**European Liberalization of the Airlines:**
**Can the Competition Commission Maintain its Credibility?**

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The European Union (EU) was established to promote a single market among member-states. Political considerations delayed the implementation of such a market in air transportation. The passage of the Single European Act in 1986 and the drive to complete the Single Market by January 1, 1993 increased the pressure on governments to accept liberalization. Moreover, deregulation in the United States, the globalization of markets and the rapid diffusion of modern technology made the EU realize that it not only had to liberalize air transportation, but also create a comprehensive transportation policy covering all sectors; otherwise, the continued competitiveness of European companies in the global marketplace could be compromised.

This paper will discuss the various trade distortions created by regulation of air transport, and the liberalization measures introduced by the Commission to mitigate these distortions, and provide insight into whether a free market in European aviation is possible. Parts one and two include an analysis of the liberalization packages and the distortions they were intended to mitigate. Parts three through five discuss the remaining trade distortions, such as competition policy; the substantial infrastructure inadequacies in airport and traffic control that limit challenges from small and new airlines; and the effects of the inexorable trend towards globalization.

Although the Commission has made great strides in reforming an industry riddled with price and capacity cartels, where revenue pooling was an accepted means of operation, it must continue these strides by imposing and enforcing tougher restrictions on state aid, changing its slot allocation policy, and vigorously enforce European Union competition rules. If the Commission does neither, or delays in implementing these actions, it not only risks hindering the liberalization underway, but also risks losing its political will and credibility in the process. The recommendations listed in my paper, combined with a renewed commitment by all member-states to work towards increased liberalization of air transport, should resolve the continuing market distortions and create an air transport industry that will further the economic vitality of the EU.

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## I. Introduction

The European Union (EU) is in the midst of liberalizing its air transport industry. The passage of the Single European Act, and the creation of a Single European Market, coupled with the increased competitiveness of American airlines resulting from the United States Airline Deregulation Act of 1978, made it imperative for the European nations to liberalize their industry.[1] The globalization of markets and the rapid diffusion of modern technology illustrated the grave necessity for the EU to create a comprehensive transportation policy covering all sectors; otherwise, the continued competitiveness of European companies in the global marketplace could be compromised.

Over the past six years the European Commission has introduced three liberalization packages in an effort to create a free market in air transport. This paper will discuss the various trade distortions created by regulation of air transport, the three liberalization packages introduced by the Commission to mitigate these distortions, and provide insight into whether a free market in European aviation is possible. Parts one and two include an analysis of the liberalization packages and the distortions they were intended to mitigate. Parts three through five discuss the remaining trade distortions, such as competition policy; the substantial infrastructure inadequacies in airport and traffic control that limit challenges from small and new airlines; and the effects of the inexorable trend towards globalization. In my conclusion, I hope to provide some insight into the potential for the European air transport industry.

## II. Part One: Why the EU is Liberalizing Air Transport

All nations have traditionally guarded their sovereignty over aviation, allowing airlines owned by foreign nationals to enter their markets only in exchange for reciprocal benefits.[2] As a result, the airline industry has been strictly regulated by policies favoring and protecting national interests. The Chicago Convention of 1946 decreed that every state has complete and absolute sovereignty over the airspace above its territory. Market access to fly over another country's airspace could be obtained only through a series

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[1] The term European Union is the umbrella name created by the Maastricht Treaty and refers to the new three "pillar" construction, the European Community, the Common Foreign and Security Policy, and Justice and Home Affairs. I will be using the term European Union to refer to all European Community policies and action, since it is often difficult to delineate what is strictly EC or EU business.

2 Paul Stephen Dempsey, "European Aviation Regulation: Flying Through the Liberalization Labyrinth," *Boston College International and Comparative Law Review* V.15 #2 (1992): 370.

of bilateral agreements, such as the two Bermuda treaties.[3]

This convention of sovereignty over airspace has been reinforced in over 2,000 bilateral treaties. [4] As airlines grew in importance, member-states began to treat the air transport industry as a tool for achieving wider social, regional, and political objectives. Protectionist policies, reinforced by national pride, insulated national carriers from competition--from other carriers in that state, from carriers from other member states, and from nonmember carriers--substantially distorting the international air transport market and making liberalization efforts extremely difficult.

It was thought that a certain amount of government control was necessary to ensure adequate safety of, and services to, passengers. Government control, however, had an opposite effect; consumer interests were hurt by high prices, inadequate service, and subsidies that resulted in large deadweight losses for taxpayers. Subsidies denied, and still deny, efficient producers the fruits of expansion and undermined the EU's competitiveness in the world market. Industry insulation created monopoly profits and led to inefficiency and low productivity.[5] Airlines had no reason to restructure or strive to improve productivity; their profits were assured by the state.

The graph on the following page illustrates the economic ramifications of monopoly pricing.

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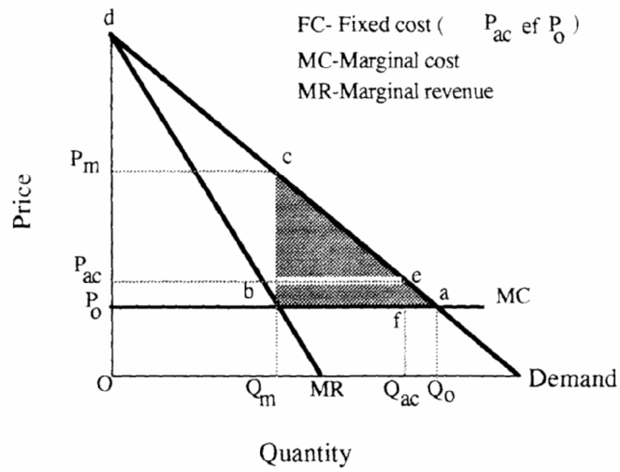
[3] Bruce Stockfish, "Opening Closed Skies," *Journal of Air Law and Space*, v.57 Spring 1992: 602. The Chicago Convention codified five "freedom" for airlines. They are: 1)The right to fly over the territory of another without landing; 2) the right to land in another country for technical reasons; 3) the right to discharge traffic from the home country in a foreign country; 4) the right to pick up traffic in a foreign country for home; 5) the right to pick up traffic in a foreign country for conveyance to another country, provided that the flight originates and terminates in the home country.

Rigas Doganis, *Flying Off Course: The Economics of International Airlines* (London: Harper Collins, 1991) 347. Douganis adds a sixth "freedom" to the five previously mentioned. This freedom, although not formally recognized, combines third and fourth "freedom" rights, by granting airlines the right to pick up passengers in the foreign country of destination and carry them back to the airline's country of origin.

4 Stephen Wheatcroft, The Economist Intelligence Unit Special Report. *European Liberalisation and World Air Transport.* (London: Economist Intelligence Unit, 1990) 1

5 David I. Weimer, Aidan R. Vining, *Policy Analysis: Concepts and Practice* (Engelwood Cliffs, Prentice Hall, 1992) 63-64.




| Monopoly Pricing ( $P_m$ ) | | Efficient Pricing ( $P_o$ ) | |
|---|---|---|---|
| Consumer Surplus: | $P_m$ cd | Consumer surplus: | $P_o$ ad |
| Total revenue: | $P_m$ c $Q_m$ O | Total revenue: | $P_o$ a $Q_o$ O |
| Total cost: | FC+ $P_o$ b $Q_m$ O | Total cost: | FC+ $P_o$ a $Q_o$ O |

Deadweight loss due to monopoly pricing: abc

The Treaty of Rome, which created the European Community in 1957, sought to establish an economically efficient market and to restrict anti-competitive behavior among the signatories. Under the Treaty, a common transport policy was a main goal. A reduction in transportation costs was seen as having the same effect as elimination of artificial and political barriers in increasing market share and productivity.[6]

However, a common market free of distortions and barriers to competition was not put in place until January 1, 1993, almost 23 years after the date projected in the Treaty, November 1970. Initially, air transport was excluded from any common transport policy because issues of state sovereignty over air

