European Policy Paper Series

OPEN SKIES - FEWER PLANES?
Public policy and corporate strategy in EU-US aviation relations

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The recent decision of the European Union's (EU) transport ministers to authorize the Commission to begin negotiation of a multilateral aviation agreement with the United States was long in coming and in the process was overtaken by developments in the airline industry itself.

The EU has been fighting within itself since 1991 about whether the Commission should exercise authority that it claims under Article 113 of the EC Treaty to negotiate with "third countries" over international air services. In exercising such authority, the Commission would supplant national negotiators who are responsible for maintaining and modifying bilateral Air Service Agreements (ASAs) and would become the sole negotiator for all Member States.

Meanwhile, American and European airlines have gone through dramatic changes in corporate strategy and internal structure. They have been forced to adapt to regulatory changes that are intended to create greater competition in an industry that has tended toward oligopoly and that in many countries has been the object of state ownership. On the American side, the deregulatory process is still running its course, eighteen years after the 1978 Air Transportation Regulatory Reform Act. In Europe, the airlines are responding to the three liberalization "packages" intended to create competition within a single EU aviation market. More exposed on long-range routes than their American counterparts, European carriers have made a major strategic change from for ms of protectionism through efforts at intra-European cooperation to an emphasis on alliances with US carriers - a process that has culminated in the recently announced agreement between British Airways (BA) and American Airlines (AA).

While the industry goes through this turmoil, governments have tended to press on with established policies or have sometimes reacted in ways that may cause further problems. The EU, having argued so long about the Commission's power, has finally authorized the Commission to negotiate with the U.S. But the trading block in air services it aspired to represent has effectively disintegrated, leaving a set of transatlantic airline alliances plus the walking wounded of liberalization, headed by Air Franc e.

The U.S. Department of Transportation (DOT) has pressed on trying to secure "open skies" agreements with foreign countries, in the belief that "open skies" will lead to greater competition. But its tactics in obtaining such agreements raise questions about the

future of competition. Those creating the alliances want anti-trust immunity: the U.S. uses the prospect of such immunity to pressure foreign governments (through the national airlines which are parties in the alliances) to accept "open skies" agreements; then immunity is granted. But such immunity creates the conditions for a new, protected oligopoly.

This paper explores the interaction between international aviation policies and corporate strategies on both sides of the Atlantic. These two processes are now acting upon each other in ways that have serious implications for the structure of international aviation and for the character and level of competition in the industry.

I emphasize here the dilemmas facing airlines as a result of the stakes they have in different markets and the limits and opportunities presented by their own domestic markets. Airlines have different histories, different stakes, and even different cultures. They can be assumed to be rational economic actors in seeking to maximize market share and increasing revenue. As with most rational actor models, however, this assumption gives us only the grossest insight into a category of actors: of itself, it provides no instrument to explore differences of behavior between those within the broader category. By extension, the rational economic actor assumption does not help us understand differences in relations between particular firms and their supposed political "protectors."

This emphasis on the dilemmas and strategies of airlines is necessary because commentary on international aviation tends to concentrate on official policies and positions at the expense of illuminating the problems of particular firms in the industry. Such commentary assumes either that, in an industry historically dominated by the state, companies do what governments tell them to do or (as in some American writing) that the larger airlines effectively dictate to DOT officials and (presumably) their counterparts elsewhere.[1]

These assumptions are mutually exclusive as generalizations. More harmfully, they deflect analysis from the really interesting and open question of just how official policy and corporate strategy in civil aviation really interact. Though historians of civil aviation have given us rich, full and colorful stories about the lobbying activities of such flamboyant individuals as Juan Trippe, Howard Hughes and, more recently, Robert Crandall and Freddie Laker, the larger picture of government-corporate relations remains hazy.

In exploring the emerging issue of how deregulation here and in Europe is shaping competition and the choices of consumers, I try here only to establish how official policy has affected the strategies of particular categories of carriers. I concentrate on three such categories:

1. the "big three" American carriers which have expanded into international service after strengthening their already-strong hold on the domestic market;
2. European carriers (such as British Airways (BA)) based in the larger EU Member States which also have large stakes in long-distance routes; and

3. European carriers (such as KLM Royal Dutch Airlines) based in smaller countries but with large stakes in intercontinental routes.

Deregulation and International Aviation:

If deregulation leads back to oligopoly, this outcome will be perversely logical. Advocates of airline deregulation in the US have always wanted the process extended to international aviation, though mainly because they believe (as they believed about domestic deregulation) that it will lead to greater competition. European liberalizers are more reticent about the international benefits of the liberalization entailed in creating a single EU aviation market. Such reticence may be due to the universal E U propensity to be preoccupied with the complexities and benefits of creating a single market to the exclusion of concern about its external ramifications. It may also be due to an uncertainty about what deregulation will do to the international stakes of EU carriers.

Whatever the consequences may be, few observers anywhere doubt that some liberalization of international aviation is imperative and, indeed, long overdue. The industry still operates within the framework of a fifty-two-year-old trade agreement (the 19 44 Chicago Convention) and of the several thousand bilateral Air Service Agreements (ASAs) to which it led. Such agreements stipulate which carriers may fly on what routes and with what frequency: they may also contain limits on capacity (the number of seats available) and provisions for regulating fares.

The United States and like-minded partners abroad are currently seeking liberalization of international air transport, as of other service industries, through the medium of "open skies" agreements. At its purest, "open skies" means that technically-qualified carriers may fly internationally between whichever cities in the countries concerned they choose, at whatever frequency, with whatever capacity, and charging whatever fares they decide are commercially appropriate. Many observers expect such agreements to accelerate the internationalization and globalization of the airline industry, though many also think that they will lead to a globalization under American hegemony.

