PUBLIC POLICY AND CORPORATE STRATEGY IN EU-US AVIATION RELATIONS

MARTIN STANILAND

GRADUATE SCHOOL OF PUBLIC AND INTERNATIONAL AFFAIRS
UNIVERSITY OF PITTSBURGH

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Addresses for correspondence and comment:

**3R26 Forbes Quadrangle
University of Pittsburgh
PITTSBURGH, PA. 15260**

Telephone: (412) 648-7656

E-mail: mstan+@pitt.edu

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INTRODUCTION:

The recent decision of the EU's 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" (meaning mainly the US and some Asian countries) over international air services. In exercising such authority, it would supplant national negotiators who are now responsible for maintaining and modifying bilateral Air Service Agreements (ASAs) becoming the single negotiator for all EU Member-States.

Meanwhile, American and European airlines have gone through dramatic changes in corporate strategy and internal structure. On both sides of the Atlantic, airlines have been forced to adapt to regulatory changes that are intended to create greater competition in an industry that has tended toward oligopoly and in many countries has been the object of state ownership. On the American side, the deregulatory process is arguably 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 forms 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 that will provide the new alliance with control of 61% of passenger traffic between the UK and the US and 24% of traffic between Europe and the US.

Observers sometimes have a sense that official policies in Washington and Brussels pursue their own logic, with only a loose relationship to what is happening in the industry itself. At the least, it is often unclear whether government is pilot, co-pilot or passenger. Officials of the US Department of Transportation (DOT) (sometimes supported by their colleagues in Justice and State) continue to press for "open skies" agreements, cleaving to the traditional American view that international aviation - a notoriously over-regulated industry - needs more competition and that "open skies" will bring more competition. Yet the US government increasingly rewards carriers in countries that sign the railways may be in competition with airlines, with the interests of automobile and truck owners challenging both. Externally, governments may find that other "reasons of state" outweigh even the claims of flag-carrying airlines.

Moreover, airlines themselves have different histories, different stakes, and different cultures. They can be assumed to be rational economic actors in seeking to maximize market share and increasing revenue. But, as with most rational actor models, this assumption gives us only the grossest insight into a category of actors, but of itself 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."

The advent of deregulation, liberalization and privatization means that received assumptions about government-industry relations may be either invalid or only broadly and partially valid. It also means that observers have to explore more actively specific interests and strategies of companies, the conflicts that may exist within an industry, and the interaction between (on the one hand) industrial associations and particular firms and (on the other) government agencies - bearing in mind the possibility of similar differences of goals and strategies among these agencies.

This paper explores the interaction between international aviation policy and corporate strategies on both sides of the Atlantic. As the introduction suggests, it sometimes seems as if the processes of official policy-making and international diplomacy move quite separately from those of corporate strategizing and implementation. This appearance of separation may be due to occasional incongruity between the goals espoused and their consequences; but it may also be due to our ignorance of who is talking to whom about what. However, whether through communication or by coincidence, the 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.

DEREGULATION AND INTERNATIONAL AVIATION:

Advocates of airline deregulation in the US and of liberalization in the EU have always based their arguments mainly on expected domestic benefits. But they have reinforced their claims by pointing to probable benefits for their own carriers (and supposedly for customers) from liberalization of air transport beyond the borders of the EU and the US.

Such liberalization is, in the opinion of many observers, long overdue. International civil aviation still operates within the framework of the 1944 Chicago Convention and the several thousand bilateral Air Service Agreements (ASAs) to which it led. Such "open skies" agreements with antitrust immunity covering their alliances with American carriers, responding to the assertion that, without such immunity, the alliances will fail to realize their commercial potential.

Yet critics are beginning to wonder whether the DOT is actually contributing to a re-enactment in international aviation of the drama of domestic deregulation, in which the sovereign abdicated in order to free his subjects, only to find that the barons moved in and set up an oligopoly that was both more pervasive in its control and less accountable than the bad old rule of government regulation. The comparable question is whether the combination of airline alliances, "open skies" and antitrust immunity may be leading to a new - but international - oligopoly on the North Atlantic and, potentially, around the world.

Is this occurs, will it be a result of government policy remote from the forces driving business? Will it be a result of an inadvertent confluence of official and corporate strategies, pursued separately but nevertheless affecting each other? Or will it be the result of collusion conducted beyond public scrutiny?