6 Kenneth Button, *The Single European Market and Beyond: A Study of the Wider Implications of the Single European Act*, ed. Dennis Swann, (New York: Routledge, 1992) 146.

space, as provided for in Article One of the 1946 Chicago Convention, remained in effect.[7] Articles 85 through 89 of the Treaty of Rome, which ban all agreements that restrict or otherwise distort competition unless specific exemptions have been granted by the Council of Ministers, were considered inapplicable to air transportation.[8] Article 86 forbids abuse of a dominant position if it is found to impede competition, which is defined as preventing freedom of choice by purchasers or consumers, or freedom of access to business.[9] As a result, the Commission, prior to 1986, did not feel it had the power to take action, since air transport was believed not to be covered by EU competition rules. Only Articles 92-93 (regulations covering granting of State Aid) could be applied to air transport. In 1986, the European Court of Justice (ECJ) in its *Nouvelles Frontières* decision gave the Commission the right to apply EU competition rules to the air transport sector.[10] The Commission's competence in air transport was further strengthened by the ECJ's decision in the *Ahmed Saeed* case, which classified the airlines price fixing cartels as an abuse of a dominant position under Article 86 of the Rome Treaty, thereby giving the Commission the authority to act.[11]

The passage of the Single European Act in 1986 and the drive to create a Single European Market, free of all barriers to trade by January 1993, pushed the Commission to end the collusive and discriminatory prices and the variety of non-tariff barriers that insulated national transportation networks from foreign competitors. The objective of the Single European Act was to remove the restrictions that impeded the free movement of all goods, services, people and capital throughout the European Union. A liberalized market was intended to make the EU more competitive with the U.S. and with Asian countries. A single market throughout Europe would enable producers to become efficient, consumers to receive a

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7 Op cit supra at 3.

8 Op cit supra at 6, p.148.

9 Treaty on European Union, Treaty of Rome, Article 86, Office of Official Publications: European Commission, 1993.

10 Op cit supra at 6, p. 149.

11 Op cit supra at 2 p. 339.

better deal, and the economy to be more dynamic. A main goal of the Single Market was for producers, in this case the airlines, to be allowed to supply their services freely and without discrimination throughout the EU.

Recent technological changes, such as the globalization of markets and the rapid diffusion of modern technology, made the EU realize the importance of creating a comprehensive transportation policy covering all sectors, and thus allow European companies to compete in this new global marketplace. EU officials realized that the European airline industry could no longer afford to "sell[ ] a product, produced at European cost levels, at world market prices, nor combine above average growth with below average productivity."[12]

Liberalization was chosen over deregulation because of the predominance of flag-carriers and the high subsidization of the industry. EU member nations remained preoccupied with preserving their own national share of the air transport market. Liberalization would permit the nation states to harmonize and coordinate existing policies into a completely unified and integrated system.[13] Liberalization was thought to allow existing companies to survive while market restrictions were gradually removed; deregulation, by immediately abolishing all protections, would have threatened the survival of national airlines.[14] As a result, a phased liberalization policy, rather than a U.S. style deregulation, was the policy that was chosen.

## III. Part Two: An Analysis of the Three Completed Phases of EU Liberalization

The first liberalization package, adopted December 1987 and effective January 1, 1988, was concerned primarily with international operations within the EU. Hence, it did not directly impact upon

12 David Garner, "'Wise Men' Favour Open Skies Policy" *Financial Times* (London), 12/2/93.

13 Stacy Weinberg, "Liberalization of Air Transport: Time for the EC to Unfasten its Seatbelt," *University of Pennsylvania Journal of International Business Law*, v.12 Fall 1991, 433-34.

14 Ibid., p.444.

the existing domestic regulatory systems.[15] Phase one provided for a three year transition period. The five components to this package were:

1) creating a procedure to apply the competition rules contained in Articles 85 and 86 of the Rome Treaty to the air transport sector;

2) establishing rules regarding fare-prices by creating two classes of discounts, regular and deep-discount, and providing for automatic approvals within defined percentages. It also decreed that airlines could not reject a fare simply because it was lower than the fare charged by their national carrier;

3) reducing levels of capacity sharing between carriers to 60%-40% of traffic, in stages over two years;

4) allowing for multiple designations enabling other than preferred flag carriers to fly international routes, e.g., allowing British Midland or any other carrier to fly from London to Paris, instead of restricting the route to British Air, and;

5) allowing states to grant fifth "freedom" rights, limited to 30% of seats initially, with the possibility of full rights at some later stage.[16]

Five block exemptions illustrate the political deals that were made by the Commission to persuade the Council of Ministers to adopt its proposals. Nations were allowed to engage in joint scheduling, revenue sharing, and tariff consultation, joint landing slot allocations, and joint development and operation of Computerized Reservation Systems (CRS), in exchange for the trade liberalization measures mentioned above. This legalization of price collusion and other forms of anti-competitive activities constituted a heavy price. Revenue pooling arrangements, like capacity sharing, encouraged carriers to operate without concern for profitability and distorted competition. The rationale--that these collusive measures would promote the public good--is perplexing; Consumers were harmed by inefficiencies and higher prices, as illustrated in Appendix A. Additionally, once exemptions are granted they are difficult

15 Eddy E Van de Voorde, "European Air Transport after 1992: Deregulation or Reregulation?," *The Antitrust Bulletin*, v.37 Summer 1992: 208.

16 Op cit supra at 2, p. 359-361. Please see footnote #3 for a description of "freedom rights."

to rescind. Except for revenue pooling, these exemptions are still in force, having been extended many times, most recently until June 1998, while the problems they were designed to address remain unsolved.

In July 1989, effective November 1990, the Council of Ministers adopted a second package of liberalization measures. This package improved upon the pricing, capacity, and market access categories of the earlier package. The package:

1) created a system of double disapproval, i.e., fares must be vetoed by both states in order to be rejected, with disputes to be settled by arbitration. Additionally, the fare zone for discount fares was narrowed to between 80-94%, while those for the deep-discount fares were widened to between 30-79%, thereby encouraging fare competition;

2) reduced capacity sharing 7.5% a year, until it reached 25-75%, subject to the right of the Commission to intercede if financial harm resulted; and

3) improved access to markets by requiring member-states:

(a) granted licenses to any airline established on its territory meeting technical, safety, and economic requirements; [17]

b) allowed member-states the freedom to use third and fourth "freedom" rights on a reciprocal basis;[18]

c) increased fifth "freedom" traffic to 50%, with no limit for traffic to regional airports, and;

d) limited consecutive cabotage rights to 30% for intra-European flights.[19] This granting of cabotage rights was an extremely important event because it paved the way for treating all EU states as one territory.

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17 Op cit supra at 1, p. 364-65. Previously, nations, such as France, had refused to grant route licenses to other domestic carriers, namely *Union des Transports Aériens.*

18 Ibid. Please see footnote #2 for a definition of "freedom rights."

19 Ibid. An example of consecutive cabotage is authorization to British Airways to fly to Nice and brings passengers from Nice to London instead of just from London to Paris.

The third liberalization package made further improvements towards increasing competition. It:

1) widened the zone for double disapproval of fares to 105% of the reference fare, widened the availability of discounted fares, and required complaints about fares to be decided by the Commission;[20]

2) replaced all route licenses with carrier licenses that new or expanding airlines received under the second package. Carriers must satisfy geographic and nationality requirements, rather than restrictive route requirements, as well as technical, economic, and safety requirements;[21]

3) eliminated all capacity restrictions, thus allowing fifth "freedom" rights to all intra-Community flights, not just those of the host country, and provided for complete cabotage by April 1997, and; [22]

4) ended the exemptions that permitted revenue pooling and required that all remaining capacity sharing agreements be subject to EU competition laws.[23]

The liberalization of the air transport industry was supposed to be completed with the implementation of the third package of liberalization measures in January 1993, but it is increasingly apparent that a fourth package is needed. Block exemptions from the first phase of liberalization, discriminatory ground handling, and continued subsidization by states of their flag carriers continue to impede competition. The new date for complete liberalization is set for mid-1997, the date that full cabotage rights come into force; however, the remaining block exemptions do not expire until mid-1998.