In reality, "open skies" agreements (and indeed all bilateral aviation agreements) are subject to two restrictions that impede substantive internationalization. One restriction prevents domestic operation by foreign carriers. Under "cabotage" rules, Iberia, for example, may not pick up passengers in Miami and fly them on to Albuquerque, even as a continuing segment of an international flight from (say) Madrid to Miami. By the same token, under EU rules, only "Community carriers" may normally pick up passengers in London and fly them to Frankfurt.

The other restriction limits foreign ownership of domestic airlines. Under US law, at least 75% of the voting stock of a US airline must be owned by US citizens. Moreover, the president and at least two-thirds of the board of directors and "key management officials" of US airlines must be US citizens. The U.S Department of Transportation (as a recent GAO report notes) interprets the law as requiring that effective control also be in US hands. Effective control means that the US citizen owners and managers of the airline

must have the independence to make decisions, even if those decisions would not coincide with the best interests of a particular foreign investor.2

EU law uses similar language (entailing similar problems of interpretation), stipulating that, to be recognized as a "Community carrier," an airline 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.3

US International Aviation Policy:

Even before domestic deregulation, the US consistently favored greater competition on international routes, though ironically the US itself had only two or three carriers seriously committed to serving such routes. By contrast, many European states an d most developing countries have favored continued or modified bilateral regulation, partly out of fear of the commercial power of the US in this field.

Since the advent of airline deregulation in the US in 1978, American pressure to relax or abolish the Chicago regime has increased and has taken two forms, one applied diplomatically, the other a consequence of corporate strategy.

Diplomatic pressure has involved a diplomatic campaign to renegotiate ASAs toward some form of "open skies." In particular, US policy has, during the past eighteen years, envisaged extending deregulation to international flights. American officials have succeeded in renegotiating a number of bilaterals, especially with the smaller European states, their hope being that these more liberal agreements will put pressure on the more mercantilist countries (notably France and the UK). Such pressure would arise if liberalization of, say, air transport between the US and the Netherlands or the US and Belgium led to greater competition, the offering of greater capacity, and the lowering of fares on transatlantic services from Amsterdam or Brussels.

Passengers throughout Europe might then decide that, given the short surface and connecting air journeys within the EU and the intense competition between the larger European airports, they could save money on long-distance services by starting their journeys from airports in countries with liberalized ASAs. London, Paris and Frankfurt (not to mention Rome) would lose business to Amsterdam and Brussels. Since European airports compete actively for customers, the potential winners would do all they could to ensure that passengers took advantage of their opportunities.

Especially under the Carter and Clinton administrations, the US has openly adopted such a "divide-and-rule" tactic in dealing with the EU. The tactic has failed to break down the resistance of the more obdurate Member States, but it has (in association with a policy of encouraging alliances between US and European

carriers) been highly successful in diverting trade toward more cooperative countries such as the Netherlands.

But the strategy that this tactic serves does not imply that the US is in principle against negotiating with the EU under the "single negotiator" procedure favored by the EU Commission since 1990 and reasserted recently by Neil Kinnock as transport commissioner. The US might well be wary of this procedure, since the latter is promoted as a way for Europeans to get better deals from Washington by offering a united front. But what matters is the substance of any kind of multilateral agreement - whether it embodies liberal provisions for market access and commercial operation.

US Corporate Strategies:

The second source of US pressure on the Chicago regime has been commercial, stemming from the process of domestic deregulation (as distinct from its philosophy). After an early period of expanded competition, this process led to a substantial re-concentration of the US airline industry around five or six major carriers, with three of them (American, Delta, and United) controlling 58% of domestic traffic. How this happened is of some importance, given current fears of a re-enactment on transatlantic services.

The strategy of the major carriers involved (and their power depended on) the creation of highly concentrated traffic hubs, through which by 1993 some seventy per cent of domestic passengers passed. Such hubs were often set up away from the traditional ports-of-entry for international traffic, in smaller cities such as Charlotte, Cincinnati, and Pittsburgh. The concentrations of traffic at these hubs were sufficient to sustain international services. But by the same token, the huge cost of developing hub-and-spoke systems and (with some carriers) the large debt burdens imposed by over-purchase of aircraft made it imperative to exploit hubs to the maximum.

International flights were attractive because they were typically more profitable than domestic flights. Also, American carriers could expect to take business away from many of the established European airlines because their costs (relentlessly cut under the pressure of a deregulated market) were significantly lower. They could offer lower fares - and, with spare planes, large numbers of seats - and still make money. Carriers such as Continental and Northwest which were facing bankruptcy might not make money; but, by adding international flights, they might at least survive.

The main barrier to this strategy was regulatory. The newcomers had to obtain authority under existing bilateral agreements to operate international services. Fortuitously, the financial problems of Pan Am and TWA (the only two US carriers with sizable overseas networks) moved them to sell rights on specific routes (though such sales required the approval of the governments concerned).

Ironically, three airlines that were mainly domestic in character took over from two airlines, which had, arguably, concentrated too much on international aviation. United and American took over the bulk of the services from the UK to the US and shared with Delta a complex inheritance of routes from US cities to other European cities.