Uncertainty about whether governments are pilots, co-pilots or passengers is not removed by studying what academics and journalists write about policy-making in international aviation. Much American writing assumes, characteristically, that the airlines - at least the more powerful airlines - stand at the shoulders of DOT negotiators and that these negotiators express either the consensus of the airlines's view or some compromise between them. Writing within and about the EU concentrates - equally characteristically - on the texts of laws and regulations and the actions of public authorities in implementing them. It is quite silent on the pressures surrounding policy-making and on the strategies of the airline industry and of individual companies.

Indifference to - or at least silence about - the dynamics of relations between governments and the airline industry is reinforced by a conventional, "realist" view of the industry that depicts it as especially liable to protection, direction and regulation by the state.[1] This view has some historical substance, but only in a broad sense, for purposes of distinguishing between how this and other industries are treated by government. It leads to an assumption of identity of interest between states and airlines, based on the premise that government is able to call the shots. This assumption is natural where there is a single flag carrier, and most natural where that carrier is state-owned. But state-owned carriers are dwindling in number. Moreover, all countries have different modes of transport, and governments have many interests beside looking after civil aviation. Domestically,

[1] For an interesting recent exposition of this view, see Baldev Raj Nayar, "Regimes, Power, and International Aviation," International Organization, 49, 1, Winter 1995, 139-70.

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 each week or month) and provisions for regulating fares.

The United States and like-minded partners abroad are currently seeking liberalization of trade in international air transport, as of other service industries, using the slogan "open skies." However, "open skies" agreements (and indeed all bilateral aviation agreements) are subject to two restrictions that impede substantive internationalization and globalization of the airline industry. One restricts domestic operation by foreign carriers: under "cabotage" rules, Iberia (for example) could not pick up passengers in Miami and fly them to Albuquerque, even on a continuing flight from Madrid to Miami. By the same token, under EU rules, only "Community carriers" can normally pick up passengers in London and fly them to Frankfurt.[2]

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.[3] The U.S Department of Transportation (as a recent GAO report notes)

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[2] So-called "fifth freedom" (or "beyond") rights embodied in earlier bilateral agreements do allow non-EU carriers to carry traffic on specified routes within the EU. US airlines have worried about the possibility that the creation of a single aviation market in Europe will lead to a redefinition of such previously "international" routes as "domestic" and to a consequent invalidation of inherited traffic rights. While "fifth freedom" rights are a subject of intense controversy between governments (because they threaten to take away traffic from national carriers), the EU does not intend to revoke inherited rights.

Until the advent of a complete single aviation market in April 1997, Community carriers may operate at will between points in different Member-States and may operate "consecutive cabotage" flights, on which an international flight may be continued to a second point within a Member-State with up to a half of the flight's seats being filled by passengers picked up at the first point of entry. Thus a British Airways flight from London to Paris may continue to Marseilles with 50% of its seats filled by passengers taken on at Paris. After April 1997, Community carriers will be able to fly purely domestic flights within the territories of Member-States (such as Paris-Marseilles).

[3] The law does not provide for restrictions on non-voting stock, nor does it restrict arrangements for debt financing.

> interprets the law as requiring that effective control also be in U.S.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.[4]

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 national of Member States. It shall at all times be effectively controlled by such states or such nationals.[5]

U.S. INTERNATIONAL AVIATION POLICY:

Historically, the US has always favored greater competition on international routes, while many European states and most developing countries have favored continued or modified bilateral regulation. 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." The latter, at its purest, means that technically-qualified carriers may fly internationally between whichever cities in the countries concerned, at whatever frequency, with whatever capacity, and charging whatever fares they decide are commercially appropriate.

US policy has also, during the past eighteen years, envisaged

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[4] US General Accounting Office, Airline Competition. Impact of Changing Foreign Investment and Control Limits on Foreign Airlines, GAO/RCED-93-7, December 1992, 13. The report also notes that the US DOT has revised its interpretation of "effective control" to allow for foreign ownership of as much as 49% of total equity, provided that the current limit on voting stock is observed. The DOT has subsequently endorsed a proposal to raise the limit on voting stock to 49% but this change would require a change in the law.

[5] Regulation 2407/92, Article 4. It will be no consolation (though perhaps a surprise) to would-be purchasers of EU airlines to discover that EU legislation on licensing does not apply to hot-air balloons and ultra-light aircraft. For the text of the Regulation and a discussion of licensing provisions, see Bernadine Adkins, Air Transport and E.C. Competition Law, London: Sweet and Maxwell, 1994, Appendix 9 and Chapter 10.

