+ 17.0%	+15.2%
AIR FRANCE	+ 30	+ 8.0%	+8.4%
KLM	+ 4	- 1.0%	-0.8%
SWISSAIR	+ 44	+ 25.0%	+25.4%
TOTAL:	+ 388	+ 8.7%	+8.8%

* - planned capacity, September 1999 compared to September 1998.

Source: "Mind the capacity gap," *Airline Business*, November 1999, 85.

While a gap between capacity and demand has been endemic in this market, the 1999 glut was brought about by a special factor – the transfer of aircraft from services to and from Asia where the serious economic crisis had caused a severe decline in air traffic. Most airlines responded in the usual way, by seeking market share through a fare war that, while appealing to the public, pushed revenue down to a point where the costs of offering service were barely covered by revenue.

The 1999 crisis was, however, especially significant because the consequent drop in revenues and profits was bad enough to cause one carrier – BA – to opt out of the usual race to the bottom, with its inevitable consequences for profits.²⁶ Arguing that it made no sense to sell seats at less than the cost of providing them, BA took the radical (and, in some eyes, dangerous) course of reducing capacity by using smaller aircraft, eliminating less profitable routes (including connecting domestic and European services) and (above all) concentrating on attracting high-yield business passengers.²⁷ This strategy was generally acknowledged to be bold and courageous in "an industry long characterized by an institutional inability to reject any marginal business."²⁸ It was also very risky in that it could alienate

loyal, non-business passengers without attracting a sufficiently large proportion of the (much-coveted) business customers to compensate for the loss of revenue at the back of the plane (where fewer seats for economy travelers would be available). Statements by BA spokesmen did not always seem to recognize the fine line between attracting one without insulting the other²⁹. BA acquired the image of a carrier that (in the words of the highly respected aerospace correspondent of *The Financial Times*) was trying to become “an airline for the wealthy” – an assertion that its Director of Communications was at pains to dispel.³⁰

The inarticulate premise of BA’s strategy may be (as suggested above) the continuation of a dominant position protected, outside of Europe, by a web of quite restrictive bilateral agreements (including the Bermuda II agreement). Such protectionism puts it in a stronger position to pick and choose customers - a luxury not available to its competitors operating under “open skies” agreements.

AIRLINE STRATEGIES II: ENTERPRISE ALLIANCES:

The rationale for the initial alliances between specific EU and US carriers is quite clear. By 1992, essentially the same dilemma faced both the major EU and major US carriers. Both had very large stakes in North Atlantic routes (and both had been hurt badly by the slump in traffic caused by the Gulf War). Both groups were anxious to draw more directly on traffic within the other’s home markets (that is, the Americans from the EU market and the Europeans from the US market).

Of the two, the Europeans were perhaps the more anxious. They saw an American market which (in terms of traffic rather than population) was larger even than that becoming available through the emerging European single market. Further, and critically, they saw an American market that was becoming increasingly rationalized into hub-and-spoke route systems, with the hubs often located well away from the traditional east and west coast ports of entry for international traffic. International airlines – American and European – had quite automatically followed the logic of sea travel (and of population distribution as it was in the forties and fifties) and concentrated on east and west coast cities. At this time, Chicago would have been an obvious, additional inland port of entry. But no-one would have dreamed that Atlanta would become the world’s busiest airport, that Chicago, Dallas, Denver and Miami would all eventually be busier than New York, Boston, Philadelphia and Washington - or that Charlotte, NC, might eventually rank right under Singapore.³¹

The new US hubs provided great concentrations of traffic that would support international services by those – the US majors – who could schedule feeder services so as to provide fast connections. The predicament of EU airlines was that, even if they could obtain international authority to fly to the hubs concerned, they could not under US law organize their own hub-and-spoke systems within the US. The next best solution was to form alliances with the carriers who did control these hubs and arrange connecting flights that would appear in computer reservation systems as direct flights by a single carrier (even if in reality the flights were operated by two carriers). This practice – known as “codesharing” – produced, as if by magic, thousands of apparent direct services between points all over the US and points all over Europe. Flights may bear two or even three airline designator codes and indeed the price of an identical seat on the same flight may vary substantially from one airline to another.

Access to a European network represented the reciprocal advantage for American carriers in alliances with EU airlines. Just as European carriers cannot fly between Washington Dulles and Lynchburg, Va., so American carriers cannot fly between London Heathrow and the Isle of Man. Under EU law, only “Community carriers” may fly on routes within the European Union, and to qualify as a “Community carrier” an airline must (in language only too familiar from the wording of the Chicago convention) have “its principal place of business and...registered office” within a Member State and must be:

owned and continue to be owned directly or through a majority ownership by Member States and/or nationals of Member States. It shall at all times be effectively controlled by such states or such nationals.³²

In the EU’s case, “effective control” is interpreted to mean that at least 51% of voting stock is in the hands of EU nationals.³³ (The EU’s rule is in fact more liberal from the point of view of foreign investors than that currently in US law (which requires 75% national ownership).)

The European Commission has proposed to the US that, as an element in creating a “common EU-US aviation area”(discussed below), both parties should accept a 49% limit on foreign ownership of voting equity, “while ensuring that majority ownership and effective control remain in the hands of member States and/or their nationals and in the hands of US nationals for US carriers.”³⁴ But even with such a relative liberalization, the rules governing foreign ownership of airlines - in both EU and US jurisdictions - remain more restrictive than those applying to investment in other industries.

To fall into line with the latter, the ownership requirement would have to be replaced by one simply requiring establishment. Indeed, Article 58 of the EC treaty gives the right of establishment to “companies or firms formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the Community”. Application of this principle (accompanied by a parallel substitution of the criterion of local incorporation for substantive ownership in countries outside the EU) would, of course, open the gate to full foreign direct investment in the airline industry.

While opposition to lifting such restrictions on foreign investment and establishment certainly comes from some active and identifiable sources, the immediate obstacle is the nationality principle vested in the Chicago convention and accepted by all states (including, of course, the US). While some enterprise alliances do involve equity purchases, the latter are typically small on both sides of the Atlantic. Both BA and KLM have run up against US restrictions in their separate alliances with US carriers.³⁵

On the European side, the existence of the common market means that there are no restrictions on complete takeover of or mergers between airlines operating exclusively within the territory of the Union. However, a takeover of an airline with routes outside the Union (whether by a company based in another Member State or by one based outside the EU), while it would break no laws, could well be commercially self-defeating. Suppose, for example, that American Airlines and BA were allowed to buy a 51% share in Iberia, instead of the total of ten percent currently approved by the Spanish government. In this situation, Iberia would be not only

privatized but – in a special sense – “denationalized”. It would cease to be an airline “substantially owned and effectively controlled” by Spanish nationals. The Spanish government would then be obliged, under its various bilaterals, to withdraw its authority to fly on routes outside the EU. The relevant foreign governments (probably on the urging of their own airlines) would either withdraw its landing authority or (if the Spanish government insisted on allowing it to operate) would probably renounce the bilateral agreement in force.³⁶ Thus Iberia’s new owner might find that all its investment had bought it (apart from a fleet usable on intra-EU routes) was an impressive but costly static display of intercontinental airliners, and a correspondingly impressive payroll.³⁷

“Enterprise alliances” are thus second-best solutions to the forbidden (but more normal) commercial and investment options of direct establishment in a market (American-BA would operate its own flights within as well as to and from Spain) and equity purchase (American-BA would simply buy Iberia and take over all its routes). As the chairman of KLM has put it: “Alliances are...a reasoned response to an antiquated regulatory system...[They] permit indirect access to restricted markets.”³⁸ Alliances enable airlines to make the best of a situation in which they are forced to operate under a divided regulatory regime - one (deregulated or liberalized) governing the domestic US and EU markets, the other (only partially liberalized) governing flights between cities in these two markets.

At the European level, what we now see emerging is a regional system that is structurally quite different from its North American counterpart. The European structure (and the larger global structure now taking form) is one dominated by multi-tiered alliances rather than by a consolidation into four or five “mega-airlines” such as emerged in the US in the mid-eighties. Nationality rules (and the preferences of governments) stand in the way of such a consolidation. Instead, we can discern an almost-feudal hierarchy of major and minor European carriers, linked to larger alliance systems. This hierarchy, in fact, resembles (and is linked to) corresponding hierarchies within the US and (increasingly) elsewhere. Through a range of devices, the larger carriers have both created alliances among themselves and have attached the smaller carriers to themselves as “clients” feeding traffic into a set of international hubs.³⁹ Such a hierarchy is intentionally exclusive in character. It is intended to exclude upstarts such as easyJet and Virgin Express from competing on regional routes (in this case, those within Europe), and to exclude rival alliances from central hubs by starving them of feeder traffic for their international services.

Supposing for the moment that this characterization is roughly accurate, we need to consider two questions: first, how strong and permanent is this structure likely to prove; and, secondly, what are the implications of such a structure for the goals that are sought through liberalization?

As to durability, we are now going through a phase of what one observer describes as “alliance churning.”⁴⁰ On a global scale, the warfare between the alliances goes on spasmodically and in phases concentrated in different regions (rather like a commercial version of the Thirty Years War). In recent weeks, a major and intense pitched battle has been occurring on the plains of Canada, as the champions of Oneworld (the BA-American league) struggle for control of Air Canada with their sworn foes in the Star Alliance (the league led by Lufthansa and United). Intense tactical action and realignment is also occurring at present on the European

field: Delta has just separated from Swissair and its European associates in the “Qualiflyer” alliance, Austrian Airlines has also left “Qualiflyer” to join the Star Alliance, and Lufthansa has made a major investment in British Midland (which owns over twenty per cent of slots at London Heathrow).