The impact of the "900-pound-gorillas" on North Atlantic routes was initially dramatic and uncomfortable. By 1992, seven US airlines were operating scheduled services on North Atlantic routes, compared with two in 1988: European carriers saw their tot al share of traffic decline to 44% (compared with 50% in 1978). While the overall market share of US carriers rose only slightly (the new carriers replacing the bankrupt TWA and the dissolved Pan Am), their impact on particular markets was substantial. For example, the market share of US carriers on routes between the US and Germany went up from 54.2% in 1989 to 61.0% in 1993 and that on routes between the US and France went up from 64.5% to 72% over the same period. Much larger proportional increases occurred in smaller markets, such as the US-Spain, US-Belgium, US-Scandinavia, and US-Switzerland markets (all markets in which US airlines faced high-cost national carriers).

Restrictive bilaterals, however, prevented comparable expansion by the newer American carriers, most notably in the US-UK market and in others, such as the US-Italy market. United and American replaced Pan Am and TWA at Heathrow, but only after some tough bargaining which had the effect of limiting subsequent expansion. All other American carriers were required to use Gatwick (London's second airport) which (apart from being regarded as less convenient) lacked the breadth of connecting flights that ma de Heathrow so attractive to passengers and airlines (and so vital for the profitability of services). The American carriers' share of US-UK traffic was only 41.9% in 1995, down from 46.1% in 1994 - a frustrating outcome for them, considering that passengers on services between the UK and the US constituted 34.9% of all passengers carried across the North Atlantic (and considering the costs of purchasing the traffic rights).[4]

The American "invasion" alarmed both airline managements and officials of national governments and the EC, especially in view of the financial exposure of European airlines on international routes (discussed below). Such alarm has, however, abated recently, to be replaced by an increasing concern about the implications of alliances between US and European carriers.

But use of the term "invasion" itself begged questions about the aims of corporate strategy and, indeed, about the limits on pursuing such strategy. American carriers could expand their shares of international traffic with the acquiescence of liberal foreign governments and could, with the same support, draw traffic from other European hubs. But cabotage rules prevented them from setting up their own feeder networks within Europe (just as they prevented European airlines from setting up such networks within the US). Moreover, not even the most liberal EU

Member State would encourage an American carrier to strip traffic from its own national airlines (especially since the most liberal states also had carriers dependent on long-distance flights).

Equity purchase in European carriers was no solution, at least if the purpose was control. Law in the EU and the US (as noted above) firmly restricted foreign ownership of shares in national airlines. In any case, opportunities for stock purchase were limited by the fact of extensive government ownership.

But American carriers did not need to go to the expense of buying into European airlines, or (equally expensively) operating their own flights and hubs within Europe. What they needed was to control "feed" from European markets onto their transatlantic flights at levels and through hubs comparable to those available from their American networks. EU airlines (especially but not only those based in smaller countries) had an equally compelling need to gain access to the huge US domestic market. In doing so, they faced the same regulatory barriers as American carriers trying to penetrate the European market. But they also had to deal with the daunting power of "fortress hubs" controlled by the "Big Three" American carriers and their fellow hubbists.

"Enterprise alliances" between American and European airlines were the solution, albeit a pragmatic and imperfect solution. As one airline official put it succinctly: "Alliances are ... a reasoned response to an antiquated regulatory system ... [They] permit indirect access to restricted markets."5

However, it was asymmetry of markets, as much as regulatory restrictions on access to them, that, ironically, created complementarity and thus a basis for airline alliances. Under American law, US negotiators were required in negotiating bilaterals to assure "a balance of economic benefits," meaning that countries should receive traffic rights proportionate to the size of the national market they could offer. This approach necessarily implied that, given the size of the American market, US carriers would nearly always have much greater leverage in seeking rights abroad than foreign carriers would having in seeking rights to operate to the US.

This provision was a continual source of irritation in ASA negotiations. The more domestically oriented US airlines and labor unions complained that "'open skies"' agreements gave airlines from smaller countries the run of the American market without providing comparable opportunities abroad. Foreign carriers and unions, for their part, feared that the "equal benefits" provision was a license for an American "invasion" of their markets, small as they might be.

There were only two solutions to this problem. One was to create a market roughly comparable to the American market and thus create a platform for more equitable bargaining. Such might be the outcome of the creation of a single EU negotiating authority. The less belligerent advocates of the EU proposal pointed

out that the US administration would be in an easier position domestically arguing for "open skies" with the EU than pushing on with negotiations with such countries as Luxembourg and Austria.

The other solution was to encourage or acquiesce in commercial arrangements that effectively increased the traffic flow available to American carriers. Alliances might provide such a flow, the size of which (as at smaller city hubs in the US) might be much greater than the traffic that the relevant local city could generate. If, that is, a European carrier was sufficiently enterprising and attractive to passengers, it could create a regional network that would pull in traffic somewhat as "fortress hubs" did in the US. To understand the relative attractiveness of such an arrangement to different European carriers, it is necessary first to examine the diversity of stakes held by such carriers and the range of strategies open to them.

The Dilemmas of European Airlines:

The European airline industry differs radically from its American counterpart in its historical development and consequently in the way in which its market stakes are distributed. Most European airlines still have a larger stake in international (including long-distance) markets than American airlines.6 This stake is partly a legacy of the earlier role of national airlines in imperial communications, but it also reflects the economic and geographic impediments to developing an airline purely within Europe, let alone within one country. Shorter distances made it difficult for airlines to compete with railways or even road transport, whereas longer distances (as in the US) have favored development of a strong domestic airline industry. In terms of population, even the larger national markets fall short of the American domestic market.