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 be created if liberalization of particular markets (such as the US-Netherlands or US-Belgium markets) led to greater competition, reduced fares, and greater capacity. In these circumstances, passengers might decide that, given the short surface and connecting air journeys in Europe 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, Brussels and other airports in smaller countries. Since there is active rivalry between European airports, the potential winners would do all they could to ensure that passengers took advantage of their opportunities.

Under the Carter and Clinton administrations, the US has openly conducted such a "divide and rule" approach to the EU. While it has not broken down the resistance of the more obdurate Member-States, the strategy (reinforced by an acceptance of alliances between US and European carriers) has been highly successful in diverting trade toward more cooperative countries such as the Netherlands.

This strategy does not, however, mean that the US is necessarily averse to 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. Nor it averse in principle to some form of multilateral agreement involving the US, liberal EU Member-States and other countries (such as, perhaps, Canada and Singapore).

U.S.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. The strategy of these 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 such smaller cities as Charlotte, Cincinnati, and Pittsburgh. The concentrations of traffic they created were sufficient to sustain international services, while the huge cost of developing the hubs 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 in these circumstances because they were typically more profitable than domestic flights. Moreover, 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 therefore 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 sizeable overseas networks) moved them to sell rights on specific routes (though such sales required the approval of the governments concerned). Ironically, four 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.[6]

The impact of the "900-pound-gorillas" on North Atlantic routes - and on the attitudes of European airline and transport officials - was initially dramatic and uncomfortable.[7] By 1992, seven US airlines were operating scheduled services on North Atlantic routes, compared with two in 1988 and European carriers saw their total share of traffic decline to 44% (compared with 50% in 1978). While the overall market share of US carriers rose only

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[6] USAir acquired rights from TWA, while Continental and Northwest acquired new authorities and expanded capacity on existing routes.

[7] The US GAO reported that "from 1980 to 1990 U.S.airlines increased the number of passengers carried to and from Europe by 103 per cent, almost double the rate at which the number of domestic passengers grew"(International Aviation. Measures by European Community Could Limit US Airlines' Ability to Compete Abroad, GAO/RCED-93-64, 12). By 1992, transatlantic flights were generating 9.9% of United's traffic (as against zero in 1988), 13.3% of American's traffic (as against 7.9% in 1988), and 19 % of Delta's traffic (as against 7.0% in 1988)(Air Transport World, March 1993, 1). Overall, the international traffic carried by U.S. airlines has grown from 21% of all Revenue Passenger Kilometers (RPKs) in 1980 to 27% in 1995, with a predicted further growth to 30% by 2007 (U.S. G.A.O. International Aviation. DOT's Efforts to Increase U.S.Airlines' Access to International Markets, GAO/T-RCED-96-32, p.2). This follows a larger trend in which the proportion of all air travel represented by international air travel will grow.

slightly (the new carriers replacing the bankrupt TWA and the dissolved Pan Am), their impact on particular markets was substantial.[8] 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 a high-cost national carrier).

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 made Heathrow so attractive to passengers and airlines (and so vital for the profitability of services).[9] The American carriers' share of US-UK traffic only rose from 54.2% in 1989 to 55.0% in 1992 - 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 for these routes).[10]

The American "invasion" alarmed both airline managements and officials of national governments and the EC - all the more so since it was accompanied by the US government's campaign to negotiate more liberal ASAs with Member States.[11]

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[8] Overall market share rose from 43.1 % to 44.6%.

[9] British Airways has recently reported that fourteen of its twenty-two services between the UK and the US "would not be economical" if they had to depend solely on passengers from the origin-and-destination cities (John D.Morrocco, "BA defends pact with American", Aviation Week and Space Technology, 15 July 1996, 44.

[10] The next largest market was US-Germany (with 16.2% of all traffic), followed by US-France (with 12.4% of the total). United paid $400 million for Pan Am's London routes (which were estimated to generate $550 million in revenue in 1990). American paid $445 million for three TWA routes to London: in 1990, all of TWA's London services (including three to Gatwick) generated a revenue of $519 million) (US General Accounting Office, Airline Competition. Impact of Changing Foreign Investment and Control Limits on U.S. Airlines, GAO/RCED-93-7, 40; Perry Flint, "Action on the North Atlantic," Air Transport World, June 1991, 28).

[11] The Financial Times referred to the American carriers' "insatiable appetite for international access"("'Open skies' accord could set trend," Financial Times, 7 September 1992, 4).