Table 3: AIRLINE ALLIANCES (major partners, 12/05/99; passengers, 1998)

Alliance	Star Alliance Members (Passengers, 1998)	Oneworld Members (Passengers, 1998)	Qualiflyer Members (Passengers, 1998)	Wings Members (Passengers, 1998)	Delta Members (Passengers, 1998)
Europe	LUFTHANSA (36,059,000) S.A.S. (21,688,000) AUSTRIAN (1,576,000) BRITISH MIDLAND (905,000)	BRITISH AIRWAYS (31,325,000) IBERIA (21,753,000) FINNAIR (7,385,000) AER LINGUS (5,506,000)	SWISSAIR (12,891,000) SABENA (8,749,000) TAP AIR PORTUGAL (4,538,000) THY TURKISH (10,504,000)	KLM (15,077,000) ALITALIA (24,103,000) BRAATHENS S.A.F.E. (6,973,000)	AIR FRANCE (33,169,000)
North America	UNITED (86,867,000) AIR CANADA (14,800,000)	AMERICAN (81,477,000) CANADIAN (8,344,000)	?	NORTHWEST (50,500,000) CONTINENTAL (43,625,000)	DELTA (105,390,000)
Central & South America	VARIG (11,019,000)	LANCHILE (2,998,000)			AEROMEXICO (7,816,000)
Asia	THAI (15,613,000) SINGAPORE (12,329,000) ALL NIPPON (41,491,000)	CATHAY PACIFIC (10,299,000) J.A.L. (31,363,000)		MALAYSIA A.S. (12,521,000)	
Pacific	ANSETT (6,150,000) AIR NEW ZEALAND (6,399,000)	QANTAS (18,865,000)			
Passengers (total, 1998)	254,896,000	366,761,000	36,682,000	152,799,000	146,375,000

Sources: “World Airline Report,” *Air Transport World*, July 1999, 50-143; “News Briefs,” *Air Transport World*, November 1999, 9; “Headline News,” *Aviation Week and Space Technology*, 25 October 1999, 28-9.

In the short term, all this activity simply means that the various alliances are scrambling to sign up the ever-smaller pool of unaffiliated (and attractive) airlines, while some of the second-rank airlines are re-examining their original choices before they become locked in to long-term relationships from which they might find it difficult to extricate themselves. How “long-term” any of these relationships will be is anyone’s guess. After much early talk about “global mega-carriers”, the mood among observers of the airline industry seems to have swung in a more sceptical direction. The airline industry is certainly as subject to fads in strategic management as any other and it is possible that experience will show that the disadvantages of coordination generally outweigh the advantages.

Regulatory action of two kinds would certainly alter the pros and cons of alliance-building. Sustained, publicly-supported opposition to alliances from competition authorities, notably DG Competition in Brussels and the US Department of Justice, on grounds that the alliances are anti-competitive would probably cause at least some reduction in the ambitions of alliance-leaders. The DOJ’s rejection of the AA-BA alliance and the lengthy scrutiny of this alliance in Brussels are unambiguous signals of growing doubts about the probable benefits for consumers from alliances. (Ironically, airline managers (including some alliance leaders) may, unintentionally, have fed such doubts by attacking the BA-AA arrangement and others as “monopolistic” and “anti-competitive” – a charge that may have woken some dogs that might otherwise have slept on).⁴¹

Rather belatedly, the European Commission has launched investigations of the alliances preceding AA-BA (all the way back to the original KLM-Northwest wedding of 1988). Members of the European Parliament and other legislatures, as well as officials of competition bodies, are all too aware of the oligopolistic outcome of deregulation in the US and have also had long and recent experience of their own local oligopoly – the state airlines so frequently abused and so recently privatized. Denial or withdrawal of anti-trust immunity – which is crucial to the integration of alliances and to the economies to be gained through them - might be enough to cause some strategic rethinking (not to mention some defection).⁴²

The other type of regulatory change that might put an end to the alliance system (for better or worse) would be substantial relaxation and even abandonment of the Chicago regime and its apparatus of nationality-constrained bilaterals. If the bilateral system and national rules limiting foreign equity purchase were to disappear or be relaxed to allow a right of establishment by foreign airlines in domestic market, the alliance system might well crumble quickly. As the veteran airline analyst Julius Maldutis has commented about alliances:

Some 25 years ago, we used to call them interline agreements. The only difference is that today you fool the passenger into thinking he’s flying on one single airline. But alliances...are nothing more than substitutes for mergers.⁴³

The remainder of the paper examines ways in which the international air transport industry might break out of the corset within which the Chicago system currently requires it to live.

ROUTES TO LIBERALIZATION:

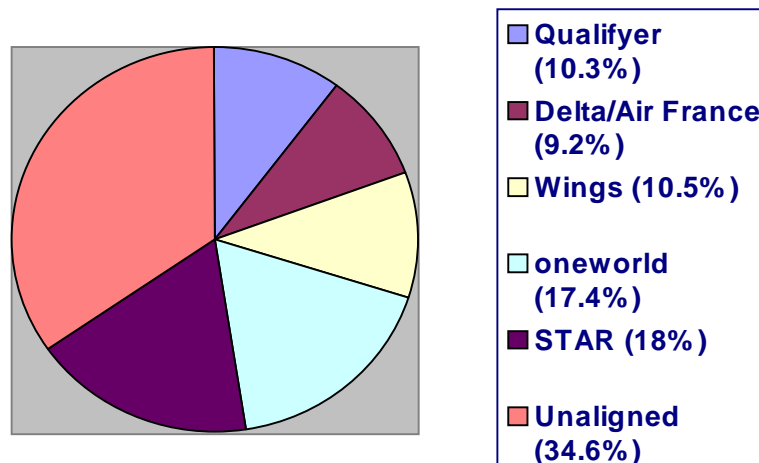
ROUTE I: “OPEN SKIES” AGREEMENTS

Conclusion of bilateral “open skies” agreements has been the consistent objective of US international aviation policy since 1978. Under the Carter, Bush and Clinton administrations, this objective met resistance from the larger EU Member States (notably France, the UK and (until 1996) Germany). In response, American negotiators deliberately adopted the tactic of seeking agreements with the smaller Member States, in the hope that expanded service and lower fares from the latter would draw passengers away from the more obdurate states, forcing them to reconsider their opposition to “open skies”.

Progress in this campaign has been uneven. Though the US was highly successful in concluding “open skies” agreements with the smaller Member States (starting with the Netherlands in 1992), it only obtained an open skies agreement with Germany (the second largest transatlantic market) in 1996, while the agreement for gradual liberalization signed with France in 1998 is not described by either party as an “open skies” agreement. The UK (which offers the largest transatlantic market, with roughly 34% of all traffic) has resisted any substantial liberalization, especially liberalization of access to London Heathrow, into which only two US airlines are allowed to fly. Moreover, the American campaign has provoked a counter-campaign by the European Commission, at least one object of which has been to frustrate the avowedly “divide-and-rule” strategy of Washington.⁴⁴

FIGURE 1. Global Alliance Volume, 1998.

Global Alliance Volume 1998 (Revenue Passenger Kilometers)



Source: Salomon Smith Barney, Report to the Minister for Public Enterprise and the Minister for Finance [Republic of Ireland]. Advice and Assistance in Relation to a Strategic Alliance for Aer Lingus, July 1999, 8.

Though the US has succeeded globally in securing fewer than forty “open skies agreements”, its claims about the benefits of liberalization have been borne out by experience in the liberalized markets. A study published in 1995 suggested that liberalization in the late eighties (before the current wave of open skies agreements) had decreased fares on North Atlantic services by between 35% and 45% and had increased boardings on these services at US airports by as much as 55%.⁴⁵ The same study concluded that transatlantic liberalization had resulted in consumer gains of \$5.1 billion in 1989 alone – the equivalent of \$585 per consumer.

The effects of the post-1992 agreements have been equally dramatic. According to a Department of Transportation official, fares on all services governed by open skies agreements with European countries have dropped by seventeen per cent since 1996.⁴⁶ The Dutch agreement led to a substantial increase in North Atlantic traffic through Amsterdam (a large proportion of the increase being traffic drawn from airports in neighboring countries that were under still more restrictive bilaterals – exactly the kind of diversion of trade that US negotiators had hoped would occur).⁴⁷ By 1995, Schiphol airport in Amsterdam had overtaken Charles de Gaulle airport in Paris as the fourth largest European “gateway”, the number of transatlantic passengers flying through Amsterdam having grown by 74% between 1989 and 1994.⁴⁸ In the case of Germany, fares (which had risen by fifty per cent between 1993 and 1996) dropped by ten per cent in the two years following signature of an open skies agreement with the US in 1996.⁴⁹

But the open skies formula suffers from at least four serious limitations as a route to broader liberalization of air transport. Three of these limitations derive from the premises and principles of the Chicago convention, while the fourth stems from the response of the European Commission.