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20 Op cit supra at 1, p. 367.

21 Europe Daily Bulletin,*Agence Europe*, 1/15/93.

22 Op cit supra at 3, p. 347. Complete cabotage is differentiated from consecutive cabotage, the earlier form authorized in phase two: for example, allowing British Midland to pick up passengers in Milan and drop them off in Rome, even if the airline was not authorized to fly any leg of that route.

23 Ibid.

## IV. Competition Policy

Although the Commission has spent the last seven years attempting to strike down all the anti-competitive, discriminatory, and collusive agreements in the air transport sector, much still remains to be done. Approximately 95% of internationally scheduled routes within the EU are served by monopolies or duopolies; only 26 routes are served by three or more carriers. This is because national carriers have co-existed for many years with price and capacity cartels and thus had little incentive to start price wars (Appendix A). Studies have found that when two flag carriers operate, competition is slim, but where three or more players operate, competition is dramatically improved.[24] British Midland, England's second largest carrier, has managed to acquire 20% of the world's airline market by introducing competition on several heavily travelled routes, e.g.,Heathrow-Paris. [25]

On paper, it appears that the three packages have completely liberalized the market. However, a closer look will show that many of the same market-distorting tactics used previously, are still used today; they are just hidden from the public and the Commission's view. The three liberalization packages were supposed to break down the barriers for new airlines to enter the market. However, in reality it is extremely difficult, sometimes impossible, for new airlines to operate because of continued subsidization, abuse by flag carriers of their dominate position, and severe shortages of landing slots at all major airports. These reasons make it clear that a level playing field still does not exist, and make it imperative that the Commission vigorously apply the EU competition laws to all sectors of the air transport industry. Sir Michael Bishop, Chairman of British Midland Airways, complained, "Smaller airlines were enticed to expand their services in the new deregulated market on the grounds that the EU would stop state aid for national flag carriers . . . A number of these airlines are going bust, while the bigger companies, which are really bust,

24 "Closed Skies," editorial, *The Financial Times,* 11/2/93.

25 Howard Banks, " Friendlier Skies," *Forbes*, 11/21/94:140, Nexis.

are being allowed to carry on through artificial supports."[26] As indicated by his frustration, only vigorous enforcement by the Commission will ensure that new and small carriers operate on a level playing field.

### IVA. Subsidies

Governments have been subsidizing their national carriers for years. Although the EU has weakened national requirements, encouraged member states to privatize their national carriers, and made granting state aid to these carriers illegal, only Britain has privatized its national carrier. France still heavily subsidizes its flag carrier, Air France, even though it has been disciplined many times by the Commission and even forced to repay the French government for accepting illegal state aid.[27] Subsidies, by their very nature, distort markets. Companies that compete against subsidized enterprises are at an economic disadvantage. Additionally, subsidies result in overcapacity. In a free market, one without subsidies, the least efficient airlines would be forced to cut capacity or go out of business. However, because of the granting of subsidies, the excess capacity remains.[28]

Subsidies can take many forms: the capacity and revenue pooling schemes that were common before liberalization are an example of one type of subsidy. Granting of state aid, whether it is in the form of tax breaks, equity investments, loan guarantees, or "soft" loans (loans at low or no interest) are other forms.[29]

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26 Paul Betts, "UK Airline May Sue Over EU Subsidies," *The Financial Times,* 11/25/93.

27 Paul Betts, *The Financial Times*, 11/11/93.

28 Lawrence Chimerine, Gregory Stanko, "Stop the subsidies to Europe's Airlines," *The New York Times,* 12/11/94

29 Douglas E. Rosenthal, "Competition Policy," ed. Gary Clyde Hufbauer, *Europe 1992: An American Perspective.* (Washington DC, The Brookings Institute, 1990) 332.

### 1. Subsidies Impeding Competition

Since the granting of a subsidy can take many forms, it is imperative that the Commission narrowly define what constitutes a subsidy. Dictionaries define subsidies as any form of monetary assistance granted by a government to a person or a private commercial enterprise. S. Linn Williams, former Deputy U.S. Trade Representative, maintained that equity investment(s) in state-owned companies should be considered subsidies unless the government would make the same investment(s) in a private company.[30]

Article 92 of the Treaty of Rome authorizes the Commission to disallow any "aid granted by a member state, or through state resources, ... which distorts or threatens to distort competition . . . be incompatible with the common market." [31] The Commission must approve all state aid, and under Article 93 can force a benefited corporation not only to repay the aid with interest, but also can monetarily penalize member countries giving the aid.[32] The Commission is the sole arbiter of whether to approve state aid requests, thus it may choose to grant aid to a country even when the aid distorts competition. As a result, state aid decisions become part of a secret and broader bargaining process between the Commission and member-states.[33] Thus, aid is often allowed when there are only a few companies in the marketplace and an economic analysis confirms that the subsidies in question will adversely affect the survival of the other companies.[34]

Even though the Commission, in creating a barrier-free market, has abolished most forms of state aid, with the exception of one-time aid for industry restructuring, states continue to grant

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30 S. Linn Williams, "Issues in U.S. Foreign, Economic and Trade Policy," Guest Lecture, New York, 11/10/93.

31 Treaty on European Union, Treaty of Rome, Section 3, Article 92, Office of Official Publications: European Commission, 1993.

32 Ibid.

33 Anton van Schijndel, " A case for stricter discipline," *The Financial Times*, 2/17/95.

34 Ibid.

aid, or camouflage the aid as something else, often tempting the Commission to nullify it. France has used this tactic often.[35]

Politics also plays a role in whether the Commission approves a country's request for state aid, especially when the nation requesting the aid holds, or is the next in line for, the EU Presidency. In 1994, the French government requested and received approval from the Commission to plow $3.75 billion of fresh capital into Air France, a figure equivalent to all of the world's airline losses combined.[36] In reaction to this, several EU nations threatened to take France to the ECJ for violating Article 93 of the Rome Treaty. Moreover, the European Association for Airline Companies urged the Commission that Air France's recapitalization plan could not possibly be successful and would only delay the eventual collapse of the Air France Group. Furthermore, it believes that Air France would use the aid to cover current losses and not for restructuring.[37] British Transport Secretary Mawhinney remarked angrily, "it will distort competition in european aviation and work against the interests of all European consumers and against British airlines which operate successfully without subsidy."[38]

Commissioner Van Miert has tried to define narrowly what the Commission should consider as restructuring aid, or "one time, last time aid," by writing new guidelines. These are:

1) the aid must be part of a competitive restructuring program enabling the company to regain viability without further aid;

2) the aid shall be the last one the carrier receives in conformity with EU law, unless there are exceptional circumstances, which are unforeseeable and external to the company;

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35 Op cit supra at 25. French aid given to national companies who are in serious financial trouble are examples of attempts to camouflage aid. This aid often takes the form of equity purchases or capital injections by state owned or controlled companies.

36 'Whitewash," *The Economist*, 4/16/94, p.73.

37 Europe Daily Bulletin, *Agence Europe*, 7/6/94, 15.

38 Jackie Davis, Edward Verity, Christoper booker, "One law for them, hundreds for us." *The Daily Mail*, 7/28/94, p.13, Nexis.

3) the government must not interfere in the management of the company;

4) capacity reductions may need to be included, and by no means can the aid be used to increase capacity to the detriment of other European carriers;

5) the aid can only be used for restructuring and can not be used to purchase or acquire shareholdings in other carriers;

6) the aid can not be used for any anti-competitive actions that might delay implementation of the reforms proscribed in the third package, and;

7) the aid must be transparent.[39]

Van Miert explains that exceptional circumstances do not mean a currency devaluation, a recession, or a war, but acts of God, such as an earthquake.[40] However, other commissioners, not as liberal minded-- e.g., Commissioners from Spain--will likely interpret it looser. These guidelines cover aid granted by EU member-states and include any activity associated with air transport. They do not, however, deal with subsidies to manufacturers, aid to third countries, or public financing of major infrastructure projects, i.e., airports. [41]

The Commission with its new subsidy guidelines appears to be moving in the direction of creating a stricter definition of industrial restructuring, and what qualifies as a beneficial subsidy. Competition Commissioner Van Miert states, "Commission approval (of state aid) must be matched by substantial cutbacks in production capacity. . . to ensure the industry is put back on a sound footing.[42] Commissioner Van Miert, in writing the new aid rules, pledged that "aid to airlines, to ease the pain of reorganization, is last chance aid. If a reorganization fails, no further

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[39] "State aid: Conditions agreed for airline subsidies," *Transport Europe*, 11/22/94, Nexis.