Such alarm over an American "invasion" has abated recently, to be replaced by an increasing concern about the implications of alliances between U.S. and European carriers. The initial anxiety was understandable in view of the financial exposure of European airlines on international routes (discussed below). But use of the term "invasion" 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 away 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 networks within the U.S.). Moreover, not even the most liberal EU Member State would encourage an American carrier to strip traffic from its own airlines (particularly since the most liberal states also had carriers especially 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.[12] In any case, opportunities for stock purchase were limited by the fact of extensive government ownership.

American carriers did not, in fact, 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 U.S. 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."[13]

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[12] While the purchase of a controlling share might be legally possible, the consequence of exceeding the stipulated percentage would be that the airline in question would cease to be designated as a "national" carrier for the all-important purpose of receiving traffic rights.

[13] Leo van Wijk, Managing Director of KLM Royal Dutch Airlines, quoted in Joan M.Feldman, "Right Ends, wrong means," Air Transport

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. U.S. airlines (at least those without a stake in the market concerned) 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. While EU officials clearly saw the establishment of such authority mainly as a defensive tactic (uniting against the American threat), the less belligerent advocates of the EU proposal also pointed out that the US administration would be in an easier position domestically arguing for "open skies" with the EU than pushing on with agreements 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 U.S.) could be quite independent of the size of the local market. 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

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World, January 1995, p.60.

(including long-distance) markets than American airlines.[14] 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 have favored development of a strong domestic airline industry not only in the U.S. but in poorer countries such as Brazil and Russia. 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 <u>the size of their national markets</u>, and, secondly, to <u>the distribution of their market stakes between domestic, European, and intercontinental operations</u>.

"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 of the kind practised in the former USSR), whether this potential is realized will depend partly on income levels.[15]

[14] 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, <u>Air Transport Relations with Third Countries. Communication from the Commission to the Council</u>, COM(92) 4343 final, Brussels, 21 October 1992, p. 12 and Table E, p.55).

[15] Thus the dramatic development of air travel in China, which offers obvious potential in terms of distance, has had to await the recent rise in personal incomes.

TABLE 1: POPULATION SIZE AND SHARE OF TRANSATLANTIC AIR TRAFFIC:

Country:	Population (1991): (x 1000) (a)	Share of total US-Europe passenger traffic (1989) (b)
Germany	63,200 (FRG only)	16.2 (FRG only)
Italy	57,746	5.9
United Kingdom	57,485	34.9
France	56,893	12.4
Spain	38,999	3.9
Scandinavia	17,985	2.9
Netherlands	15,010	5.7
Greece	10,200	N.A.
Belgium	9,987	2.5
Portugal	9,858	N.A.
Ireland	3,518	2.4
Luxembourg	384	N.A.
Switzerland	6,751	5.1

Sources: (a) Eurostat, Basic Statistics of the Community, 29th Edition (Luxembourg, 1992), p.107;

(b) Perry Flint, "Action on the North Atlantic," Air Transport World, June 1991, 27 (based on data from Global Aviation Associates)

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, as Table 1 indicates, there is only a rough correlation between population size and (in this case) transatlantic traffic. Centrality helps to explain the relatively large share of traffic passing through Amsterdam and Brussels (just as the relatively low shares of Spain and Scandinavia reflect peripheral positions within Europe. London's predominant position is due to its excellent network of onward connections southward and eastward.

Politics and corporate strategy also shape a country's prominence in the international aviation market. The surprisingly low share of Italy (given its tourism and its population) is partly due to the restrictive bilateral between the U.S. and Italy. Moreover, traffic figures also reflect the preferences of airlines and their success in attracting traffic.

TABLE 2. EUROPEAN AIRLINES: SHARES OF DOMESTIC, EUROPEAN AND EXTRA-EUROPEAN TRAFFIC:

Airline/state:	Share (%) in total traffic of: Domestic:	International (including European):	Non-European as share of all international:
Sabena (Belgium)	0	100.0	32.6
Luxair (Luxembourg)	0	100.0	0
KLM (Netherlands)	0.7	99.3	49.0
Aer Lingus (Ireland)	10.1	89.9	13.1
Air France (France)	20.9	79.1	37.5
British Airways (U.K.)	21.8	78.2	36.9
TAP (Portugal)	25.7	74.3	28.1
EU AVERAGE	***26.3***	***73.7***	*26.6*
Lufthansa (Germany)	36.0	64.0	31.6
Alitalia (Italy)	39.3	60.7	28.5
SAS (Denmark/Norway/Sweden)[16]	44.3	55.7	12.4
Iberia (Spain)	52.0	48.0	22.2
Olympic (Greece)	64.1	35.8	27.4

Sources: 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, Annex 3, Table A, 51 (based on Association of European Airlines, Statistical Appendices to Yearbook, May 1991).