Historically, then, the two airline industries developed in opposite directions. The European industry emphasized first inter-continental, then European, and finally domestic business: the American industry grew for many decades as a domestic industry , with a separate and specialized international sector dominated by one airline, Pan American. (Indeed, the demise of Pan Am demonstrated to American airline executives the folly of trying to run international service without a large domestic feeder network)

However, important as the broad distinction between European and American carriers is, equally important for understanding EU aeropolitics are differences between European airlines. Such differences can usefully be related, first, to the size of their national markets and, secondly, to the distribution of their market stakes between domestic, European, and intercontinental operations.

"National market" crudely equates with population size, modified (in the case of air transport) by real income and physical size. Thus even in densely populated countries such as Belgium and the Netherlands, there is little or no market for domestic aviation because short route distances put airlines at a disadvantage

relative to rail and road transportation. Physically larger countries offer greater opportunities for airlines, but (absent heavy subsidization) whether this potential is realized will depend partly on income levels.

The size of a country's population is necessarily an important factor in how much traffic will flow into and out of an airport, but there is only a rough correlation between population size and (in this case) transatlantic traffic. Centrality helps to explain the relatively large share of transatlantic traffic passing through Amsterdam and Brussels (5.7% and 2.5% respectively of the 1989 total), just as the relatively low shares of Spain and Scandinavia (3.9% and 2.9% respectively) reflect peripheral positions within Europe. London's predominant position (with 34.9% of all transatlantic traffic) is due to its excellent network of onward connections southward and eastward.

Table 1: European Union Airlines Traffic Share

Politics and corporate strategy also shape a country's prominence in the international aviation market. The relatively low share of Italy at 5.9% is surprising, given its tourism and its population: it is partly due to the restrictive bilateral between the US and Italy. Moreover, traffic figures also reflect the preferences of airlines and their success in attracting traffic.

How each airline has spread its market stakes has been partly shaped by the opportunities that location and national market offer and partly by commitments imposed by imperial government and opportunities created by trade and migration. Explanations a side, European airlines vary considerably in how much of their traffic and their revenue derive from intercontinental routes.

Using the criteria of market size and distribution of market stakes, it is possible to construct a typology that, although simple, helps to illuminates the dilemmas and strategies of particular carriers:

1. Large market/smaller carrier stake in long-distance market (examples: Alitalia, Iberia);
2. Large market/larger carrier stake in long-distance market (examples: BA, Lufthansa, Air France);
3. Small market/smaller carrier stake in long-distance market (examples: SAS, Olympic, Aer Lingus, TAP Air Portugal, Luxair);
4. Small market/larger carrier stake in long-distance market: (examples: KLM, Sabena, Swissair).

By definition, those carriers in categories (1) and (3) are of little significance in trying to understand transatlantic diplomacy and corporate strategies. However, they are politically significant, since their governments can support or oppose EU policy. Several of these carriers are state-owned and are based in the southern

European countries that have been least enthusiastic about liberalization, whether applied to the EU internal market or to relations with third countries.

For purposes of understanding the current arguments about international aviation and alliance making, the two important categories are therefore categories (2) and (4).

Large countries with large international market stakes:

Those in category (2) have attracted most attention. Not only are they the largest carriers in Europe, but the support of their governments is crucial to the shaping and acceptance of EU international aviation policy. The carriers concerned are based at airports that both serve relatively large domestic markets and have excellent networks of onward connections. These airports control the bulk of North Atlantic traffic: in 1993, 21,018,000 passengers of a total of 31,900,000 traveling between the US an d Europe passed through British, French and German airports.

By the same token, however, foreign carriers are attracted to such airports. The national carriers in fact control a smaller proportion of international departure slots than do their counterparts at airports in smaller countries (let alone US carriers at their hubs), and the national governments are under greater pressure from American carriers and the US government to arrive at "open skies" agreements.7

Table 2: European Union Airlines Derivation of Revenue

The potential for disputes with third country governments is increased by the large stakes that BA, Air France and Lufthansa have in long-distance markets. In 1990, the North Atlantic market alone accounted for 19% of all BA's non-domestic traffic, with corresponding figures of 15.2% and 8.8% for Lufthansa and Air France respectively.8 But, by 1993, the market share of Air France had fallen to approximately 31% of US-France traffic, while that of Lufthansa had fallen to 40% of US-Germany traffic, whereas UK carriers (BA and Virgin Atlantic) had 57% of US-UK traffic. The dramatically larger share of UK carriers was attributed by critics (in the US and elsewhere in Europe) to restrictions on access to Heathrow.

With the large markets involved and the large international stakes held by national carriers, it is not surprising that France, Germany and the UK have resisted "open skies" proposals. France renounced her ASA with the US in 1991, German officials talked of doing so, and the British have been involved in a tense running battle with the US DOT throughout the last decade.

BA's strategic dilemma is somewhat different from the dilemmas facing Air France and Lufthansa. It is privately owned and faces an aggressive British

competitor, Virgin Atlantic, on transatlantic routes. Its stake in the domestic UK market is smaller relatively than the stakes of Air France/Air Inter and Lufthansa in their domestic markets.9 While BA has recently absorbed several competitors (and franchised itself to others), its main strategy is external. Thus BA's former chairman, Lord King, reportedly said that he did not care what the British government did about the domestic market: "I really don't mind ... it's overloaded and it doesn't pay."10

What does pay is long-distance services, even on the competitive North Atlantic. Though (as Table 3 shows) the Atlantic routes were not as profitable as those to Africa, the Middle East and the Indian subcontinent, they brought in 32% of BA's revenue. 11 Moreover, BA had over years of hard bargaining by the British government collected rights to twenty-two American cities.