[40] Ibid.

[41] Ibid.

[42] "Brussels made to look the real fool - Commission powerless on airline state aid control," *Airline Business*, 9/1/94, Nexis.

aid will be granted."[43] Britain's Civil Airport Authority (CAA) would take a stricter position. It argues that the Commission is being too soft in granting aid to some state-owned companies. CAA wants the Commission to insist that state aid not be used by airlines to buy market share through purchase of smaller competitors, nor be used to pay employees, but instead be used to restructure the company, i.e., lay off workers.[44] The Chairman of Air France and Iberia have done exactly the opposite. Air France's Chairman used state aid to avoid cutting 2,000 employees rather than to restructure Air France. While, Iberia's Chairman, in 1992, used the $1.3 billion in state aid to buy unprofitable Latin American routes and is now seeking another $1 billion in new state aid. These actions increased the tension between France and Spain and other member-nations.

Commissioner Van Miert appears to realize the harmful consequences of this action on EU competition policy. A true single market will develop only if local monopolies, such as flag carriers and other large state-owned companies, are obliged not to interfere with new competitors.[45] In theory, the powers granted to the Competition Commissioner are strong enough to accomplish his goal, but in reality, he is only one voice in the Commission and can be overruled.

It is for these reasons that many people have been urging the Commission to create an independent competition commission.[46] A transfer of the Commission's enforcement powers to an independent body is the best way to strengthen the EU's enforcement powers. The upcoming Inter-governmental conference in 1996 will be able to make the necessary changes to the Maastricht and Rome Treaties.

There are, however, at least three problems with this idea of creating an independent body:

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43 Antitrust and Trade Regulation Report, *Bureau of National Affairs*, 10/14/93.

44 Paul Betts, "EC airline liberalisation under threat," *The Financial Times*. 11/2/93.

45 "Banned aid," The Economist, 11/19/94, 75.

46 Claus-Dieter Ehlermann, "Case for a cartel body," *The Financial Times*, 3/7/1995.

1) some form of political veto would be inevitable, i.e., decisions or rulings would probably have to be confirmed or rejected by the Commission where non-competitive based considerations, such as community interests, enter into its decision making process;[47]

2) removing the Competition Directorate (DG IV) from the Commission would result in the loss of a strong advocate of free-market thinking; currently it is consulted on major new legislative initiatives; and[48]

3) lack of any European-wide consensus on what type of competition policy is needed, thus making decisions turn on a case-by-case basis, rather than principal, analysis.[49]

A temporary proposal might to create, at least until these problems are resolved, a separate body to comment publicly, even after the fact–on decisions made by the Commission. The body could also assist the Commission on policy matters and new legislation.

The Commission is hampered in its monitoring of state aid because it relies on information from the member-states themselves about the total amount of aid they have given, and information received is often not completely accurate. In 1993, 15% of all subsidies given by member states were unauthorized, that is, given to state-owned companies without the Commission's knowledge.[50] Lately, Commissioner Van Miert has been inviting competitors of companies receiving unauthorized aid to sue that company in the ECJ for violating Article 93 of the Rome Treaty.[51]

All of this deference to national politics makes it difficult for other airlines to compete. As Roger Burnell of Britannia Airways put it, "States are finding imaginative backdoor ways of subsidizing their former flag carriers." In Spain, the state-run airport concern granted a 65%

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[47] Op cit supra at 33.

[48] Op cit supra at 46.

[49] Ibid.

[50] Luke Hill, "Commissioner defends EU subsidy role," *UPI International*, 11/10/94, Nexis.

[51] Ibid.

discount to Spanish airlines. As Burnell exclaims, "how am I supposed to compete against that?"[52]

### 2. Subsidies Enhancing Competition

Although all forms of subsidies distort the market and thus impede competition by creating uneven playing fields, in some cases, specifically subsidies used to speed up the adjustment process in a restructuring, the beneficial effects have resulted in long term gains of increased efficiency and productivity much greater than the distorting effects of that subsidy.[53] Examples of beneficial subsidies within the EU could be investments in, or subsidies for, public infrastructure improvements, or for purchasing new and up-to-date air control equipment. The scarcity of these items has created additional barriers that new airlines must surmount to compete effectively against existing airlines.

## B. Abuse of Dominant Position

Many former flag carriers continue to abuse the dominant position they hold, both in the sky and on the ground, often in violation of EU Competition laws. Until January 1995, the French government had insisted that all non-French carriers use Charles DeGaulle airport, a more distant airport from Paris, instead of nearby Orly. The Commission had in October ordered France to open Orly to all carriers, but, France defied the Commission and the European Court of Justice and refused to open the airport until January 1995.

Article 86 of the Rome Treaty requires that dominant carriers must not abuse their position by restricting competition or taking advantage of their market power by discriminating against other airlines desiring to use their facilities. Abuse of position is defined as:

1) entering into agreements on fares, or using predatory pricing, designed to eliminate competition;

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52 Arthur Reed, *Air Transport World*, Sept. 1993.

53 Michael Mussa, "Government Policy and the Adjustment Process," ed. Bhagwati, *Import Competition and Response*, 1982.

2) providing travel agents with bonuses if they deal exclusively with a favored airline, or CRS;

3) using their CRS to give themselves an undue advantage over their competitors;

4) restricting purchases of equipment to suppliers of their own nationality;

5) refusing to accept interline traffic (a practice where a passenger holding a ticket with one carrier can switch to flights offered by another carrier) from another airline without sufficient justification; and[54]

6) manipulating their airport arrangements in such a way as to cause artificial disadvantages for their competitors, e.g., by tying up more terminal facilities or landing slots than necessary.[55]

Almost all of the former flag carriers are guilty of one or more of these items. For example, since the majority of airports are still controlled and operated by governments, they are subject to public procurement laws which give preference to national suppliers, even when these suppliers are not the lowest bidders.[56] A dispute is currently raging over Greece's choice of contractors for Athens's new airport. Vertical integration, access to public infrastructure, control of marketing distribution, and control over CRS are other methods of reducing and eliminating competition. All of these methods place competitors at a significant disadvantage in terms of higher costs and lower reliability of service.[57]

### 1. Vertical Integration

Vertical integration occurs when carriers control the key suppliers to the airline industry, such as control of feeder carriers, ground facilities, and CRS, computer information systems that

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54 Antitrust and Trade Regulation Report, *Bureau of National Affairs*, 7/1/93.

55 Op cit supra at 3, p. 85.

56 Ibid.

57 Center for Transportation Studies, Michael W. Tretheway and Tae H. Oum, *Airline Economics: Foundations for Strategy and Policy* (Vancouver, University of British Columbia, 1992) XVI.

contain information on airline schedules, fares, rules, and seat availability for all airlines participating. Control over feeder carriers (carriers servicing regional airports) ensures a continued stream of passengers and revenues to the dominant airline.[58] Competition is reduced because foreign carriers are excluded from carrying this traffic. Vertical integration also helps airlines create economies of traffic density. The more traffic that can be carried in a given market, the lower the fixed costs per passenger. Other carriers cannot develop the same type of traffic density and thus have higher costs per passenger.[59] Lack of competition also harms consumers because of higher prices for tickets.