[16] Figures refer to entire SAS network

TABLE 3: DERIVATION OF REVENUES (%) (1992):

Services: / Carrier:	**EUROPEAN**	**EXTRA-EUROPEAN**	**(ATLANTIC)**
KLM	28.9	65.3*	(33.9)
BRITISH AIRWAYS*	42.2	57.8	(30.7)
SWISSAIR	47.6	52.4	(24.9)
AIR FRANCE	50.1	49.9	(16.7)
EU AVERAGE:	*50.7*	*49.3*	*(18.4)*
LUFTHANSA	52.8	47.5	(20.6)
ALITALIA	55.6	44.4	(16.6)
IBERIA	70.1	29.9	(25.6)
SAS	80.9	19.1	(10.2)

Source: Anon, European Airlines: A Turbulent Decade, 14 September 1993.
* - see also 1993/94 figures in Table 4.

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.[17] Explanations aside, 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 (as indicated in the tables above), it is possible to construct a typology that, although simple, illuminates the dilemmas and strategies of particular carriers:

(1) Large market/small carrier stake in long-distance market (examples: Aeroflot (Russia), Alitalia, Iberia);

(2) Large market/large carrier stake in long-distance market

[17] The relatively large-scale involvement of Lufthansa in domestic and European services goes back to the period before World War 2 when Germany - lacking a colonial empire (but wanting an air force) - invested heavily in building up services within Germany and across Europe.

(examples: BA, Lufthansa, Air France);

(3) Small market/small carrier stake in long-distance market (examples: SAS, Olympic, Aer Lingus, TAP Air Portugal, Luxair);

(4) Small market/large carrier stake in long-distance market: (examples: KLM, Sabena, Swissair).

By definition, those carriers in categories (1) and (3) have relatively small stakes. However, those carriers based in EU Member States are significant politically, because of their governments' power to support or oppose EU policy. Several 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: they are the largest carriers in Europe, while the support of the British, French, and German governments is crucial to the shaping and acceptance of EU international aviation policy. The major national carriers are based at airports that both serve relatively large domestic markets and have excellent networks of onward connections eastward and southward. These airports control the bulk of North Atlantic traffic: in 1993, 21,018,000 passengers of a total of 31,900,000 travelling between the US and Europe passed through British, French and German airports.

By the same token, however, foreign carriers are attracted to these airports. The national carriers control a smaller proportion of international departure slots than do their counterparts at airports in smaller countries, and the national governments are under greater pressure from American carriers and the US government to arrive at "open skies" agreements.[18]

The potential for disputes with third country governments is

[18] Thus in 1991, BA controlled 38% of international departure slots at Heathrow, Air France 43% of such slots at Paris Charles de Gaulle, and Lufthansa 46% of slots at Frankfurt. By contrast, Aer Lingus controlled 62% of international departure slots at Dublin, JAT 59% of slots at Belgrade, and Icelandair, 82% of slots at Reykjavik ("Making competition take off," Economist, 19 October 1991, 79 (from data supplied by the Association of European Airlines)). The markets are, of course, far smaller. Icelandair is a particularly interesting case of an airline that has created, without competition, a hub-and-spoke system between Europe and North America.

increased by the large stakes that BA, Air France and Lufthansa have in long-distance markets.[19] 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.[20] But, at least until 1993, the market shares of Air France on North Atlantic routes had fallen to approximately 31%, while that of Lufthansa had fallen to 40%. Because of restrictions on access to Heathrow, American carriers were held to only 43% of the UK-US market - a matter of great bitterness on the part of American officials (not to mention officials of BA's European competitors).[21]

With the large markets involved and the large international

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[19] The only other long-distance scheduled carriers in France, Germany and the UK are Virgin Atlantic, a major competitor to BA on routes to the US, with services also to the Far East and South Africa, and AOM-French Airlines, which has services to the French West Indies and to Los Angeles.

[20] 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. They also accounted for 11.6% of all traffic carried by airlines registered in the EU ("Eurocarriers must fight for American market share," Aviation Week and Space Technology, 31 May 1993, 35; Commission of the European Communities, Air Transport Relations with Third Countries, 51) (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)

[21] In an interview in September 1993, the then-chairman of Air France, Bernard Attali, said:

> We've had eight US carriers dumping prices into our market, while BA has been protected from this because of the restrictive bilateral aviation agreement between the UK and the US. I call that kind of bilateral the equivalent of state aid.