TABLE 3: REVENUES AND PROFITS, FY 1993-4

REGION	REVENUE: ($ mn)	PRE-TAX OPERATING PROFIT: ($ mn)	PROFIT RATE: (%)
EUROPE	3,6000 (38.5%)	103.5 (13.9%)	2.7
AMERICAS	3,000 (32.0%)	193.5 (26.0%)	6.4
AFRICA, MIDDLE EAST, & AFRICA	1,350 (14.4%)	304.5 (40.9%)	22.5
FAR EAST & AUSTRALIA	1,400 (15.1%)	142.5 (19.2%)	10.0
TOTAL	9,350	744.0	7.9

Source: "BA maintains profitable edge," Aviation Week and Space Technology, 13 June 1994, 31.

Even with these rights, BA was at a serious disadvantage in dealing with the newer US international carriers. Its rights were concentrated in the more traditional east and west coast ports-of-entry. When it did get access to such inland fortress hubs as Atlanta and Dallas, BA was unable to draw on the concentrations of traffic developed at these hubs by the dominant American carriers. While it carried 64% of traffic between New York and London in 1993, its share at Dallas and Atlanta was only between 35% and 40%. This weakness was directly due to the extensive and streamlined networks of connections established by American Airlines and Delta at these two cities, in contrast to the more open and competitive situations at east coast airports.12

BA's response involved increasing its access to connecting traffic on both the European and the American sides. It set out to expand its market share within the EU, while (following a familiar MNC approach) consolidating its home base - in the UK but especially in London. BA has, indeed, been among the most enthusiastic supporters of liberalization and the single aviation market: it has also been the most aggressive EU carrier in building up affiliates and venturing onto new routes in Europe. Liberalization has created ever-larger opportunities for dominating the European market as cabotage restrictions are lifted. Further, the single market, when complete, will allow all EU carriers to operate long-distance flights from points in Member States other than their own (a little-noticed provision that obviously undermines any power to negotiate ASAs left to Member States).

BA's European strategy has served the immediate objectives of drawing more traffic into London and enlarging market share and revenue in the European market itself. However, compared with its aggressive advocacy of "open skies" within Europe, it has been fairly unenthusiastic both about liberalizing the UK-US market and about the EU's proposal to take over bargaining with Washington. BA initially made it clear that it regarded a consolidated single market in Europe as an important platform for its strategy:

We need the Community [Lord King remarked in May 1991] to begin to make use of its negotiating strength against strong countries outside ... only then can "open skies" be an economic and commercial reality.13

Subsequently, however, BA officials have worried publicly about the possibility of UK carriers losing existing traffic rights and about the fairness of Brussels in distributing any new rights that might be won. The British government, for its part, has consistently opposed the Commission's proposal, on grounds of principle (that national sovereignty would be undermined), and has recently found itself at odds with the British EU transport commissioner, Neil Kinnock, albeit a former leader of the Labor party.

While the source of the British government's opposition is clear, it is not so clear why BA, having initially (and quite logically) backed a unified front toward the US, subsequently edged away from this position.

The answer may be that BA, like other EU carriers, has increasingly staked more on allying with American carriers than on any political strategy involving Brussels. What the EU proposes is essentially a trading bloc approach. But as BA and other EU carriers develop alliances with their large American counterparts, they undermine the economic and political basis for such an approach. In their efforts to penetrate the

American market, they are in effect slicing the transatlantic market crosswise, creating stakeholders that have interests within both the EU and the US and that, indeed, are losing the national identity on which the Chicago system depends.

But, in BA's case as in others, the strategy has paid off, despite its choice in 1992 of a financially weak US airline, USAir, as its initial American partner. (Other US carriers were reportedly eager for BA's hand.) BA obtained access to USAir's hubs in Charlotte, Philadelphia and Pittsburgh and was able, by application of codesharing to selected routes, to weave a complex if fictitious set of "direct" connections between cities on its own network and points on USAir's network. The appearance of such connections on their computer screens caused travel agents (as BA had hoped) to feed passengers into the BA-USAir system.

By taking to heart E.M. Forster's injunction, "Only connect," BA (and other European partners of US carriers) broke into some of the fortress hubs that had previously been such a barrier. The percentage of passengers on BA's US services connecting fro m and to USAir flights rose from 12% (before the alliance) to 42% in 1994. Overall, BA's connecting traffic in North America grew by 31%.14

Financially, the USAir alliance also paid off. By purchasing voting stock in USAir, BA provided capital and obtained some influence on corporate strategy. The main benefits, however, came from codesharing. Partly because USAir had a very limited inter national network, BA reaped considerable (and disproportionate) profits from the alliance. In 1994, it reported that its link with USAir had brought in $100 million in extra revenue, while USAir had earned an additional $20 million. Of the additional $100 million, $45 million had been earned directly from the routes to which codesharing was applied, the rest coming from traffic attracted by marketing and more coordinated schedules.

BA's more recent decisions to create supplementary alliances (with America West and AA) reflect a wish to increase its access to the west and southwest of the US market. The AA alliance is, however, also a defensive reaction to the creation of new alliances, one involving Germany, the other several smaller EU states.

Small countries with large international market stakes:

The smaller European states (including Switzerland) are particularly important to understanding both why the trading bloc approach has broken down and how the dynamics of alliance-creation are creating a problem of transatlantic oligopoly. Although the larger states and their conflicts with the US (and the European Commission) have attracted occasional media

attention, the smaller states have been central to the tactics of American diplomacy and to developing the new alliance systems. Indeed, their airlines have been more inventive and radical in their relations with US carriers than have those of Germany and the UK. They have set - and, indeed, forced - the pace.