### 2. Access to Public Infrastructure

Control over ground facilities also impedes competition as airlines, other than the dominant one, are forced to pay monopolistic prices for services. This is illustrated by a recent complaint lodged with the Commission by seven national carriers, notably KLM, British Air, & Air France, against German and Spanish airports. Fees for ground facilities at these airports are 33-50% higher than at other airports for the same services.[60]

These impediments to competition exist throughout the industry. In many airports there is still only one company licensed to provide ground facilities. There is no reason why airport authorities should be allowed to continue to restrict competition by not allowing other providers to enter the market. Airlines should be able either to provide their own ground facilities, or make a choice from several independent ground facility operators. Belgium, for instance, licenses several

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58 Ibid.

59 Ibid., p. XVII.

60 Europe Daily Bulletin, *Agence Europe*, 8/25/93.

providers; as a result, charges for ground facilities are much less than at airports without such competition.[61] Liberalization of ground services would reduce airline costs.[62]

Lack of access to public infrastructure also distorts the market and reduces competition. Incumbent carriers have advantages in that they have access to airport facilities and to take off and landing slots, while competitors often find themselves discriminated against and thus unable to obtain the same access.[63] Some 15 airports have been identified as being completely saturated, without room for new slots.[64] At Heathrow last summer, many airlines were refused take-off and landing slots because there was no room for them.[65]

Currently, landing slots are allocated by a scheduling committee composed of incumbent slot owners. New slots are allocated by this committee as they become available. Since new airlines are not members of this committee, they lack the ability to bid for new slots. Additionally, many of the world's airports are so congested that new slots rarely become available. Worse, when airlines find that they can no longer use a slot, they rarely put these slots back into the pool; instead, they trade them among themselves.[66] This type of backroom politics places competitors at a severe loss, and clearly violates Article 86. The Commission should put an immediate end to this type of behavior.

Several alternative methods have been proposed for reallocating slots: 1) auctioning all slots to the highest bidders; 2) establishing peak and off-peak charges for slots; 3) turning over new

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61 Ibid.

62 Paul Betts and David Gardner, "Slow Recovery on the Runway," *The Financial Times*, 11/1/93.

63 "How Much for a Slot," *The Economist* 11/27/93, p. 66.

64 Op cit supra at 4, p. 55. These airports are located in ten countries: Heathrow, Gatwick & Stanstead (Britain), Malpensa(Italy), Charles DeGaulle, Nice, & Marseilles (France), Frankfort, Berlin (Germany), Zurich, Madrid, Copenhagen, Dublin, Brussels & Schiphol (Netherlands). Furthermore, an additional 11 airports will be completely saturated shortly after the year 2000.

65 Michael Skapinker, "Capacity shortages stack up over London,", *The Financial Times*, 3/7/95.

66 Op cit supra at 63.

slots to the Commission, instead of to a scheduling committee, to distribute; 4) reallocating all unused or slightly used slots to new airlines,[67] and; 5) legalizing squatters's rights to slots and to terminal space, aircraft parking, and runway space.[68]

Auctioning of slots to the highest bidders will not improve the situation for new carriers, because they often do not have the money to outbid a dominant carrier. Charging more for a slot depending on the time of day appears to have a lot of validity, but it does not open up more slots to new entrants or small airlines wishing to expand. The Commission is beginning to play a role in slot allocation by ruling that half of all newly created slots go to newcomers.[69] Legalizing squatters rights would eliminate backroom dealing and give airlines the confidence to trade slots openly. Slots could then be bought, sold or even leased among carriers. Competition authorities would police trade.[70] I believe a combination of options four and five are the best ways of solving this problem, at least until new runways or airports are built.

The National Economic Research Associates (NERA), as quoted by the *Economist*,[71] advocates that prices for all slots be raised because the current price does not reflect the true costs of the airport services that accompany them. If charges were raised, airlines would be forced to either use their slots more efficiently or to sell them. Although the NERA anticipates that raising the prices of slots will increase costs and thus result in higher fares, it believes that in the long run the boost to competition from airlines being allowed openly to buy and sell slots will significantly lower airfares.[72]

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67 Op cit supra at 6, p. 157.

68 Op cit supra at 63.

69 David Garner, *The Financial Times*, 11/29/93.

70 Op cit supra at 63.

71 Ibid.

72 Ibid.

### 3. Marketing Distribution Agreements

Marketing distribution agreements between carriers also distort competition. The market power of the major carriers has been greatly expanded by the popularity of CRS. An airline can be represented as either a hosted or participating carrier. The hosted airline uses the CRS as its internal reservation system, while the participating carrier does not. As a result, the participating carrier's seat availability is not as current as that of the host.[73] An existing block exemption, dating back to phase one, allows joint operation by airlines of CRS systems, provided they are run in a nondiscriminatory manner.

Another form of marketing distribution is code sharing, that of representing a flight of an affiliated carrier as being on a dominant carrier. These two flights essentially share the same airline code. As a result, they are treated as one flight and thus given a higher priority in the CRS than that of a connecting flight, placing all other airlines at a disadvantage since agents have to scroll through many screens to see these flights. A recent study found that 90% of all agent reservations are booked from the first screen. Also, approximately 50% of all tickets sold are for the first flight on the screen that matches the customers request. U.S. carriers have calculated that these practices increase their revenues by some 13%.[74]

The preference of travel agents to choose the hosted airlines flights over all other flights has been called the "halo" effect.[75] The advantages of code sharing is that it provides airlines with more opportunities to fill their flights and thus reduce their per passenger costs. Moreover, by teaming up, airlines can offer international flights that were previously closed to them because of bilateral treaties or because there was not enough traffic to justify it. Delta Airlines, as a result of a

73 Witold B. Jankowski, "Applying the New Competition Legislation to the Deregulated Airline Industry: The Case of Computer Reservation Systems," *Transportation Research Forum*, v.31 (1990): 368.

74 Marj Leaming, "Enlightened regulations of computerized reservations systems requires a concious balance between consumer protection and profitable airline marketing," *Transportation Law Journal*, v.21 ('93):486.

75 Op cit supra at 75.

partnership with Virgin Atlantic, now flies into Heathrow, the preferred London Airport, instead of Gatwick.

Since 1991, the following airlines have code sharing or block-booking agreements with U.S. carriers: KLM with Northwest, British Airways with US Air, British Midland with American, Air France and Alitalia with Continental, Sabena with Delta, Lufthansa with United, and Virgin Atlantic with Delta. The goal in all these partnerships is to attract more passengers by making it easier to reach distant places.

### a. Opportunities to Distort Competition

CRSs are either owned by one or a combination of airlines. Many smaller CRSs have banded together to form super CRS. There are three super CRSs and they control almost all air traffic in Europe and abroad. Control over a CRS distorts competition in many ways:

1) CRS owners paying travel agents a fee to use their system in preference to a competitors's systems;

2) having the host's flights listed before those of other airlines;

3) manipulating travel agents and corporate programs and incentives to deny other airlines business, thereby limiting consumer choice;

4) discriminating against certain airlines by refusing to carry their pricing information, or not confirming connecting flights, or discriminatory placements of flight information, and;

5) providing the host with informational advantages: for example, the potential to identify changes and shifts in the market sooner than competitors, or viewing other carriers's sensitive business information.[76]

The EU is establishing a code of conduct to prevent these market distortions from occurring. The thorniest issue is that of dehosting, requiring an airline owning a CRS to separate

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76 Op cit supra at 73, p. 368-69.

its business activities from the system's management.[77] Code sharing is another problem because passengers often are not told which airline is flying which segment. As a result, preferential treatment is given to the affiliated carrier over its competitors. Senator Wendell Ford of Kentucky claims that "Code sharing is the consumer ripoff of the decade".[78] In the U.S., the Federal Aviation Administration has fined many airlines for failing to disclose code-sharing arrangements to passengers booking tickets for these flights.