("Wielding the knife with politicians at his elbow," Financial Times, 27 September 1993, 17).

In a similar vein, Juergen Weber, the chairman of Lufthansa, remarked that:

> due to British Airways' government-supported agreement with the US, it is making money on the North Atlantic routes because it has limited the number of competitors and has limited the capacity.

("Lufthansa chief plots turnaround strategy," Aviation Week and Space Technology, 8 March 1993, 43).

stakes held by national carriers, it is not surprising that France, Germany and the UK were resistant to "open skies" formulas. 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.[22] While BA has recently absorbed several competitors (and franchised itself to others), its main strategy is external. Thus BA's former chairman, Lord King, is reported to have 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."[23]

What does pay is long-distance services, even on the competitive North Atlantic. Though (as Table 4 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.[24] Moreover, BA had over years of hard bargaining by the British government collected rights to twenty-two American cities.

Even with these traffic rights, BA found itself at a serious disadvantage in dealing with the newer and more aggressive US international carriers. Its rights tended to be concentrated in the more traditional east and west coast ports-of-entry. Even when it could get rights for such "fortress hubs" as Atlanta and Dallas, it was unable to draw on the concentrations of traffic developed at

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[22] 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 on 34% of French domestic routes: Lufthansa operated 60.4% of German domestic services on 35% of German domestic routes (Civil Aviation Authority (U.K.), Airline Competition in the Single European Market, CAP 623, London, November 1993, pp.80, 81, 86, 88).

[23] 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, p.7.

[24] In 1995, revenue from routes to "the Americas" had dropped to under 20% of the total but the percentage of total profits drawn from these routes had gone up to 43% (Carole A.Shifrin, "British Airways' track record offers competitive paradigm," Aviation Week and Space Technology, 3 June 1996, p.61).

TABLE 4: B.A. REVENUES AND PROFITS, FY 1993-4:

REGION:	REVENUE: ($ mn)	PRE-TAX OPERATING PROFIT: ($ mn)	PROFIT RATE: (%)
EUROPE:	3,600 (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 AND AUSTRALASIA	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, p.31.

these hubs by the dominant American carriers.[25] Whereas BA carried 64% of traffic between New York and London, its share at Dallas and Atlanta was only between 35% and 40%.[26] 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.[27] Even more irritating was the discovery that US carriers were carrying a higher proportion of connecting traffic boarding or leaving transatlantic flights at London than BA (and Virgin Atlantic) were attracting at US hubs.

[25] The chairman of BA has recently pointed out that, while BA is regarded as "dominating" Heathrow through its control of 38% of international slots, Delta controls 79% of all slots at Atlanta, Continental 78% of all slots at Houston, American 60% of slots at Dallas-Fort Worth, and United 49% at Chicago ("Myths muddy US-UK air pact progress," Aviation Week and Space Technology, 25 March 1996, 66. Interestingly, he omitted to mention the very large number of slots controlled by BA's partner, USAir, at Charlotte and Pittsburgh.

[26] "UK asks US to allow larger stake in carriers," Aviation Week and Space Technology, 26 July 1993, 22.

[27] BA in fact had only a 16% share of connecting passengers at Atlanta and 17% at Dallas: the rest of its passengers were either local or were garnered from the traffic of carriers who were not busy routing passengers through other hubs ("UK asks US to allow larger stake in carriers," 22).

BA's strategy in the face of this challenge involved increasing its access to connecting traffic on both the European and the American sides. Following a familiar MNC approach, it set out to expand its market share within the EU, while fending off challenges to its home base in London (and especially at Heathrow). BA has 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.[28] Liberalization has created ever larger opportunities for dominating the European market as cabotage restrictions are lifted. Just as importantly, 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 would seem to undermine 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 throw the bargaining power of the single market into negotiations with Washington. BA had 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."[29]

Subsequently, however, BA officials expressed concern about the danger of UK carriers losing existing traffic rights and about the fairness of Brussels in distributing any new rights that might be won.[30] The British government has consistently resisted assumption

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[28] Carriers in other liberal Member States have returned the compliment: both KLM and SAS have substantial holdings in British domestic airlines competing with BA. BA has already begun operating services, in its own name and through affiliates, on domestic French, German and Italian routes.

[29] Speech to the Royal Aeronautical Society, 16 May 1991, quoted in Dobson, Flying in the Face of Competition, p.190.