Three smaller country carriers - Sabena, Austrian Airlines, and Swissair - are in alliance with Delta (which also has a specific arrangement with Virgin Atlantic). This alliance has developed a "blocked space" form of capacity sharing, under which carriers control separately marketed allocations of seats on the same plane. Thus a joint flight from Atlanta to Zurich and Vienna might carry Swiss, Austrian, and American cabin crew in separate sections (and a Swiss crew on the flight deck). This arrangement makes it possible to offer frequent service on routes that would not otherwise justify it. It enables the cooperating airlines to avoid flying with empty seats, and also provides, via codesharing, a wider range of direct flights.

"Blocked space" formulas benefit American carriers that want to draw on traffic from smaller countries, which do not offer enough traffic for regular flights of their own. They also benefit carriers in such countries that wish (or need) to maintain a significant presence on international and particularly long-distance routes. Consumers benefit to the extent that they can use nonstop or direct flights that might not otherwise be offered. They will at least know what airline controls their section of the cabin, though possibly not who owns or is flying the plane.15

The dilemma facing airlines in small countries is that they cannot depend on domestic traffic (KLM, Sabena and Luxair have no domestic services at all). They must compete aggressively on international routes to succeed, and some have in fact been highly successful (two of the most aggressive Asian carriers (SIA of Singapore and Cathay Pacific of Hong Kong) are in fact based in virtual city-states).

As these cases suggest, success may stem from location in an important business and financial center. Tourism is another source of the foreign traffic that is essential for survival (Swissair has both). Ex-imperial countries such as Belgium and the Netherlands, have inherited large stakes in the long-distance market, sustained by the commercial and cultural networks that empire leaves behind.16

While smaller EU states tend to be liberal in their approach to aviation, their airlines nevertheless remain national carriers, with the limits and advantages that this status entails. The main (perhaps sole) advantage of this status is control of a hub airport. The limits are those of the small national market.

A small state carrier can overcome these limits in two ways. One is to poach traffic from surrounding countries (at least if these countries are themselves small). The other is (as for large country carriers) to penetrate the American domestic market (and others that offer large concentrations of passengers with a propensity for foreign travel).

KLM has been for several decades a successful and even notorious practitioner of the first stratagem. An airline that even between the Wars had established a reputation for fast and efficient long-distance travel, it was the first European carrier to begin regular scheduled service to New York. But with the loss of the Dutch East Indies, KLM became more dependent on transatlantic services. It recognized that it had to gather traffic from other European countries in order to sustain these services. By 1974, well over 50% of KLM's passengers on North Atlantic services were so-called "sixth freedom" passengers who began or ended their journeys in European countries other than the Netherlands but transited through Amsterdam. At one point, KLM was operating fourteen 747 services weekly on the Amsterdam-New York route alone.

This strategy upset both the US government and other European airlines. Washington argued that, in emplaning so many foreign nationals, KLM was stretching the intent of its bilateral ASA. Moreover, it was carrying a disproportionate share of passenger s, given the presumption that national carriers would offer roughly equal capacity (a notion actually at odds with the "balance of economic benefits" criterion). The Dutch government felt that KLM was simply an enterprising and popular airline of the kind that American "open skies" policies were intended to reward.

More fundamentally, however, the Dutch and the Americans did share a belief in liberalization. KLM, moreover, was both highly vulnerable and highly needy in relation to the US market. The two governments thus found it easy to cooperate, at least when the US could see an opportunity of exploiting Dutch aggressiveness to put pressure on the larger EU countries and to the extent that the Dutch saw a chance of getting more rights to American cities. Amsterdam lacked the network of onward connections that Heathrow had and the Dutch particularly wanted to draw UK transatlantic passengers to Schiphol.

In 1989, KLM found an American codesharing partner, in Northwest Airlines. Northwest had two fortress hubs, at Detroit and Minneapolis, and its transatlantic services complemented, rather than competed with, those of KLM. Like USAir, it needed an injection of capital. Moreover, by codesharing, it could tap into KLM's extensive European feeder network and offer "direct" service between smaller cities on its own domestic system and European cities through Amsterdam. Better still, it could do all this without the expense of stationing planes and crews in Europe.

While this alliance resembled the BA-USAir alliance in form and motivation, it eventually led to much closer operational integration. But until 1992 it was a fairly conventional codesharing arrangement. In September 1992, however, the Netherlands and the US signed an "open skies" agreement which, sustained by a granting of antitrust immunity by the US Department of Justice, gave KLM and Northwest liberty to expand services, set their own fares, and especially to integrate operations without the fear o f being charged with anticompetitive practices.

The Dutch "open skies" arrangement annoyed the European Commission, other Member States, and some American carriers and labor unions. The Commission was displeased at the unilateralism of the Dutch action, which it felt undermined the prospects for successful negotiation with the US at Community level.17 The Financial Times was less circumspect, describing the "open skies" agreement as "a step backwards" and declaring:

Holland has seen the opportunity of establishing itself as Europe's airport at the expense of its neighbors. [The US is] luring individual states with the bait of access to its market while the opportunity lasts.18

The subsequent history of the KLM-Northwest relationship has revealed the power, the problems, and the implications of international airline alliances. For Amsterdam, the alliance has been a dramatic success. The number of transatlantic passengers flying through Schiphol increased by 74% over a five-year period, reaching 2,400,000 in 1994: in 1995, Amsterdam overtook Paris Charles de Gaulle as the fourth largest European transatlantic gateway.19 The share of the US- Netherlands market in overall transatlantic service went up from 5.6% in 1978 to 7.7% in 1993.