First, “open skies” agreements are simply liberalized Chicago-regime bilaterals. Each (typically) opens up market access to all the airlines registered to operate by the two signatory states. Thus (to take a particularly pathbreaking example) under the US-Netherlands agreement of 1992, any certified US airline may fly between any US city and any city in the Netherlands (though this effectively means Amsterdam) and any Dutch airline (and this might be one of at least four, including KLM) may fly between any city in the Netherlands and any city in the United States.

To this extent, an “open skies” agreement is liberalizing. But it is still restricts competition on routes between the signatory states to airlines “substantially owned and effectively controlled” by nationals of those states. Only airlines that meet this nationality requirement as specified by the Netherlands for Dutch airlines and by the US for US airlines may take advantage of the Netherlands-US open skies agreement. Air France and Sabena, for example, cannot enter the Amsterdam-US market: the scope for greater competition is thus limited and, conversely, a significant potential for cartel-like behavior remains.

Secondly, only certain parts of the skies are “open” under “open skies” agreements. The nationality restrictions that apply to designation for international services also forbid services by foreign carriers within domestic markets. Lufthansa can fly between Frankfurt and Chicago, but it cannot pick up passengers in Chicago and fly them on to, say, Denver - much less operate a free-standing domestic service between American cities. Such service would constitute

“cabotage” and is strenuously opposed by labor unions and other interests in the US (as well as being illegal under American law).

On the European side, the issue of cabotage has been complicated by the establishment of the single market. Before the market was set up, various foreign airlines (including several American carriers) obtained so-called “fifth freedom” rights to carry traffic between national capitals as extensions of transatlantic services. In the logic of the single market, such services ceased to be “international” flights and became “domestic” flights – and therefore in principle open to challenge as “cabotage” services operated by foreign airlines. In truth, fifth freedom services by non-EU carriers carry a very small proportion of intra-EU traffic and their significance for competition across the Atlantic has been dwarfed by the recently-created transatlantic alliance systems. But European (particularly British) negotiators like to use the existence of such “fifths” as a stick with which to beat their American counterparts, claiming that they demonstrate inequity: US airlines are (the argument runs) allowed to operate within the EU domestic market, but EU airlines are excluded from operating within the American domestic market.

A third problem about the open skies approach is that it does not deal with the problem of unequal benefits, least of all when the US signs an agreement with a small state. In such cases, it may actually provoke criticism on the American side, while inflaming fears in the smaller state. On the American side, critics see the “balance of benefits” as tipped excessively toward the smaller state. For example, the US-Netherlands agreement provoked outrage in some air transport circles in the US because it gave Dutch airlines the run of the huge American market, while offering only the very small Dutch market to American carriers in return. This objection is not usually tempered by pointing out that the airlines of smaller countries do not usually have the resources (or the domestic demand) to be able to offer services to multiple American cities.⁵⁰

On the European side, however, open skies agreements have sometimes inspired a fear that national carriers would be overwhelmed by the larger American carriers, as well as a suspicion that the US Department of Transportation is simply a stalking horse for the large American carriers. While many of the smaller EU Member States do not in fact offer the traffic to attract great expansion by US carriers, the domestic flag-carriers (which until very recently were still commonly weak, state-owned airlines) have in the past feared a relative decline in market share on routes that were crucial to them for earning revenue.

The fourth limitation of the “open skies” approach is that it involves reaching bilaterals with Member States of the EU that are exclusive in character and thus at odds with the principles of the EC Treaty and with the single aviation market. This issue is discussed in more detail below in considering the potential for an EU-US common aviation area.

ROUTE II: A TRANSATLANTIC COMMON AVIATION AREA

In response to the US campaign to liberalize transatlantic aviation through bilateral “open skies” agreements with individual Member States, the European Commission has throughout the nineteen-nineties asserted that it should take over the role of negotiator with third countries (such as the US) on behalf of the Member States.

The EU's campaign has been justified on legal, logical and tactical grounds. Legally, the Commission has argued that its assumption of this role is justified by its authority as negotiator of external trade agreements under Article 113 of the EC Treaty.⁵¹ This role was also, in its eyes, in the logic of the single market, while, conversely, exclusive bilateral agreements were inconsistent with the single market. The Commission did not seek to annul existing bilateral agreements and, indeed, did not initially propose to take over all bilateral negotiations from Member States (a task for which it clearly lacked sufficient professional staff).⁵² It does, however, argue that the nationality clauses in bilaterals (including the new generation of "open skies" bilaterals) are inconsistent with the right of EU airlines (like other businesses) to establish themselves in any Member State and to fly to third countries. Consequently, the Commission holds that nationality clauses (as required under traditional bilaterals) are "contrary to Community law, since they discriminate on the basis of nationality and undermine effectively the right of establishment."⁵³ The Commission has in fact challenged the legality of the open skies agreements signed by many Member States through proceedings against the latter in the European Court of Justice.⁵⁴

Tactically (and perhaps most persuasively to the industry), the Commission has argued (and argues) that a better deal for Europe could be obtained by an authority representing 374 million people than by fifteen authorities representing as few as 394,000. It also argued, more specifically, that such a better "balance of benefits" for both the EU and the US could be obtained between a bloc representing 374 million and a country with a population of 260 million. Indeed, it envisages that such a parity of markets and benefits could lead to the creation of a single transatlantic aviation area - an aviation free trade zone, which might, with the abolition of the existing nationality and cabotage restrictions develop into a single aviation market.⁵⁵

After some argument about the legal basis of the Commission's claim to external competence and opposition by some Member States in the Council of Ministers, the latter body finally agreed in June 1996 to give the Commission a limited mandate to negotiate with the US for a "common aviation area", largely because of the threat to competition implicit in the creation of two new major alliances.⁵⁶ However, the mandate excluded traffic rights from the first phase of negotiations, authorizing only discussion of "soft rights", relating to competition rules, state aids, code sharing, reservations systems and ownership rights: "hard rights" (notably traffic rights) were to follow in a separate second phase.⁵⁷ However, the US government insisted that traffic rights be included in a single agenda for talks and announced in October 1996, after an unsuccessful meeting with the Commission, that it would continue to pursue open skies bilaterals.

In March and again in October 1998, the Council of Ministers rejected Kinnock's request for a comprehensive negotiating mandate for discussions with the US. The Commission then decided to seek support for the Commission's claim to competence by taking legal action in the European Court of Justice (ECJ) against eight Member States which since 1995 had signed bilateral agreements with the US.⁵⁸ Undaunted by the Commission's action, three other Member States (France, Italy and Spain) went ahead and signed new bilaterals with the US, one of them (the accord with Italy) being a full open skies agreement. Similarly, as noted above, the alliance structure continued to grow, albeit with some changes of partner.

Yet with the approach of the new GATT round and the announcement by the US DOT of an international meeting (which eventually took place in Chicago in December 1999), interest in the idea of an EU-US common aviation area returned. Eight Member States had declared their support for giving the Commission its full negotiating mandate for talks with the US, as had the Association of European Airlines (AEA), the president of Air France, and various business lobbies.⁵⁹ The AEA's support was especially heartening for the Commission, although it was accompanied by recommendations that Member States be allowed to continue negotiating bilaterals until an EU-US agreement was signed and that the actions against Member States in the ECJ be stopped.⁶⁰ In late November 1999, the new Transport Commissioner, Loyola de Palacio, and the director of air transport at DG Transport, Michel Ayrat, expressed their determination to press energetically for a Transatlantic Common Aviation Area.⁶¹ At the DOT's Chicago meeting, the Transport Commissioner in fact suggested that the EU and the US should hold bilateral meetings every six months to prepare for a "framework conference for [air transport] relations" by the summer of 2002.⁶²

Compared to the open skies formula, the notion of a common aviation area offers significant "value added" (a phrase invariably used in EU statements). It would make it possible to complete the single aviation market within the EU by permitting European airlines to fly from *any* European city to any city in the US, thus transcending the limits imposed by nationality requirements in open skies and other bilaterals. Air France, for example, could thus offer direct services from Brussels or Amsterdam to New York or anywhere else in the US, as well as connecting services from France through other European cities to North America.

Both the merits and the limitations of this change have, however, to be gauged by considering the present operation of and potential for hub-and-spoke networks set up by the various airline alliances. The latter have created a few magnetic hubs within Europe: Frankfurt and (to a lesser extent) Copenhagen for the Star Alliance, Amsterdam and Milan for the Wings Alliance, Paris for the Delta-Air France alliance, and London (and perhaps Madrid) for Oneworld. The common aviation area would enable airlines to challenge the domination of these hubs by a particular alliance and would, indeed, encourage greater competition between alliances. KLM and Alitalia might (by operating so-called "seventh freedom" flights between Germany and the United States) challenge the Star Alliance's domination of Frankfurt. But to do so economically would require the Wings Alliance to establish its own traffic-feeding hub in Frankfurt, to attract passengers from central, northern and southern Europe. It would have to offer lower fares or more convenient scheduling than the Star Alliance in order to overcome the latter's much larger network of connecting services.

If the common aviation area were accompanied by simultaneous removal of cabotage and nationality restrictions on both sides of the Atlantic (as the EU proposes), the outcome would indeed be a single aviation market stretching from Seattle to Athens (or wherever was the eastern most point of an enlarged EU). In the EU's formulation, airlines could then fly at liberty "between and within the EU and the US." Such an outcome would truly vindicate the Commission's claims about its power as a single negotiator for the EU and would truly represent the end of the Chicago regime. But, given the strong opposition in the US to yielding restrictions on cabotage and nationality, the EU would probably have to settle for a less ambitious deal

which would in effect be an EU-US open skies bilateral, allowing flights by any EU or US between any points in the EU and any points in the US (but without rights to operate connecting flights within the domestic markets of either entity). Even such a reform would be a substantial blow to the global authority of the Chicago system, and it might also go some way to undermining the current alliances, or at least their potential for choking competition.