[30] In a submission to the US National Commission to Ensure a Strong Competitive Airline Industry in June 1993, Sir Colin Marshall (then chairman of BA) said that, while a multilateral approach to aviation negotiations would eventually prevail, it would require a great deal of preparation and continued:

> If we take the European Community as an example, it will be essential that the members of the single market in

of negotiating authority by the Commission, on grounds of principle (that national sovereignty would be undermined) and technical competence. More recently, the UK government has found itself at odds with an EU transport commissioner (Neil Kinnock), albeit a former leader of the Labour party. More curiously, it has found itself agreeing with the French government (with which it has repeatedly differed on liberalization) in opposing the idea of unitary negotiation.[31] The UK government was, in fact, "the lone dissenter" when the EU Council of Transport ministers in June 1996 finally granted the Commission authority to negotiate a multilateral agreement with the US.[32]

The British government's position on this issue reflects a more general opposition to any erosion of national sovereignty by the European Commission. The only, minor mystery may be why BA, having initially (and quite logically) backed a unified front toward the US, subsequently edged away from this position.

The answer is presumably (as it is for questions about tactical changes by other carriers) that after 1991 BA had changed from a potential supporter of a trading bloc approach into an active seeker of allies among American carriers (several of which were eager to make a deal). Through its alliance with USAir in 1992, BA made considerable progress toward its object of penetrating the domestic market in the US. Access to the USAir hubs in Charlotte, Philadelphia and Pittsburgh enabled it, by application of codesharing to selected routes, to weave a complex if fictitious set of "direct" connections between cities on its own network (such as Kirkwall) and points on USAir's network (such as Kalamazoo) that would cause travel agents using computer reservation systems 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 the "fortress hubs" that had been such a barrier to them at inland airports such as Atlanta and Dallas-Fort Worth. Purchase of voting stock in USAir to the maximum legally permissible allowed BA some role in shaping the American partner's strategy (though not much in sorting out its serious managerial problems).

> Europe are agreed as to how the pie will be cut up and allocated around the members before they clearly would be ready to enter into multilateral discussions.

("Airline heads suggest multilateral agreements," Aviation Week and Space Technology, 14 June 1993, p.43)

[31] "EU ministers to discuss air rights in June," Aviation Week and Space Technology, 20 March 1995, p.33.

[32] John D.Morrocco, "EC to Begin Aviation Talks with US," Aviation Week and Space Technology, 24 June 1995, 33.

Partly because USAir had a very limited international network, BA reaped considerable (and disproportionate) profits from the alliance. In 1994, BA 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. Indeed, the percentage of passengers on BA's US services connecting from 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%.[33]

BA's more recent decisions to create alliances (with America West and American Airlines (AA)) reflect a wish to increase its access to the west and south-west 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:

While the larger states and their conflicts with the US (and the European Commission) have attracted occasional media attention, the smaller European states have been very important not only in aviation diplomacy but also in developing the alliance systems that have effectively undermined the "trading bloc" approach to transatlantic air service. Indeed, these states have on the whole been more inventive and radical in their relations with US carriers than 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 had until March this year a specific arrangement with Virgin Atlantic). This alliance has developed a "blocked space" form of capacity sharing, under which carriers control separately-market allocations of seats on the same plane. Thus a joint flight from Atlanta to Zurich and Vienna carries 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. Further, it enables the cooperating airlines to avoid flying with empty seats, and also provides, via codesharing, a wider range of direct flights.

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[33] The continuing importance of connecting traffic is indicated in a recent remark by the chief executive of BA to the effect that "without its transfer services, 14 of BA's 22 services to the US would not be economical." Regarding a new service that KLM has started between Amsterdam and Memphis (a Northwest hub), a KLM official commented that it expected only about ten passengers a day from the Memphis area itself: the rest would come from connecting Northwest flights.

Formulas of this kind benefit countries with smaller markets that wish (or need) to maintain a significant presence on international and particularly long-distance routes. The national carriers in such countries cannot depend on domestic traffic (KLM, Sabena and Luxair have no domestic services at all). Yet some small countries do (partly out of necessity) support highly-successful international airlines: 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, an important business and financial center will generate considerable traffic, as will tourism (Swissair draws on both assets). In the cases of Belgium and the Netherlands, large stakes in the long-distance market are a heritage of imperial history and the commercial networks it has created.