Commercially, this alliance was, like the BA-USAir arrangement, highly profitable, generating annually between $125 million and $175 million in new revenue for Northwest and $100 million for KLM. It also captured some $16.5 billion's worth of traffic from EU carriers and $25 billion's worth from US carriers.

From Trading Bloc To Alliance System: Issues and Implications:

The KLM-Northwest alliance is, for two reasons, historically more important that any relationship involving larger EU carriers and states.

First, it demonstrated the potential of highly-integrated operations in transatlantic alliances, going further than the BA-USAir alliance in

coordinating schedules, marketing, and the sharing of aircraft and servicing facilities, all in pursuit of the ideal of "seamless service."

Secondly, it provided the model for a corporate alliance facilitated by diplomatic and legal sanction. This model - involving, on the corporate side, a close relationship (with or without equity purchase) and, on the governmental side, an "open skies" agreement and the granting of antitrust immunity - is now being faithfully followed by United (in its relationship with Lufthansa and SAS) and Delta (in its relationship with Austrian, Sabena and Swissair).

Indeed, one incident in the history of the KLM-Northwest alliance may have marked, more than any action in the political or diplomatic domain, a watershed in the strategies of the smaller European states. More broadly, this episode illustrates better than any other how far European airlines have abandoned intra-European alliances and its political counterpart, the EU's single negotiator/trading bloc approach, in favor of lateral, transatlantic relationships.

In 1993, four small market carriers - KLM, SAS, Swissair, and Austrian Airlines - spent ten months in negotiating to establish an alliance (called the Alcazar alliance) that would unite the smaller carriers in the face of BA, Air France, and Lufthansa . SAS, Swissair, and Austrian had already developed a significant degree of cooperation, and by November they and KLM had reached sufficient agreement to justify collectively approaching the US DOT to probe probable American attitudes to the "fourth force ." Only one week later, the negotiations collapsed, and did so solely because the airlines found that they had "fundamentally different views on a US partnership." Specifically, while its partners had (and wished to continue) an alliance with Delta, KLM insisted that Northwest should be the American partner for the Alcazar group.

The failure of Alcazar was a major turning point for the carriers concerned. KLM intensified its relationship with Northwest; Swissair, Austrian and Sabena developed a closer alliance with Delta; and SAS scaled down its ambitions and has become a junior ally of Lufthansa in its alliance with United. The cumulative power of these alliances then pushed BA into its new alliance with AA, with BA publicly arguing that otherwise it would be "left on the shelf."[20]

Certainly on the shelf are those EU carriers that do not have a US partner - the most conspicuous example being Air France, which has presided over a continued stagnation of transatlantic traffic into Paris. Despite all the years of argument in Brussels about the relevance of Article 113 to international aviation, the bloc for which the Commission aspired to negotiate has in reality collapsed, and the North Atlantic market has been

sliced into a set of corporate alliance systems. These systems have be en created as a strategy for bypassing the restrictions that the archaic regulatory regime of bilateral ASAs has imposed on airlines that find themselves faced with more intensive competition, partly as a result of deregulation in the EU and the US.

Where does this leave the EU single negotiator proposal? Reflecting the usual divergence between Community policy and corporate strategy, the EU has now agreed to allow the Commission to negotiate for a multilateral agreement with the US. The negotiations in question seem to have a different agenda from that which was intended back in 1991. They are to create a framework for a "common aviation area," meaning the establishment of some broad principles which "will allow air carriers of both sides to pro vide their services in the European and US markets on purely commercial principles." Subject to some special circumstances, the EU's guidelines allow for cabotage within both the US and the EU markets, for the removal of all restrictions on capacity and o n the number of carriers serving particular routes, and for minimal control of fares. They also provide for lifting the limit on foreign purchase of airline equity up to 49% in both the EU and the US, and they allow for extensive code sharing and blocked space agreements, subject to rules ensuring fair competition and full information for consumers.[21]

These guidelines come so close to US policy that it is a challenge to identify basic issues for negotiation. Indeed, discussion on transatlantic aviation is shifting increasingly toward issues of competition policy and consumer protection, and away from the earlier emphasis on protecting national markets and national carriers. On both sides of the Atlantic, the markets are already penetrated: that is how the national carriers have protected themselves in the face of the liberalization and deregulation that governments have forced on them and of the competitive pressures they apply to each other. Policy-makers will now have to deal with the implications of highly rationalized alliance systems in which traffic is fed through a selection of international fortress hubs on both sides of the Atlantic.

The technical and marketing features of the emerging system are clearly apparent and quite sophisticated. Through the electronic manipulations of codesharing, small towns will in future be linked by "international" services to small towns on the other side of the Atlantic. Rather than continue the earlier strategy of trying to connect smaller cities directly to each other, using smaller planes, the airlines are developing international hub-and-spoke systems - so-called "double barbells" - which (in the case of the Northwest/KLM alliance) will connect 201 cities in the US and Canada through Northwest's US hubs and through Amsterdam to 107 European cities. This strategy offers altogether 21,708 permutations for

connecting flights between "beyond" cities across the Atlantic.22 The overall scope of the alliance systems is staggering: including all routes flown, the BA/AA-led alliance will serve 36,000 city-pairs throughout the world, while the Lufthansa/United/SAS-led alliance will serve 55,212 city-pairs.23

Uncomfortable as travel on such a system may be for travelers required once more to pass through congested hubs, the fact is that airlines cannot afford to operate international services in markets that can only offer, say, ten passengers a day. Nevertheless, the much-proclaimed "globalization" of air transport looks as if it will be accompanied by concentration both of traffic and of ownership. US airlines have actually been cutting capacity on North Atlantic routes in order to fill planes and improve profits.