ROUTE III: THE GENERAL AGREEMENT ON TRADE IN SERVICES

Air transport (as noted earlier) was specifically excluded from the General Agreement on Trade in Services (GATS) which came into force in 1995. This “unique sectoral exclusion” (as a WTO document puts it) was also unanimous on the part of all 108 delegations to the Uruguay round negotiations.⁶³ The exclusion is embodied in a specific annex which provides that, while the WTO Agreement will apply to maintenance and marketing services related to air transport, it will *not* apply to measures affecting:

- (a) traffic rights, however granted; or
- (b) services directly related to the exercise of traffic rights.⁶⁴

Reinforcing the point that the GATS does not challenge the Chicago regime, the Annex states:

It is confirmed that any specific commitment made or obligation assumed under this Agreement shall not reduce or affect a Member's obligations under bilateral or multilateral agreements that are in effect on the date of entry into force of the WTO Agreement.⁶⁵

While the body of the Annex clearly excludes all forms of air transport traffic rights, an opportunity for reconsidering this exclusion will arise in 2000.⁶⁶ The WTO's Council for Trade in Services is required to review, “at least every five years,” further developments in the air transport sector and the operation of the active provisions in the Annex “with a view to considering the possible further application of the [GATS] agreement in this sector”.

However, while some advocates of air transport liberalization (including, now, some governments) do see inclusion of the entire industry in the GATS as a logical and efficient way of putting an end to the Chicago system, the arguments against taking this route will be the same in 2000 as in 1990.⁶⁷ The main objection concerns application of two central elements of the GATT system – the Most Favored Nation principle and “national treatment” - to international air transport. The Most Favored Nation principle requires that a country offer to all trading partners treatment as generous as that offered to any single trading partner. Its application would entail opening up the markets of the more liberal states to more protectionist states, without the assurance of reciprocity. While this principle provides an important instrument for ratcheting up the liberalization of international trade, it creates a serious risk of enabling “free-rider” protectionist states to enter large and lucrative markets (such as the US and EU markets) without any obligation to offer the same reciprocity as offered between liberal trading partners. Not surprisingly, then, countries with quite dissimilar economic philosophies but with large aviation markets (such as the US and Japan) have been among the most active opponents of including air transport in the GATS.⁶⁸

The second principle - that of national treatment – requires that foreign companies established in a country be treated in all official actions and in law the same as companies of national origin. Applied to the air transport industry, this principle would clash with current rules on nationality and on cabotage: foreign-owned airlines would, once legally established, enjoy the right to operate on equal terms with national airlines.

Politically, some of the strongest opposition to inclusion of air transport in the GATS is to be found among labor unions, especially in the US. On 29 September 1999, for example, the annual meeting of the Transportation Trades Department of the AFL-CIO adopted a resolution expressing “strong opposition to efforts to include air transport services” in the GATS negotiations due to begin in Seattle in November 1999. The conference claimed that this “disastrous proposal” would, by application of the MFN principle, open the US market to foreign airlines on both domestic and international markets: “The result would place US carriers at a severe competitive disadvantage and would in turn be disastrous for US airline workers.”⁶⁹

Conversely, officials of several governments and international organizations have argued for a reconsideration of the status of international aviation under the GATS.⁷⁰ The European Commission, in its preparatory document for the Seattle meeting, argued that “commitments to further liberalisation should be secured” and noted that “negotiations will include ... a re-assessment of the Annex on Air Transport.”⁷¹ Some officials have argued that incorporation of air transport in the GATS might be combined with an expanding liberal plurilateral agreement of the kind discussed below.⁷²

ROUTE IV: MULTILATERALS AND PLURILATERALS

An alternative to (or possibly an expansion of) the concept of a common transatlantic aviation area discussed under Route III above is the formula for one or more multilateral or plurilateral agreements.⁷³ Here, three or more liberally-minded countries would agree to constitute a zone of liberalized services among themselves, abandoning the restrictions (including those concerning nationality) of the Chicago system except in relation to non-members. In principle, the parties to a multilateral or plurilateral agreement would have to decide what range of freedoms would be available within the liberalized zone. The relevant freedoms (additional to those provided by bilaterals) are freedom to fly between any two member countries (say, for American Airlines to fly between Canada and points in the EU) (seventh freedom flights) and freedom to fly between points inside other member countries (eighth freedom – more familiarly, cabotage flights). Many proposals seem to assume complete freedom of operation within the liberalized area.⁷⁴

The members of such a multilateral “island” would not have to be physically adjacent. Indeed, proposals for potential membership of a first multilateral often refer to such geographically-distant states as the Netherlands, Singapore, and Canada. While the economic impact – and the demonstration effect - might be greater if an aviation multilateral were formed by adjacent countries, the nature of aviation itself renders territorial proximity less important.

As Brian F.Havel has argued in his excellent book, *In Search of Open Skies*, an EU-US common aviation area might form the first building block for a liberalized multilateral zone.⁷⁵

The hope would be that other countries – seeing the benefits enjoyed by airlines and consumers within the liberalized zone – would then join, accepting in the process a kind of aviation acquis communautaire. Canada would be a probable early candidate for adhesion, especially since it already has an open skies agreement with the US. Enlargement might occur through adhesion by individual states or through the combination of two or more liberalized zones (such as that recently created in central America).

Two immediate issues face the advocates of such a route to liberalization. The first is that of critical mass. Without an EU-US agreement as a basis, it is hard to identify a large enough number of potential members (judged by present policies) to give the grouping credibility with and appeal sufficient to attract further members. A group consisting of Denmark, the Netherlands and Singapore hardly suggests that an irresistible tide of liberalization has set in. The US government has expressed interest in creation of a “multilateral or plurilateral arrangements”, though it tends to see such arrangements as growing more through an aggregation of some or all of the 36 open skies bilaterals it has now signed. With the US – and even more with both the EU and the US – joining a liberalizing multilateral, the market power and possibilities of the liberalized zone would obviously increase enormously.

Politically, it would be much easier to persuade the airline industries in the larger markets to accept new membership since reciprocity would be an absolute condition for joining. The “free rider” problem associated with MFN status would not exist and presumably only those countries would be attracted to joining which had airlines sufficiently strong to withstand open competition in their own markets and to take advantage of the opportunities arising from access to a huge external market. Membership would be neither an automatic benefit flowing from membership of a general international trading agreement nor an outcome of political pressure by a superpower, and the superpower’s airlines, as has sometimes been alleged about existing open skies bilaterals. As with the EU, countries would apply to join because of the demonstrated benefits already enjoyed by countries of different sizes. Logically, they would only apply when the balance of benefits against costs appeared to them to be positive. Thus what was originally a multilateral body could evolve into a more open, plurilateral body - an expansive system of voluntary and progressive liberalization, and one that, incidentally, would be in tune with the network strategies of the airlines, both large and small.

The second issue affecting a multilateral agreement is the same as that facing EU governments and airlines regarding third countries outside the zone of liberalization, namely, the survival of bilaterals between such countries and the countries which have signed the agreement.

The nationality restrictions in these bilaterals would have at least two serious consequences. Suppose that the multilateral included Canada, the EU and the US. First, the nationality restrictions would prevent the operation of “seventh freedom services”, such as an Air France flight from Los Angeles to Tokyo or an Air Canada flight from Paris to St Petersburg. Japan or Russia could deny such services by arguing that neither airline was of appropriate nationality to fly these routes under the provisions of US-Japan or the France-Russia bilaterals, respectively.

Secondly (as is now the case within the EU), the nationality restrictions in bilaterals with third countries would inhibit movement of capital (specifically, purchase of the equity of an airline by non-nationals, whether individuals or firms) for fear that “denationalization” might lead to the suspension of traffic rights by third countries. (Most multilateral formulas assume that nationality restrictions would cease to exist within the liberalized zone – they would, in fact, no longer have a rationale) In the event of a carrier coming under “substantial ownership and effective control” by non-nationals, it might be necessary to create a procedure by which that carrier (and only that carrier) acquired a "plurilateral" nationality to enable it to continue to operate on routes covered by bilaterals with third countries.⁷⁶

CONCLUSIONS:

Ingenious though the procedure outlined at the end of the previous section is, the very need for such ingenuity highlights once again the archaic (and arcane) nature of the regulatory regime governing international air transport. Yet most observers of this sector seem now to believe that the scale and dynamics of the industry will lead in the near or medium future to an abandonment of the Chicago system. Discussions at conferences on international regulation of air transport commonly reveal a general if informal and complicit understanding between airline managers and government officials that substantial change is both overdue and imminent.