Additionally, the proposed code of conduct obliges all companies that are part of such a system to communicate their information without discrimination to all systems requesting it. European airlines are contesting this requirement because it would entail their providing sensitive business information to American Airlines, owner of the Sabre system, a super CRS owner who they claim "does not dehost."[79] If the EU accedes to some of its members wishes and adopts dehosting, there is a belief that this action might create a serious trade dispute with the U.S.[80]

American Airlines believes that those member-states insisting on dehosting are simply looking to reduce competition by protecting their own CRSs from competition. American claims that it is the programming that determines a system's neutrality, and not whether it is hosted or not. Moreover, it argues that regulations can be written to prevent discrimination and safeguard competition. Furthermore, American claims that all that is necessary to ensure the continued neutrality of the system is to make sure that these regulations are implemented.[81]

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77 Europe Daily Bulletin, *Agence Europe*, 6/12/93.

78 Adam Bryant, "Sorting Out Airline Partners," section 5, *The New York Times*, 12/5/93.

79 Op cit supra at 77.

80 Ibid.

81 Europe Daily Bulletin, *Agence Europe*, 9/18/93.

### C. National Ownership Requirements

Eleven of 12 national carriers are still fully or partially state-owned; British Airways, the only privatized national carrier, is also the only one making a profit. The belief, however, that a carrier must be owned by its citizens, appears to be fading.[82] Two years ago, Sabena Airlines sold 38% to Air France which recently, in March 1995, sold its stake to Swiss Air. Airlines that cannot be privatized should be merged with others or be allowed to become bankrupt.[83] Although this will be extremely difficult to accomplish because of the amount of national pride in each national carrier, it must be done. Privately, Commission officials believe that the biggest barrier to air transport liberalization "is this crazy idea that every member state has to have its own airline; people still assumed there is something glamorous about flying, but . . . airlines are just glorified bus companies."[84] The airlines should learn from other European businesses. As Margaret Sharp notes, in William Wallace's *Dynamics of European Integration,* once firms discarded their national champions, they were able to look at the industry and see the laws that gave preferential treatment to national champions as a major hinderance to effective operation in these markets.[85] The same is applicable to airlines; once states realize that their carrier can no longer survive in the global marketplace, they should allow their carriers either to go out of business or become regional carriers. The Chairman of Alitalia, Roberto Schisano, believes that if Alitalia's restructuring plan fails, it should give up trying to be a global airline; "Better small and making money than large and losing a pile."[86]

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82 Op cit supra at 1, p. 371.

83 Op cit supra at 12.

84 "EU approval of subsidies to airlines delays introduction of competition as national pride in flag carriers is blamed for slow move towards liberalization," *The Irish Times*, 8/5/94: Supplement, p.5.

85 Margaret Sharp, "Technology," ed. William Wallace, *The Dynamics of European Integration,* (New York: Pinter Publishers, 1990) 58-59.

86 Andrew Hill., "Alitalia chief strapped in for a turbulent ride," *The Financial Times*, 3/2/95.

Additionally, foreign nationalization requirements should be relaxed to allow for outside investment. Investment will increase the profitability of all airlines. Currently all investors must be EU nationals, thereby excluding American or other foreign investors.

The U.S. Airline Commission is investigating the possibility of relaxing its airline nationality requirements if countries offer reciprocal treatment and sign open-skies agreements. The net effect would be to allow a Dutch corporation, for example, to purchase up to 49% of an American carrier in return for a U.S. company being allowed to purchase an equal percentage of a Dutch carrier. Moreover, as an owner of an European airline, the U.S. company would then be able to exercise the right of establishment, granted to all EU carriers, and fly anywhere within the EU without being subject to current restrictions codified in bilateral treaties. Airlines not granting reciprocal treatment would be prohibited from purchasing more than the current 25% of an American carrier. This policy, if approved, would provide an American company with the ability to effectively penetrate the EU air transport market.[87]

The Commission, to prepare for this, needs to continue liberalizing the air transport industry, otherwise EU carriers will find themselves unable to take advantage of this opportunity when it becomes law. The task of developing a common transport policy is difficult because laws, procedures, and regulations among member-states are still being harmonized. As a result, many substantive legal differences remain unresolved. The integration of competition principles through rulings, directives, or promulgations are difficult to accomplish in good economic times, and even harder in bad times, when nations are facing high unemployment and low growth.

## V. Infrastructure

Infrastructure congestion coupled with poor long and medium term forecasting has resulted in severe overcrowding and has become an important factor within the airline industry. Delayed flights, restrictive air traffic flow management, and overcrowded airports are experienced daily by

87 "The War in the Skies," *The Economist*, 8/14/93, p. 71.

all European passengers.[88] The International Air Transport Association (IATA), in its most recent annual report, states that air traffic congestion is the greatest long term threat facing the airline industry.[89] Herman de Croo, chairman of the "Wisemen" expert panel, remarked that "European airlines have paid a heavy price for the fragmentation in the European market. Airports and air traffic control systems are ill-positioned to deal with change because they are founded on national and local interests, rather than forming part of an integrated European entity."[90] Lack of infrastructure limits both the size and scope of the future industry and the effectiveness of EU liberalization measures.[91] In 1990, it was estimated that air traffic control inefficiencies cost European passengers and airlines $4.2 billion a year.[92] These costs are expected to rise to $6 billion by the year 2000.[93] Ticket prices reflect the cost of this chronic congestion and resulted in losses to the consumer.

The lack of any integrated air traffic control system results in extremely high external costs for all EU carriers; costs in Europe are 40% higher than those in the U.S.[94]. The present system is composed of 44 en-route centers, connected to 22 different systems, all with different operational

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88 Op cit supra at 4, p. 52.
In 1994, congestion related delays increased by 8% compared to 1993. Europe Daily Report, *Agence Europe*, 12/19/94: 15.

89 Ibid.

90 "EU Commission Gets Report From Experts on Liberalization of Airline Industry," *Antitrust and Trade Regulation Report, Bureau of National Affairs*, v.66:#1650, 182, 2/10/94, Nexis.

91 Paul Betts and David Gardner, "Slow Recovery on the Runway," *The Financial Times*, 11/1/93.

92 Op cit supra at 4, p. 52.

93 "Meeting the challenge of airport expansion," *Aviation Week and Space Technology*, Advertiser sponsored market supplement, 2/6/95: S1

94 "European Parliament: State Aid and Infrastructure dominate parliamentary report," *Transport Europe*, 2/21/95, Nexis.

standards, while the U.S. has one integrated system of 20 centers.[95] Each membe- state still runs its own system, using incompatible technical equipment. Moreover, some centers do not even have computers or adequate radars for detecting where planes are. It is not unheard of for controllers to guide planes by sight, since radars are not operational. Additionally air controllers often use the telephone (itself not that reliable in some nations), instead of computers, to pass off airplanes from one zone to another.[96] Moreover, restrictions and regulations on the number of flight controllers each state (even each airport) must maintain means that flight controllers cannot temporarily be reassigned to other states experiencing shortages. The fragmentation of the present system costs airlines between six and eight times more than the U.S. air traffic control system.[97] The Commission can rectify this situation by working more closely with the European Civil Aviation Conference (ECAC) and with Eurocontrol to harmonize and integrate the disparate air traffic control systems into a single system.[98] This close coordination will enable the Commission to gain the competence necessary to exercise an operational role in this field.

The congestion caused by the creaking system results in delays at the terminals. It also means that takeoff and landing slots must be booked for longer period of times. If congestion were reduced, more slots could be created, and competition improved. This, though, is not likely to happen because poor economic conditions in Europe limit available investment.

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95 Ibid., p. 53.

96 Neil Turns, "European Civil Aviation," *The Challenge of a new European Architecture: Implications for the European Community's Internal and External Agendas,* European Community Studies Association: Second International Conference, p. 22.

97 David Gardner, "EU Airline Crisis: Cut Capacity or End State Aid," *The Financial Times*, 11/30/93.

98 Arthur S. Banks, ed. *Political Handbook of the World 1993.* CSA Publications: SUNY Binghampton. The ECAC is composed of transportation ministers from 23 member countries. It works closely with the ICAO in coordinating air traffic, navigation & marketing activities for its members. Eurocontrol was originally established in December 1960, however, it did not become an active participant in solving Europe's navigation problems until 1986. It consists of 19 members and has a budget of $517 billion. Its purpose is to strengthen the cooperation between its members and to develop joint activities in air navigation. In April 1990, the ECAC approved a comprehensive program to harmonize and integrate air traffic control in Europe and designated Eurocontrol to manage the project. Full harmonization is expected by 1998.