Now there is a prospect of decreased competition, accelerated by the new AA-BA alliance, which will control 61% of seats between the US and London and 24% of all traffic between the US and Europe. Globally, in 1995 five alliances (all including one or more major American carrier) flew 53% of all revenue-earning airline mileage in the world: the AA-BA-USAir alliance (which also includes Canadian International and Qantas) on its own flew 18% of total global mileage.

Such figures do conceal the unevenness of these alliances, which are mainly a North American and transatlantic phenomenon with (so far) little impact on or participation by Asian, African, Latin American and Middle Eastern airlines. Nevertheless, the power of the alliances, and the problems they pose, are likely to grow, raising again the question of whether some form of international competition policy is required. Governments have, with some cautions, acquiesced in codesharing and the lifting of antitrust immunity as a way of speeding the liberalization of international air transport. They might now consider whether it is time to reach an agreement (perhaps on the lines of the EU guidelines) that will protect not only the right of airlines to compete and to pursue commercial survival, but also the right of travelers to enjoy the benefits of competition - the promise of both deregulation in the US and liberalization in the EU.

Endnotes

1 For an interesting exposition of the "realist," state-centered view, see Baldev Raj Nayar, "Regimes, Power, and International Aviation," International Organization, 49, 1, Winter 1995, 139-70.
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2 US General Accounting Office, Airline Competition. Impact of Changing Foreign Investment and Control Limits on Foreign Airlines, GAO/RCED-93-7, December 1992, 13.
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3 Regulation 2407/92, Article 4.
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4 US GAO, International Aviation. DOT's Efforts to Increase US Airlines' Access to International Markets, GAO/T-RCED-96-32, 14 March 1996. The next largest market was US-Germany (with 16.2% of all traffic), followed by US-France (with 1 2.4% of the total).
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5 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.
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6 In 1990, long-range flights accounted for over 68% of the Revenue Passenger Kilometers flown by EU airlines, compared with 34.3% for US carriers (Commission of the European Communities, Air Transport Relations with Third Countries. Communication from the Commission to the Council, COM(92) 434 final, Brussels, 21 October 1992, 12, and Table E, 55).
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7 In 1991, BA controlled 38% of international departure slots at Heathrow, Air France 43% of slots at Paris Charles de Gaulle, and Lufthansa 46% of slots at Frankfurt. In the US, Delta controls 79% of all slots at Atlanta, Continental 7 8% at Houston, American 60% at Dallas-Fort Worth, and United 49% at Chicago.
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8 In 1992, North Atlantic routes generated revenue of $10 billion for the twenty-one members of the Association of European Airlines (AEA) - roughly twenty per cent of all earnings. (The AEA included the flag carriers of Iceland, Yugoslavia, Hungary, Switzerland and Turkey, as well as those of Member States of the EU and EFTA)
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9 In 1993, BA operated 26.7% of all British domestic flights (carrying 43% of passengers on 15% of UK routes). In the same year, Air Inter (Air France's domestic affiliate) operated 51.3% of all French domestic flights: Lufthansa operated 60.4% of German domestic services.
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10 Quoted in Alan P. Dobson, Flying in the Face of Competition: The Policies and Diplomacy of Airline Regulatory Reform in Britain, the USA and the European Community 1968-94, Aldershot: Avebury Aviation. Ashgate Publishing, 1995, 7.
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11 In 1995, revenue from routes to "the Americas" dropped to under 20% of the total, but the percentage of total profits drawn from these routes went up to 43%.
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12 BA in fact had only a 16% share of connecting passengers at Atlanta and 17% at Dallas.
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13 Speech to the Royal Aeronautical Society, 16 May 1991, quoted in Dobson, Flying in the Face of Competition, 190.
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14 The importance of connecting traffic for BA was noted recently by its chief executive when he pointed out that "without its transfer services, 14 of BA's 22 services to the US would not be economical" (John D. Morrocco, "BA defends Pact With American", Aviation Week and Space Technology, 15 July 1996, 44).
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15 Under code-sharing arrangements, passengers frequently discover that an airline other than that from which they purchased their ticket and whose flight designator appears on the departure board is actually flying him or her.
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16 A nine-year-old girl recently told me that she hadn't realized how many African countries had airlines until she had spent a morning at Heathrow.
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17 See remarks by the then-Transport Commissioner, Karel Van Miert, quoted in "EC to propose common civil aviation pacts," Financial Times, 10 September 1992, 2.
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18 "Closed skies over Europe," Financial Times, 10 September 1992, 14.
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19 In 1993, the number of passengers flying between the US and France actually fell.
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20 Robert Ayling, chief executive of BA, quoted in John D. Morrocco, "BA defends pact with American," Aviation Week and Space Technology, 15 July 1996, 44.
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21 "EU-US ASA principles," Avmark Aviation Economist, April 1995, 9.
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22 The Delta/Austrian/Sabena/Swissair system will eventually offer 17,420 city-pair combinations - for example, Macon, Georgia, to Salzburg, Austria.
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23 I am indebted to Dr. DeAnne Julius of British Airways for providing these statistics. Each alliance has other members, though none with the same market power as those named here.
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