However, to obtain a sharper sense of the probable pace and outcome of liberalization, observers of the airline industry need, however, to identify and weigh the forces working for and against liberalization. The most important pressure working for earlier rather than later liberalization is clearly the scale and the dynamics of the sector itself. As noted earlier, air transport is the most naturally cosmopolitan of industries – with maritime transport and space exploration, the only industry to operate in a borderless environment. More immediately, the economics of the industry are currently driving it towards the creation of larger and more comprehensive networks, under the sponsorship of enterprise alliances that are, as Julius Maldutis remarked, “merely substitutes for mergers.”⁷⁷

As with other sectors in which globalization is occurring, the emergence of ever-larger business entities in air transport faces barriers erected as much out of fear as out of crude protectionism. Airlines and governments in smaller and in developing countries naturally fear being overwhelmed or marginalized, whether by the current alliances or by the megacarriers that may succeed them. Organized labor fears, as elsewhere, the loss of jobs and reductions in salaries and professional opportunities that, they suspect will follow the collapse of nationality and cabotage rules. Policy-makers and others concerned with national security in some countries (including the US) are still nervous about the implications of allowing foreign nationals to obtain greater control of aircraft that might be needed in an emergency to transport troops and equipment.⁷⁸

The most vocal skeptics at present are consumer advocates (inside and outside government) who see a serious threat to competition from an industry that wants both liberalization and economic security. It is clearly true that, depending on the regulatory controls applied to them, international mergers might well present an even-greater threat to competition than the current alliances. Officials in the European Commission and their counterparts in the US

Departments of Justice and Transport are now thoroughly alert to the many aspects of airline operation in which threats to competition might arise (the Department of Justice itself having, ironically, made the consolidation of alliances possible by provision of anti-trust immunity!) Agreements between the EU and the US already exist for coordination of competition policy and one writer has even suggested creation of both an Open Skies Commission and an International Court of Air Transport to prevent anti-competitive behavior under a liberalized plurilateral regime.⁷⁹

By whatever route (or, quite possibly, combination of routes) the air transport industry moves toward greater liberalization, the impact of such liberalization will depend on the continuing interaction between airlines (and their strategies) and public bodies (and the regulatory frameworks they impose). Conditioning both are the basic economics of the industry: we may close this chapter by speculating on how such economics might shape transatlantic air transport in a completely liberalized environment.

Liberalization would certainly create opportunities for national start-up airlines and foreign airlines to operate on routes now restricted to designated national carriers. The history of this industry – especially on its transatlantic services – suggests that intensified competition would lead to more crises of overcapacity, more fare wars, and surely more bankruptcies. But such wars tend to be brief (if destructive of profits) and to be followed by a new equilibrium in which (as a quick glance at some airline Websites will confirm) more or less open “fare coordination” returns - even under the present partially liberalized regime.

Recent experience of open skies does suggest that liberalization would cause a dramatic expansion of demand, along with significantly reduced fares on existing routes (and especially on currently-protected routes, such as those to and from London). But while cities such as Pittsburgh would be freer than now to seek replacement carriers for international services when abandoned by incumbent airlines, the record of low-fare carriers such as Laker and Virgin Atlantic is one of trying to bite off a chunk of the traffic flowing into major cities which are not hubs dominated by a domestic carrier, rather than one of exploring underserved and sometimes untested international markets. Such caution may, however, reflect the very demanding and exiguous conditions for new entrants under the present Chicago regime.

Complete liberalization of transatlantic air transport may be a long-term prospect, especially if liberalization is defined as requiring the abolition of cabotage restrictions. Moreover, even if alliances collapse into mergers, the airline industry and governments will still be faced with fundamental issues of contestability and competition and with the peculiar economics of an industry that walks an interminable, fine line between tenuous profits and unpredictable loss.

While it is hard to discount the strength of the tide that now seems to be running toward further liberalization of air transport, the route by which it will come is as unclear as its timing. Of the three routes toward liberalization discussed here, it seems that the most likely (or least unlikely) route is through an EU-US transatlantic common aviation area. Admittedly, the European Commission is much more actively pressing this idea at present than its US counterpart in the DOT. In a recent interview, Rodney Slater, the US Secretary of

Transportation, acknowledged that his Department's priority is to complete its campaign for bilateral open skies agreements. He agreed that (in his own words), "If the EU was granted authority to negotiate on behalf of all Europe, we would welcome that. But until that becomes a reality, then we will negotiate with individual countries."⁸⁰

Indeed, no doubt to the dismay of the EU delegates and over the Commission's objections, the DOT used the occasion of the Chicago conference to stage a formal signing of its open skies agreement with Italy. Slater stated on this occasion that, while the Chicago conference would discuss "what are being called plurilateral arrangements", he felt that "this was an objective for the next century rather than a short-term likelihood."⁸¹

Yet, if liberalization is to come at all, it will probably have to be through a direct deal between Europe and the US, rather than through a general liberalization achieved in WTO negotiations. Reportedly, the US has in fact decided not to press for inclusion of air services in the GATS, judging (as indeed Slater suggested) that there is still insufficient support for global liberalization in this sector. The demonstrations in Seattle at the time of the WTO ministerial must surely have confirmed in Washington minds the wisdom of such caution. It is true that, despite the multitude of causes evident on this occasion, no journalist actually reported seeing placards demanding protection of the Chicago Convention of 1944. But it would be a brave (or rash) transportation official who would speak out at present for free trade in a sector as emblematic of globalization as international air transport.

APPENDIX 1:⁸²

IF PAINT SHOPS WERE LIKE AIRLINES

A man walks into a hardware shop that, unknown to him, is owned and operated by a major airline. The following exchange ensues:

- Customer:* Hi, how much is your paint?
Sales agent: Well, there is a really big price range. The lowest price is \$9 a gallon, and we have 150 different prices up to \$200 a gallon.
Customer: What is the difference in the paint?
Sales agent: Oh, there is no difference - it's all the same paint.
Customer: Well, then, I want the \$9 paint.
Sales agent: When do you intend to use it?
Customer: I want to paint tomorrow, on my day off.
Sales agent: Sir, tomorrow the paint is \$200.
Customer: What? When would I have to paint in order to buy the \$9 version?
Sales agent: That will be in three weeks, but you will also have to agree to start painting before Friday of that week and continue painting until at least Sunday. And I must check to see if we have any of that paint available.
Customer: What do you mean, "check to see if it is available"? You have shelves full of that stuff - I can see it right there.
Sales agent: Just because you can see it does not mean that we have it. It may be the same paint, but we can only sell a certain number of gallons of \$9 paint for any given weekend.
Customer: This is crazy! And what happens if I decide not to use the paint?
Sales agent: The \$9 paint is non-refundable - but you are in luck! The price just went up to \$12. Now *that* paint can be returned for a \$75 service charge.
Customer: You mean the price went up while we were talking?
Sales agent: Yes, sir. You see, we change prices thousands of times a day and, as you have not actually walked out of the store with your paint yet, the price just changed.
Customer: Well, that does it - I'm going somewhere else to buy my paint.
Sales agent: As you wish, sir. But remember: we all do business the same way."

¹Boswell's *Life of Johnson*, 31 July 1763. For political correctness' sake, I have removed this quotation from its context – one in which Johnson was comparing the dog's feat to that of a woman preaching.

² In August 1991, *The Economist* reported that "so far the only service that creates a problem for all 108 countries taking part in the Uruguay round is aircraft landing-rights ("Second best," *Economist*, 3 August 1991, 62). For further discussion of the GATS and its possible contribution to liberalizing international air transport, see below, "Route III: The General Agreement on Trade in Services".

³ International Air Services Transit Agreement, 18 June 1998, art.1, s.5.

⁴ Statistics for Air France from “World Airline Financial Statistics-1998”, *Air Transport World*, July 1999, 63; statistics for United Airlines/Star Alliance from “A soft landing,” *Air Transport World*, July 1999, 71.

⁵ Local sources claimed that surveys had shown that there was sufficient USAirways passenger feed into the hub to support two daily services to London. The route had been marginal for BA until the early nineties when BA formed an alliance with USAirways. When the latter ended the alliance in 1996, BA no longer benefited from coordinated scheduling and preferential pro rating for fares on connecting services. Even so, at the time of cancellation the service had an average daily payload of 68 per cent and traffic had increased by fourteen per cent in the preceding six months alone. BA, however, was suffering heavy losses on its transatlantic services and was (in the words of an official interviewed for this chapter) “simply not making enough money, especially at the front of the plane”.

⁶ Virgin had applied for authority to fly to Las Vegas, competing with a BA application to fly to Denver. The British government gave the authority to BA for the Denver service.

⁷ Mark Belko, “Authorities vow action on London air route,” *Pittsburgh Post-Gazette*, 13 October 1999, E1 (quoting A.Bradley Mims, Acting Assistant Secretary for Aviation and International Affairs, Department of Transportation, speaking before the Aviation Subcommittee of the House Transportation and Infrastructure Committee, 12 October 1999).

⁸ For a recent use of the fruit analogy, see Michael Skapinker, “The ups and downs of airline fares”, *Financial Times*, 27-28 February 1999, 7.

⁹ The current cost of the newer, slightly smaller, and more favored Boeing 777 is \$129.8 million (figures from “Facts and Figures,” *Air Transport World*, October 1999, 113).

¹¹ Contrary to popular myth, air travel’s initial success in beating the ocean liners was due not to the advent of jets, but to the introduction of “tourist” and then “economy” fares on services flown by advanced piston engine and turboprop aircraft (T.A.Heppenheimer, *Turbulent Skies. The History of Commercial Aviation* (New York: John Wiley, 1995), 192-5). Ocean liners continued to be built well into the 1960s (the *France* was launched in 1962 and the *QE2* in 1969): even in 1966, over forty liners were still serving on transatlantic routes, carrying in that year 607,000 passengers (Heppenheimer, *op.cit.*, 194).