Some 15 European airports are at full capacity and seven others will reach full capacity by the end of the year.[99] Although several of the most congested airports are planning new terminals, these will not be built for several years. In 1993, passenger traffic for Western European carriers went up 11.5%; over 75 million people passed through London's three airports, with Heathrow processing over 51 million--close to a point of saturation.[100] By 2000, eleven other airports are expected to reach saturation levels.[101] This congestion has led to the severe slot allocation problems, discussed earlier. At Heathrow last summer, many airlines were refused take-off and landing slots because there was no room for them. IATA forecasts that European traffic will grow by 6.6% annually between now and 1997.[102] This means that in 1997, 114 million more people than in 1992 will be flying, for a total of 414 million. By 2000, European air traffic is expected to rise to 650 million people.[103] A fifth terminal in Heathrow is expected to bring in an additional 30 million people.[104] The implications for the industry are clear; without adequate new airports and air traffic control investments, industry profitability is endangered and service to the public is compromised. Congestion problems have already led to a 7% decline in Europe's share of international air traffic since 1987.[105]

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99 Op cit supra at 4.

100 "More Travellers in W Europe" and "Heathrow Reaches Record," *The Financial Times,* 1/10/95, 1/17/95 respectively.

101 Op cit supra at 4 page 55 and at 65.

102 Ibid. This figure had been higher but was revised downward, to 6.6%, because of congestion and financial problems.

103 Op cit supra at 95.

104 Neil Buckley, "British Airways warns on plan for Heathrow airport," *The Financial Times,* 1/9/95.

105 David Gardner, "EU airline crisis:cut capacity or end state aid?", *The Financial Times,* 11/30/93.

## VI. Globalization

The most significant trend in the airline industry has been the movement among airlines to form mergers and alliances with other carriers to better position themselves in the global marketplace. Complete liberalization, I believe, will likely result in a consolidation of the industry into ten multinational airlines, competing in markets around the world. If the U.S. experience with deregulation is of any relevance, the EU should expect to see many bankruptcies, consolidations and mergers.[106] The EU has established new merger criteria to ensure that anti-competitive mergers are not allowed to occur.[107] The surviving airlines will likely be linked by three super CRSs and will have a series of code-sharing agreements or other marketing distribution agreements with a variety of international carriers. For the consumer, this means that prices will be significantly lower as competition increases. These benefits could be lost if the EU agrees to roll-back some liberalization measures, continues to grant airlines subsidies, implements short-term solutions causing long-term problems, or does not invest in its infrastructure.

Small carriers, unless they can align themselves with larger carriers, are in grave danger of becoming bankrupt. Before merger talks between Swiss Air, Austrian Airways, KLM, and Scandinavian Airline Systems collapsed in November 1993, bankers had calculated a cost savings of $1 billion a year for these airlines.[108] The need of these carriers to form a critical mass and thus insure their continued health and effectiveness in the emerging world airline market was the impetus behind the attempted merger. Although Alcazar, the planned name of the new company, failed, this need did not disappear. The merger's failure was caused by the inability to agree on a single U.S. partner, an essential aspect of any European airline's global strategy.[109]

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106 Op cit supra at 1, p. 372.

107 Op cit supra at 29, p. 343.

108 Roger Cohen, "European Airlines End Talks," *The New York Times,* 11/22/93, p. D1.

109 Ibid.

The following alliances currently exist: Swiss Air has purchased 50% of Sabena, KLM owns 20% of Northwest Airlines; British Airways (BA) owns 25% of US Air, 50% of TAT, a French airline, and 49% of Deutsche BA, a German airline; British Midland is 40% owned by SAS and has code-sharing arrangements with American Airlines; SAS owns 20% of Continental; Air France has a marketing arrangement with Continental; Sabena has a code-sharing arrangement with Delta Airlines, Lufthansa has formed a partnership with United Airlines,[110] Alitalia has a marketing and code-sharing arrangement with Continental, and Virgin Atlantic has a partnership with Delta. A Delta representative is aboard every Virgin flight from New York to Heathrow. Additionally, TAT planes are painted in BA colors and its staff wear BA uniforms.[111]

## VII. Current Competitiveness

Although the final liberalization package, implemented in January 1993, which gave any EU citizen the right to start a new airline anywhere in the 12 (now 15) member-states, moved the industry closer to a free market by allowing for instant competition on fares and giving airlines permission to start new services anywhere they choose, much work still needs to be done to complete the process. Several block exemptions, granted during the first package, do not expire until mid-1998. These exemptions should not be renewed as I have previously suggested (see part 3). Moreover, complete cabotage for EU airlines does not come into effect until April 1997.

### a) Stumbling Blocks on the Road to Liberalization

The most vexing problem the Commission is facing is whether to grant Iberia Airlines a second subsidy. It is imperative that the Commission not approve the Spanish government's second state aid request. (In 1992, Iberia was one of the first countries to receive a $1.3 billion restructuring aid under the new state aid rules, however it squandered the aid and has now come

110 Op cit supra at 78 and Paul Betts, "Dream of Freedom Turns into a Prison," *The Financial Times*, 11/22/93.

111 Op cit supra at 52.

back for another $1 billion.)[112] Granting of additional state aid to Iberia will not only severely distort competition, but also severely damage the integrity of the Commission. The Commission, especially Competition Commissioner Van Miert, has staked the Commission's liberalization policies and prestige on ending the continued subsidization of airlines. Nothing could demonstrate more clearly that the Commission lacks the will to enforce its policies of "one time, last time" aid than approving this aid. Granting of additional aid to Iberia also would set a dangerous precedent and most likely lead to other troubled companies across all European industries flouting EU rules with impunity.[113] The EU must find the political will to force its members to make painful, market oriented, choices. National carriers should not be used as government employment agencies nor as expensive vehicles for waving the flag. European Airlines have steep internal costs for these reasons; Labor costs are nearly 37% higher than U.S. carriers.[114] Air France employs one worker for every 340 passengers, in the U.S. the ratio is 1:900.[115] Current subsidies of state-owned airlines cost the EU $10 million a day. In the past year, the EU has approved $7.5 billion in state-aid to troubled airlines.[116]

Continued state aid policies are in danger of creating a two-tiered industry, subsidized flag carriers, and struggling independents. If European governments are allowed to continually bail out flag carriers which are unable to successfully operate commercially, what incentive is there for other airlines to compete on price and service?

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112 Nathaniel Nash, "The struggle to keep Iberia aloft," *The New York Times*, 1/14/95: D1

113 Ibid.

114 Op cit supra at 84 8/5/94.

115 Op cit supra at 29.

116 Op cit supra at 104.

**b) Current Status of Competition**

The granting of the right of establishment has allowed carriers to set up operations in any EU nation. For example, British Airways has created a German airline both to act as a feeder airline and to compete against the national airlines, such as Lufthansa. Sabena has opened an express route from Brussels to London, via London's City Airport. Iberia, through a subsidiary, has established a new hub at Schiphol (Amsterdam), and has signed cooperation agreements with several British regional carriers to provide connections via Amsterdam from provincial airports in Britain to Madrid, Barcelona and other Spanish cities.[117]

Liberalization has been most successful at bringing competition to regional airports. Operating around the edge of crowded airports appears to be the key to improving the level of competition within the industry. Witness the emergence of Ryan Air, Brymon, Air UK, Logan Air, Manx and other carriers that have emerged.[118] Additionally, takeoff and landing slots at regional airports are often much easier to obtain than at the bigger airports. These airports have the added benefit of cabotage rights, which are not legal in large airports until April 1997, resulting in lower prices.