¹² James Ott, “Competition to force new airline structures,” *Aviation Week and Space Technology*, 15 March 1993, 65.

¹³ “A soft landing”, *Air Transport World*, July 1999, 54.

¹⁴ Oral testimony of A.Bradley Mims, Acting Assistant Secretary for Aviation and International Affairs, Department of Transportation, before the Aviation Subcommittee of the House Transportation and Infrastructure Committee, 12 October 1999.

¹⁵ Lehmann Brothers, *European Airlines: A Turbulent Decade*, 14 September 1993, n.p.

¹⁶ “France and US fail to resolve air route row,” *Financial Times*, 6 April 1992, 3; “Lufthansa in link talks with American,” *Financial Times*, 6 April 1993, 4. Overall, in the early nineties, services across the

North Atlantic represented 11.6% of all international traffic carried by airlines belonging to the Association of European Airlines (AEA) but they generated roughly twenty per cent of the group's revenues ("Eurocarriers must fight for American market share," *Aviation Week and Space Technology*, 31 May 1993, 35).

¹⁷ "Note" (by H.E. Marking and William T. Seawell) in Jesse J. Friedman, *A New Air Transport Policy for the North Atlantic. Saving an Endangered System* (New York: Atheneum, 1976). Regarding the larger airlines and in all routes, Michael Skapinker recently noted that "in 1997, their best year ever, the airlines' operating profit was a paltry 5.7 per cent. Last year [1998], it was 5.5 per cent" ("Flying into new millennium of opportunities", "The Business of Travel", *Financial Times*, 18 November 1999, I).

¹⁸ Friedman, *A New Air Transport Policy for the North Atlantic. Saving an Endangered System* (New York: Atheneum, 1976). By 1975, the number of passengers crossing the Atlantic by sea had dropped to an estimated 50,000 - 5.2% of its level (of 962,000) only twenty years earlier (Friedman, op.cit., Appendix, Table 1).

¹⁹ In 1946, Pan Am and TWA carried approximately 92% of all passengers on air services between North America and Europe. By 1956, fifteen airlines were operating across the North Atlantic and the share of the two US carriers had fallen to 53 %: by 1962, nineteen airlines were carrying passengers across the Atlantic and the US share had fallen to 32% (Davies, *A History of the World's Airlines*, 461, 471; Sampson, *Empires of the Sky*, 110). In the French case, the end of the Indo-China war in 1955 led to the proportion of Air France's traffic carried on colonial routes falling from one-third to one-fifth of its total traffic: in the succeeding ten years, Air France ended service to a half of its destinations in former colonial territories (Nicolas Neiertz, "Air France: an Elephant in an Evening Suit", in Hans-Liudger Deniel and Peter Lyth, eds, *Flying the Flag. European Commercial Air Transport since 1945* (London: Macmillan, 1998), 28). The Dutch responded much more aggressively to the loss of their East Indies colonies: see Marc Dierikx, "KLM: an Airline Outgrowing its Flag", in Deniel and Lyth, eds., *Flying the Flag*, 143-4.

²⁰ "Eurocarriers must fight for American market share," *Aviation Week and Space Technology*, 31 May 1993, 35.

²¹ Most galling for the European carriers was the fact that at this time the number of European passengers travelling across the Atlantic was rising steeply and many of these new passengers were hoosing to fly either on the lower-cost US airlines (with their frequent flier schemes) or on European charter or private carriers such as Freddy Laker's Skytrain.

²² The fact that airlines allowed to fly into Heathrow do in fact extract such a "rent" has been documented recently by studies comparing fares between the US and London compared to available fares in the more open U.S.-Amsterdam market. According to *The Financial Times*, Gerald Gitner, chairman of Trans World Airlines, pointed out in April 1999 that "a basic economy fare from New York to London was \$1,290, compared with \$974 from New York to Paris. A typical business class fare from New York to London of \$2,683 was higher than to Paris, Amsterdam and Milan..." (Michael Skapinker, "TWA chief scorns 'high' fares to London," *Financial Times*, 12 February 1999, 8). Similar claims have been made by Sir Michael Bishop, chairman of British Midland Airways.

²² R.E.G. Davies, *A History of the World's Airlines* (London: Oxford University Press, 1964), 470; Anthony Sampson, *Empires of the Sky. The Politics, Contests and Cartels of World Airlines* (New York: Random House, 1984), 110.

²³ One example of the careful management of supply is the widespread replacement of the “traditional” widebody jet – the Boeing 747 – on transatlantic routes by the smaller 767 (or Airbus A300/310). On some “thin” routes, even the single-aisle Boeing 757 (an aircraft almost exclusively used on domestic routes within the US or the EU) is now used by both scheduled and non-scheduled airlines.

²⁴ As a recent WTO document put it pithily: “The control of capacity plays an essential part in maintaining the profitability of routes” (World Trade Organization. Council for Trade in Services, *Air Transport Services. Background Note by the Secretariat*, S/C/W/59, 5 November 1998, 22).

²⁵ Michael Skapinker, “Riders on the storm,” *Financial Times*, 19 August 1999, 11.

²⁶ To a lesser extent, KLM also dropped out, but it continued to offer fares on transatlantic services that BA in fact singled out as examples of fares that could not even cover costs (see the letter from Simon Walker (BA’s Director of Communications) entitled “Our backpacker of today is tomorrow’s business traveller,” *Financial Times*, 15 November 1999, 18).

²⁷ On BA’s strategy, see the following articles by Michael Skapinker, the *Financial Times*’ aerospace correspondent: “Flying through the flak”, *Financial Times*, 25 January 1999, 13; “Airline’s reputation for service comes down with a bump”, *Financial Times*, 27 May 1999, 9; “BA joins the jettison age”, *Financial Times*, 6-7 November 1999, ” “How to Spend It” section, 6-8; see also Susanna Voyle, “Crowded flight paths catch British Airways in turbulence”, *Financial Times*, 10 August 1999, 11; and Perry Flint, “The flight to quality,” *Air Transport World*, September 1999, 5.

²⁸ Perry Flint, “The flight to quality”, *Air Transport World*, September 1999, 5.

²⁹ Thus one spokesman was quoted as saying: “We want to reduce our exposure to low-margin passengers. They are costing the whole industry an enormous amount” (quoted in Tim Burt, “BA to cut excess capacity to bolster profits”, *Financial Times*, 9 August 1999, 13).

³⁰ Describing BA’s strategy, Michael Skapinker remarked:

the middle managers and some of the family holidaymakers would still be welcome. But the cut-price passengers could take their backpacks elsewhere ... BA has decided to turn itself into something no large carrier has attempted before: an airline for the wealthy” (“BA joins the jettison age”, *Financial Times*, 6-7 November 1999, “How to Spend It”, 7).

For evidence of the public relations problems that BA’s strategy has caused, see Philip Varley, “BA cannot afford to snub ‘lifetime customers’”, *Financial Times*, 11 November 1999, 14, and the rejoinder by BA’s Director of Communications, Simon Walker, “Our backpacker of today is tomorrow’s business traveller,” *Financial Times*, 15 November 1999, 18.

³¹ Or, for that matter, that Orlando (ranking 24th among the world’s busiest airports) would handle more passengers annually than Rome, Madrid, Paris-Orly, Tokyo or Beijing (all figures from “Special Report: Airports,” *Airline Business*, June 1999, 64).

³² Regulation 2407/92, 1992, art.4.2. On EU licensing procedure, see Bernadine Adkins, *Air Transport and EC Competition Law* (London: Sweet and Maxwell, 1994), 219-225. Ironically, the largest shareholding by one major European airline in another is Swissair’s 49.5% holding in the Belgian airline Sabena – the irony being that Switzerland is not an EU member (which is not a Community carrier. The

remaining 51% is held by the Belgian government and Belgian financial interests. This arrangement allows Sabena to fly both within the European Aviation Area as a Community carrier and as a Belgian airline on routes covered by bilaterals between Belgium and non-EU countries.

³³ To the author's knowledge, this provision has never been used to deny operating authority to any EU carrier.

³⁴ The Commission suggests that these restrictions remain for an initial five-year period, with the possibility of further liberalization at the end of that period ("EU-US ASA principles", *Avmark Aviation Economist*, April 1995, 9).

³⁵ BA in its now defunct alliance with the-then USAir, and KLM in its "Wings" alliance with Northwest. Interestingly, no equity purchase is involved in the current BA alliance with American, and KLM subsequently sold its Northwest stock, believing that both partners could gain as much from the alliance without any equity ownership and could, indeed, work together better where there could be no suspicion that one might try to take over the other.

³⁶ The standard form of Air Service Agreement attached to the Chicago Convention made the various freedoms accorded and allotted in bilateral ASAs subject to the right of a party

to withhold or revoke a certificate or permit to an air transport enterprise of another State in any case where it is not satisfied that substantial ownership and effective control are vested in nationals of a contracting State. (International Air Services Transit Agreement, art.1, s.5)

³⁷ This said, it must be stressed that several cases have now occurred in which foreign owners have acquired substantial equity of a major national airline without provoking challenges from bilateral partners. In this respect, the case of Sabena is particularly intriguing. Swissair (which is not even a "Community carrier") bought 49.5% of the Belgian airline has now obtained "an option to increase its stake to at least two-thirds" (Neil Buckley, "Sabena advisers appointed", *Financial Times*, 8 December 1999, 25). While this report acknowledges that such a takeover would be politically sensitive in Belgium ("which has seen many of its leading companies taken over by foreign groups in recent years"), commentators (not to mention the Belgian government) have been curiously silent about the implications of a Swiss takeover for Sabena's overseas traffic rights. This silence is all the more striking in the light of the legal protections against foreign takeovers devised by other EU governments for their airlines.