A major benefit of the third package is that it has allowed British Midland to directly attack the prices charged by former flag carriers for business class and, in the process, has shown that competition can drive prices down. The London Business School found a definite correlation between the entry of new competition and the improvement of punctuality of all airlines flying that route. They also found that frequency of flights increased 11% when new airlines flew these routes.[119] Sir Michael Bishop, chairman of British Midland claims that experience has shown that liberalizing the market is not enough; "the only factor that makes a difference to air fares on any

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117 Op cit supra at 52.

118 Ibid.

119 " European Industry Said Open to U.S. Carriers by End of the Decade," *The Bureau of National Affairs International Trade Reporter*, 6/30/93.

particular route is the actual entry of competition."[120] Severe congestion in most EU airports, however, has made it almost impossible for new entrants, or existing airlines, to open new services.

Currently, European business travelers spend $900 million more than their counterparts in the U.S. According to a recent survey by American Express, 70% of all European business travellers oppose state subsidies, while 60% believed that state ownership was responsible for artificially high prices.[121] Liberalization was meant to eliminate these problems, but as long as inefficient carriers can rely on governments for support, they will never address the fundamental economic problem of having price equal to marginal costs. As a result, efficiency will never be reached (Appendix A).

Moreover, the increasing number of "open-sky," bilateral agreements concluded or initialed by more liberal-minded EU nations with the U.S. exposes to all the weaknesses of the illiberals within the EU, particularly France, Spain, and Italy. The fear of isolating these nations and other like-mind ones is what drove Neil Kinnock, EU Transport Minister to threaten to block EU countries from initialling open skies agreements with the U.S..[122] For example, countries such as the Netherlands and Britain, that have operational free-markets and/or have liberal open-sky agreements with the United States, have experienced a dramatic increase in passenger traffic. Traffic at Schiphol (Amsterdam) has increased by over 30% since the implementation of the third package.[123] It is not uncommon for families to travel to Amsterdam by train to take advantage of these significantly cheaper flights.[124] The completion of the tunnel beneath the English Channel

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120 Ibid.

121 Ibid.

122 Caroline Southey, "EU retreats from threats over air deals," *The Financial Times*, 3/3/95.

123 Op cit supra at 52.

124 Martin Staniland, Professor, University of Pittsburgh, interview, 12/6/93.

will lead to a similar increase in passenger traffic for Britain, as families will now flock to Britain to take advantage of lower fares.

The EU's next move is to open cabotage rights to non-EU carriers, such as U.S. airlines. This should be placed on the agenda for a next reform, possibly before 1998 when the block exemptions expire.

## VIII. Conclusion and Recommendations

The EU was established to promote a single market among member-states. Political considerations delayed the implementation of this market in the airline sector. The passage of the Single European Act in 1986 and the drive to complete the Single Market by January 1, 1993 increased the pressure on governments to accept liberalization. Moreover, deregulation in the United States and recent technological changes made the EU realize that it had to liberalize the air transport sector. The European airline industry could no longer afford to "sell[ ] a product, produced at European cost levels, at world market prices . . .nor could they watch as European airlines combined above average growth with below average productivity."[125]

However, the EU is suffering from the greatest recession since World War II. The political pressures within each member-state to preserve national industries and the jobs associated with them, as well as protecting the flag, remain strong. National governments will continue to call for a roll back of liberalization measures until they feel less threatened by labor unrest and difficult economies. Addressing short-run concerns through band-aid solutions, however, is sure to lead to long-term problems.

Although it is unclear what the final result of liberalization will be, it is clear that the Commission has made great strides in reforming an industry riddled with price and capacity cartels and where revenue pooling was an accepted means of operation. The EU, however, must continue these strides. It must impose tougher controls on state aid, change its slot allocation policy, and back up these measures with more stringent enforcement of EU competition rules. If the

125 Op cit supra at 11.

Commission does neither of these things, or delays in implementing them, it will not only risk hindering the liberalization underway, but will also risk losing its political will and credibility in the process. Applying competition rules unevenly, particularly when doing so appears to favor politically more powerful governments, such as France, is worse than having no rules at all.[126]

Congestion in the sky and on the ground is an important reason why liberalization has slowed and promised benefits have not arrived. Airlines cannot expand if they cannot get a landing slot or terminal space. The implementation of the Commission's White Paper, "Competitiveness, Growth, & Employment" will not only provide the public spending and job creation necessary to reinvigorate European economies, but will also reduce airport congestion by focusing on infrastructure improvements.[127]

Another question is whether a European version of "Continental Lite," Continental Airline's low cost airline, will ever exist in the EU? We are already seeing moves in this direction and movement towards creating low cost carriers will increase with the recovery of European economies. If we revisit this issue after the implementation of complete cabotage in mid-1997, I believe we will see EU versions of "Continental Lite" flying throughout Europe.

Will the advent of regular and high-speed trains, especially in light of continued operational and infrastructural subsidies for rail transport, adversely affect airlines? (Currently, air transport pays for all of its infrastructure costs without any monetary assistance from the EU.) I believe that there is room for both, that each has its own market niche, and that the air transport industry will have to be competitively strong to withstand such competition.

The following recommendations, some of which were mentioned earlier, are necessary to create a free market for air transport within the EU:

1) Enforce strict guidelines for approving all state aid and other forms of subsidization and require that they promote, and not impede, competition.

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126 Editorial, "Iberia's Woes," *The Financial Times,* 12/1/94.

127 "Delors's Bridge to the Future," *The Economist,* 12/11/93, p. 53-54.

2) Investigate creating an independent Competition Commission, one free from current political constraints.

3) Open up airport ground handling to real competition.

4) Increase pressure on EU member states to submit a timetable for privatization of their flag carriers.

5) Establish an air transport infrastructure cohesion fund, which will include money for airport infrastructure improvements and fund projects such as:

   • building new runways and expanding airports.

   • integrating air traffic control centers into a single unified Europe-wide system, as recommended by the European Civil Aviation Conference and Eurocontrol.

   • investing in high performance air traffic control systems capable of controlling and coordinating all aircraft movements in European aerospace, using computers, satellites, and other state-of-the-art tracking systems.

6) Adopt the National Economic Research Associate's slot allocation proposal to expand and liberalize rights to airport slots.

7) Reduce the amount of airspace reserved for military use and pursue additional measures to enlarge the number of slots available for civilian air transport.

8) Allow block exemptions to expire.

9) Adopt a stronger code of conduct for CRSs.

10) Relax national requirements for airline ownership.

11) Open up cabotage to non-EU carriers.

These measures, combined with a renewed commitment by all governments to work towards increased liberalization of air transport, will resolve the continuing market distortions and create an air transport industry that should further the economic vitality of the European Union.

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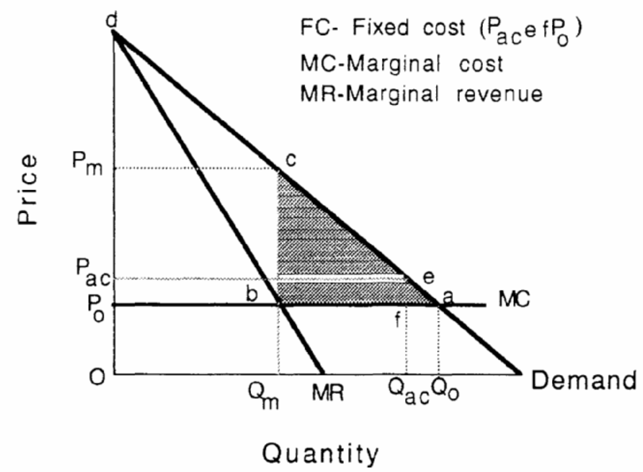
APPENDIX A

## LOSS OF CONSUMER SURPLUS CAUSED BY MONOPOLY PRICING




| Monopoly Pricing ($P_m$) | | Efficient Pricing ($P_o$) | |
|---|---|---|---|
| Consumer Surplus: | $P_m cd$ | Consumer surplus: | $P_o ad$ |
| Total revenue: | $P_m c Q_m O$ | Total revenue: | $P_o a Q_o O$ |
| Total cost: | FC+ $P_o b Q_m O$ | Total cost: | FC+ $P_o a Q_o O$ |

Deadweight loss due to monopoly pricing: abc