³⁸ Leo van Wijk, Managing Director of KLM Royal Dutch Airlines, quoted in Joan M.Feldman, "Right ends, wrong means," *Air Transport World*, January 1995, 60.

³⁹ The clients are not necessarily unwilling partners, at least as far as their managements are concerned. In the US (and now elsewhere), they are commonly identifiable through use of the word "express" in their titles ("United Express", "Delta Express").

⁴⁰ J.A.Donoghue, "Alliance churn", *Air Transport World*, November 1999, 5.

⁴¹ For example, Richard Branson, the owner of Virgin Atlantic Airlines, has consistently attacked both private and public monopolies. In a typical criticism of the BA-AA plan, he said: "If this BA/AA deal goes through, there could never, ever, be another Virgin Atlantic formed. They could never get the slots, and who in their right mind would invest or lend money to an airline with no chance of flying on a profitable route?"(quoted in David C.Forward, "Join the club," *Airways*, December 1998, 27).

⁴² At a recent conference on “Defining Global Networks, Julius Maldutis of CIBC Oppenheimer, suggested that the vogue for global alliances might prove “very short-lived”. Maldutis said: “I think that after the US government has achieved its objective of open skies, the chaps [at the Department of Justice] will conclude these are anticompetitive and the alliance game is over” (quoted in Perry Clark, “Alliance paradox,” *Air Transport World*, April 1999, pp.33-4).

⁴³ Quoted in David C.Forward, “Join the club,” *Airways*, December 1998, 27. In a recent paper, Dr Sveinn Vidar Gudmundsson of Maastricht University has commented in the same vein:

If the political climate remains focused on consumer protection, competition-enhancing regulation is bound to reduce alliance benefits...It is likely that we will see in the next ten years major changes in international air transport leading to the decline of the alliance but the rise of the multinational global carrier, firmly constrained by competition-enhancing regulation

(“Airline alliances: consumer and policy issues,” *European Business Journal*, 11, 3 (Autumn 1999), 139ff).

⁴⁴ For the EU approach, see below, “Route II: A Transatlantic Common Aviation Area”.

⁴⁵ Eric Maillebiau and Mark Hansen, “Demand and Consumer Welfare Impacts of International Airline Liberalization”, *Journal of Transport Economics and Policy* 29, 2 (1995), 115-36, cited in John E. Richards, “Toward a Positive Theory of International Institutions: Regulating International Aviation Markets,” *International Organization* 53, 1 (Winter 1999), 27.

⁴⁶ David Marchick [US Deputy Assistant Secretary for Transportation], “Clearing the air”, *Financial Times*, 14 July 1999, 10. The US Department of Transportation (DOT) also claims that in all US international aviation markets, consumers “now pay about seventeen per cent less for commercial air service, adjusted for inflation, than they did in 1992”. It also points out that over the same period traffic between the US and cities abroad has increased by 35 million passengers (written statement of A.Bradley Mims, Acting Assistant Secretary for Aviation and International Affairs, Department of Transportation, before the Aviation Subcommittee of the House Transportation and Infrastructure Committee, 12 October 1999). Since these figures apply to all international services (including those flown under restrictive bilaterals), they do not provide direct evidence of the impact of open skies agreements.

⁴⁷ The potential for market expansion was shown dramatically in the case of a new KLM-Northwest service between Amsterdam and Minneapolis, launched in April 1994. Starting with a capacity of 1,942 seats each week, capacity on this route was increased to 9,758 seats weekly by mid-summer to cope with demand: in August, a second daily flight was scheduled for the remainder of the season.

⁴⁸ Schiphol still holds that rank, although Paris has moved up to third position as a result of Air France’s success in establishing a hub at Charles de Gaulle.

⁴⁹ Marchick, “Clearing the air,” *Financial Times*, 14 July 1999, 10.

⁵⁰ KLM was in fact a rather special case. Its strategy reflected a much older Dutch tradition of overseas commerce and it was one of the earliest and most innovative European international airlines. Its strategy from 1946 onward involved exploiting the central location of Amsterdam and the eclipse of German civil aviation to make Schiphol airport into a traffic hub for transatlantic service, bringing travelers from

Germany and other countries in to Amsterdam before reboarding them on to transatlantic aircraft (and vice versa). In this way, KLM managed to be a major international airline without having a large domestic “origin and destination” market. This strategy also shaped the Netherlands’ willingness to accept an open skies agreement with the US, since this agreement would enable it to “poach” traffic originating in neighboring Member States (notably Germany) even more effectively. Naturally enough, this approach made the Dutch unpopular with many of their trading partners (notably Germany and the US), not to mention the European Commission. They, however, see themselves as the truest and most unapologetic apostles of free enterprise in the EU.

⁵¹ Article 113, s. 2 and 3 of the Treaty read as follows:

2. The Commission shall submit proposals to the Council for implementing the common commercial policy.

3. Where agreements with third countries need to be negotiated, the Commission shall make recommendations to the Council, which shall authorize the Commission to open the necessary negotiations.

⁵² Commission of the European Communities, *Air Transport Relations with Third Countries. Communication from the Commission to the Council*, COM (92) 434final, Brussels, 21 October 1992, 22, para.54. By one estimate, each Member State has between sixty and seventy bilateral agreements with non-EU states (Eugenie Kalshoven-van Tijen, “The EEC Commission as the European Version of the CAB?” *Air Law*, 15 (1990), cited in Brian F.Havel, *In Search of Open Skies: Law and Policy for a New Era in International Aviation. A Comparative Study of Airline Deregulation in the United States and the European Union* (The Hague: Kluwer Law International, 1997), 372). With the current EU membership of fifteen, the Commission would thus become responsible for monitoring and renegotiating at least 900 bilateral agreements. (Eventually, these would, of course, be collapsed into sixty-plus EU bilaterals once the Commission’s assertion of authority over negotiations was effective).

⁵³ Commission of the European Communities, *Air Transport Relations with Third Countries*, 8, para.15.

⁵⁴ More recently, it has also challenged legislation enacted by Member-States to protect privatized airlines against losing their nationality status (and consequently risking loss of their traffic rights under bilaterals) through the purchase of controlling equity by non-nationals (see “Lufthansa Set to Privatize”, *Aviation Week and Space Technology*, 26 May 1997, 40; Renée Cordes, “Dispute over Lufthansa sell-off”, *European Voice*, 22-28 July 1999, 4; and “Madrid risks court action over ‘golden shares’ in privatisations”, *European Voice*, 10-16 June 1999, 22). Similar safeguards against “denationalization” exist in other countries: for example, the nationality status of KLM is protected by an option agreement that allows the Dutch government to purchase up to 23 million of the airline’s shares at an agreed price in order to ensure that a majority of shares are in Dutch hands.

⁵⁵ On the Commission’s claims to competence and their recent history, see Brian F.Havel, *In Search of Open Skies: Law and Policy for a New Era in International Aviation. A Comparative Study of Airline Deregulation in the United States and the European Union* (The Hague: Kluwer Law International, 1997), 6-14, 267-75, 369-376; Franky de Coninck, *European Air Law. New Skies for Europe* (Paris: Les Presses de l’Institut du Transport Aérien, 1992), 122-8; Martin Staniland, “The United States and the external aviation policy of the EU,” *Journal of European Public Policy*, 2, 1 (March 1995), 19-40.

⁵⁶ Havel, *In Search of Open Skies*, 12. Havel argues persuasively that it was the conclusion of the Germany-US “open skies” agreement in February 1996, the related alliance between Lufthansa and

United Airlines (accompanied by anti-trust immunity), and the announcement of the American Airlines-BA alliance in June 1996 that impelled the Council to give a rather half-hearted mandate to the Commission, after much urging by Transport Commissioner Kinnock. Germany had reportedly been a supporter of Kinnock's campaign for negotiating authority and the German transport minister represented the open skies agreement as "a building brick for a transatlantic regime between the US and Europe... We are the key for the Americans in terms of reaching a US-European agreement." Herr Wissman reportedly remarked also that "an overall US-European accord was more likely now that the US had reached agreement with one of the large EU countries" (Michael Skapinker, Michael Lindemann and Caroline Southey, "US strikes deal on 'open skies' with Germany", *Financial Times*, 3-4 February 1996, 1). The agreement was, however, the same in character as the other open skies agreements to which the Commission objected and interestingly the consistent reaction of US officials (as reported in the same *FT* article) was that the German agreement would increase the pressure on the UK to sign an "open skies" agreement. Incidentally, Germany was one of the Member States subsequently taken to the European Court of Justice by the Commission precisely for its signature of this agreement.

⁵⁷ "Mandate secured for EU-US "open skies" accord", *Eurocom. Monthly Bulletin of European Union Economic and Financial News*, 8, 7 (July/August 1996), 1. Reportedly, France and Portugal insisted on this separation of issues as a condition for supporting authorization of direct talks with the US; the UK was the only Member State to vote against such authorization (John D. Morrocco, "EC to Begin Aviation Talks With US," *Aviation Week and Space Technology*, 24 June 1996, 33; Michael Skapinker, "US-EU aviation talks setback", *Financial Times*, 2 October 1996, 2).

⁵⁸ The eight included seven (Austria, Belgium, Denmark, Finland, Germany, Luxembourg and Sweden) which had concluded open skies agreements with the US despite a warning letter sent by the Commission to all Member States in 1994. The UK was included in the action because it had concluded in the interim a limited bilateral agreement with the US, though not one that either party considered an "open skies" agreement. The Netherlands, which had signed the original open skies agreement with the US, was presumably exempted because of the Commission's use of the 1995 cut-off point.

⁵⁹ The eight Member States were Belgium, Denmark, France, Greece, Luxembourg, the Netherlands, Spain, and Sweden (Neill Buckley, "Kinnock to press on with 'open skies' action", *Financial Times*, 2 October 1998, 8. See also Alan George, "Europe's major call for liberalised transatlantic", *Airline Business*, November 1999, 19, and Karen Walker, "Air France joins call for single US-EU market", *Airline Business*, December 1999, 9.

⁶⁰ The AEA said that the actions were "inconsistent with the objective of creating a new framework for EU-US air services and detrimental to EU trade interests" (Karl-Heinz Neumeister, secretary general of the AEA, quoted in Alan George, "Europe's major call for liberalised transatlantic", *Airline Business*, November 1999, 19).

⁶¹ Pierre Sparaco, "EC Pushes Quick Aviation Accord With US," *Aviation Week and Space Technology*, 29 November 1999, 40.

⁶² Quoted in Michael Smith, "Brussels seeks common aviation policy with US," *Financial Times*, 8 December 1999, 8. Sra de Palacio told the US delegates that she was not seeking harmonization: "I am not saying we need to have the same policies on all issues ... But we should have convergence of policy, ensuring compatibility and effectiveness. At a minimum we need the means to prevent and deflate potential conflict".

⁶³ World Trade Organization. Council for Trade in Services, *Air Transport Services. Background Note by the Secretariat*, S/C/W/59, 5 November 1998, 1; “Second-best”, *Economist*, 3 August 1991, 62.

⁶⁴ Office of the U.S. Trade Representative, Executive Office of the President, *Final Act embodying the Results of the Uruguay Round of Multilateral Trade Negotiations (Version of 15 December 1993)*, Washington, D.C., General Agreement on Trade in Services, Annex on Air Transport Services, 40: the text of the Air Transport Annex can also be found on the WTO Website, at <http://www.wto.org/wto/services/9-anats.htm>. The Annex applies to “measures affecting trade in air transport services, whether scheduled or non-scheduled, and ancillary services.” The GATS does apply to “aircraft repair and maintenance services,” “the selling and marketing of air transport services” and “computer reservation services.”

⁶⁵ Text as on WTO Website <http://www.wto.org/wto/services/9-anats.htm>, 1. The wording in the USTR document cited above differs slightly from the final WTO version.

⁶⁶ Annex on Air Transport Services, para.5. The scope of the exclusion is notably detailed and comprehensive: traffic rights are defined as

the right [sic] for scheduled or non-scheduled services to operate and/or to carry passengers, cargo and mail for remuneration or hire from, to, within, or over the territory of a Member, including points to be served, routes to be operated, types of traffic to be carried, capacity to be provided, tariffs to be charged and their conditions, and criteria for designation of airlines, including such criteria as number, ownership, and control.

(Annex on Air Transport Services, para.6)

⁶⁷ See, for example, the letter from Peter Morrison (head of the World Trade Group, at Clifford Chance, London), entitled “Air deals have outlived usefulness”, in the *Financial Times*, 29 April 1999, 10, in which the writer calls for “air carriers interested in improving services and reducing costs [to] pressure governments to restore basic WTO nondiscrimination and market access discipline to the sector.” The verb “restore” is curious in this context: most students of the industry would be hard put to identify a time when it was ever subject to anything resembling WTO and GATT trading disciplines.

⁶⁸ On the problems of including air transport in the GATS, see Havel, *In Search of Open Skies*, 406-7, and Ron Katz, “The great GATS”, *Airline Business*, September 1995, 81-2.

⁶⁹ Likewise, opening up cabotage to foreign airlines would, the conference claimed, “have dire economic consequences for US airlines and airline workers” (“Transportation Labor Leaders Adopt Key Policy Positions at Annual Meeting of Transportation Trades Department, AFL-CIO”, *US Newswire*, 30 September 1999, 100827n0041).

⁷⁰ In a speech in September 1999, Mike Moore, Director-General of the WTO, suggested that inclusion of air transport in the GATS was “certain to be an important issue in the new Round, if only because there is a growing demand for cheaper services among business users of air transport.” Moore asked that governments look very seriously at this opportunity to free up the tightly controlled world of civil aviation, so that people can more cheaply visit their family members and business can be more productive. (“The Future of International Trade in Services”, The Third Debits Services Conference, Berlin, 21 September 1999 (reproduced on the WTO Website: <http://www.wto.org/wto/speeches/mm6.htm>)

⁷¹ The European Commission, “EC Approach to Services”, May 1999, 2 (published on the EC Website at http://europa.eu.int/comm/trade/2000_round/seaserv.htm).

⁷² See, for example, the speech by Daniel Tarullo (assistant to President Clinton for international economic policy) to the International Aviation Club, Washington, D.C., 2 May 1997 (distributed on the USIA 's *Washington File*, 2 May 1997; Mario Marconini of the WTO, quoted in Katz, "The great GATS", *Airline Business*, September 1995, 81.

⁷³ The distinction between a "multilateral" and a "plurilateral" seems to be (at least in the present context) that a multilateral body consists of a determinate number of members and may thus be exclusive, whereas a plurilateral may have a varying number of members and is, by implication, open to new members.

⁷⁴ As does Havel's: see *In Search of Open Skies*, 24.

⁷⁵ Havel, *In Search of Open Skies*, Chapter 5.

⁷⁶ This solution is suggested in Havel, *In Search of Open Skies*, 438.

⁷⁷ See above, note 40.

⁷⁸ For example, at the annual Sky Harbor International Aviation Symposium held in Phoenix, Arizona, in May 1999, Mary Lou McHugh, a US assistant deputy undersecretary for defense, insisted that her department would oppose, on security grounds, any change in current US ownership laws. Specifically, McHugh argued that the Department of Defense had to be certain that US-registered aircraft offered by airlines under the Department's civil reserve air fleet program (CRAF) would be available immediately and unconditionally in time of national emergency. She contended that allowing greater foreign investment would create at least a hypothetical danger that a foreign investor (perhaps influenced by an unfriendly or neutral foreign government) might deny or delay use of airliners by the US government.

McHugh's speech (which the author heard) drew a largely skeptical (even alarmed) response from the airline managers and from some transportation officials attending the symposium. Several participants pointed out that other countries routinely required their own airlines (as a condition of certification) to agree to provide aircraft in the event of national emergencies. Since this requirement is so common, it was (they claimed) unlikely that foreign investors (certainly, foreign airlines) would refuse to accept a similar requirement as a condition of investing in US airlines. (Two quintessentially British-sounding airlines, Britannia and Monarch, which are in reality foreign-owned, had for some years troop-carrying contracts from the British government)

Incidentally, in accepting an obligation to provide "airlift" for the US government, foreign investors would in fact accept a more rigorous obligation than that currently carried by US airlines, whose participation in the CRAF scheme is voluntary and whose operations in emergencies are fully paid for by the Department of Defense. For a succinct and accurate account of McHugh's speech and responses to it, see Karen Walker, "US DOD gives red light to ownership changes," *Airline Business*, June 1999, 11. According to this article, the DOD currently has 725 US airliners available to it under the CRAF program and depends on them "for 93% of its troop movements and 41% of its cargo movements during a major conflict." An exchange on the same issue at an aviation law conference is reported in David Knibb, "Foreign ownership debate heats up," *Airline Business*, March 1999, 13.

⁷⁹ Havel, *In Search of Open Skies*, 430. For discussions of the problems of applying an international competition regime to air transport, see Joan M.Feldman, "Whose ocean is it, anyway?" *Air Transport*

World, March 1997, 48-51; International Chamber of Commerce, Commission on Transport, “Convergence of competition law and policy in the field of air transport with special reference to the EU-US context”, 16 July 1997 (on the Web at http://www.iccwbo.org/home/statements_rul.../1997/air_transport_competition_eu_US.asp); and Karel van Miert, “Competition Policy and Air Transport: The Transatlantic Challenge,” speech at the American Bar Association, Washington, D.C., 22 January 1999 (on the Web at <http://www.eurunion.org/news/speeches/990122vm.htm>).

⁸⁰ According to Karen Walker (the interviewer), Slater said that the DOT would be “willing to move on and deal with Europe as an entity in multilateral negotiations [sic]”. But he made it clear “that the USA cannot put its open skies ambitions on hold while the European Union works out its stance on this one” (“Sky opener”, *Airline Business*, December 1999, 39).

⁸¹ Nikki Tait, “US and Italy conclude open skies aviation deal,” *Financial Times*, 7 December 1999, 10.

⁸² From the Internet, courtesy of Tom Norwood: published in *Airways*, April 1999, 77.