While such airlines (and the states in which they are based) tend to be liberal in their approach to trade (including transportation), they 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 Royal Dutch Airlines was from the early seventies onward, a successful and even notorious practitioner of the first stratagem. An airline that had established even between the Wars a reputation for fast and efficient long-distance travel, it was the first European carrier to begin regular scheduled service to New York (in 1946). With the loss of the Dutch East Indies, KLM became more dependent on transatlantic services and 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 passengers, 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 - three years before BA - 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, say, Hamburg and Des Moines, Iowa, through Amsterdam. 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 of 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.[34] 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 neighbours. [The US is] luring individual states with the bait of access to its market while the opportunity lasts.[35]

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[34] The then-Transport Commissioner, Karel Van Miert, said diplomatically that he could "not criticize the Netherlands for getting the maximum advantage out of the existing situation," he warned that the US was pursuing a divide-and-rule strategy and that responses such as that of the Dutch might lead to "discrimination between ourselves in our own market"("EC to propose common civil aviation pacts," Financial Times, 10 September 1992, 2).

[35] "Closed skies over Europe," Financial Times, 10 September 1992, 14.

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. Between 1990 and 1992, traffic in the US-Netherlands market increased by 24% (that is, even before the open skies agreement took effect): it rose by a further 22% in 1993, and by 11% in 1994 [36] The number of transatlantic passengers flying through Amsterdam increased by 74% over a five-year period, reaching 2,400,000 in 1994.[37] The share of the US-Netherlands market in overall transatlantic service went up from 5.6% in 1978 to 6.6% in 1992, to 7.7% in 1993, and on to 8.3% in the first nine months of 1994: and in 1995 Amsterdam overtook Paris Charles de Gaulle as the fourth largest European transatlantic gateway.[38]

Commercially, the alliance was successful in increasing revenues, generating annually between $125 million and $175 million in new revenue for Northwest and $100 million for KLM.[39] It also captured (by one estimate) some $16.5 billion's worth of traffic from EU carriers and $25 billion's worth from US carriers[40]. Six EU and US carriers claimed in response to inquiries from the US GAO to have lost business to the NW/KLM combination, while a consultant's report estimated more precisely that US carriers were

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[36] Heini Nuutinen, "The North Atlantic market. Rationalising to profitability," Avmark Aviation Economist, April 1995, 3. On average, US-UK traffic rose by roughly five per cent each year, the German market by an average of one per cent, and the French and Italian markets by three per cent (in 1993, the number of passengers flying between the US and France actually fell) (ibid).

[37] Perry Flint, "If you can't beat 'em.." Air Transport World, May 1996, 41. In the summer season of 1994, Northwest had a load factor of 79.4% on transatlantic services. It and KLM began a new service between Amsterdam and Minneapolis in April 1994 with an initial 1,942 seats available each week. By mid-summer capacity had been increased to 9,758 in response to demand and in August a second daily flight was added on the route ("Northwest, KLM add Amsterdam flights," Aviation Week and Space Technology, 29 August 1994, 30). In 1993, Detroit and Minneapolis had increases in international traffic of 11% and 14% respectively, set against a national average of 4.9% (Harold Shenton, "Tracking the 1993 trends," Avmark Aviation Economist, August 1994, 14)

[38] Harold Shenton, "Codesharing only part of the big picture," Avmark Aviation Economist, May 1995, 2; Joan M.Feldman, "Some call it oligopoly," Air Transport World, May 1996, 46.

[39] Heini Nuutinen, "The North Atlantic market. Rationalising to profitability," Avmark Aviation Economist, April 1995, p.7.

[40] Nuutinen, "The North Atlantic market. Rationalising to profitability," Avmark Aviation Economist, April 1995, 3

collectively losing $25 billion in revenues to the alliance, while EU carriers were losing.[41]

CONCLUSIONS:

One incident in the history of the KLM-Northwest alliance is revealing about the changes that have overtaken EU-US aviation relations. Indeed, it may have been a watershed in the struggle between the trading bloc/single negotiator approach favored by the European Commission and the transatlantic alliance approach to which carriers with large stakes in intercontinental transport found themselves pushed.

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. Significant cooperation had already been achieved between SAS, Swissair, and Austrian, and the four airlines had reached sufficient agreement by November that they had collectively approached the US DOT to discuss 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 the group pick Northwest Airlines."[42] The other three airlines were reported that "the depth of KLM's commitment to Northwest came as something of a surprise."[43]

The collapse 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.[44] The cumulative power of these alliances then pushed BA into its new alliance with American, with BA publicly arguing that otherwise it would be "left on the shelf."[45]

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42 Carole A.Shifrin, "European carriers regroup as Alcazar hopes fizzle," Aviation Week and Space Technology, 29 November 1993, p.29.

43 Ibid.

44 See Perry Flint, "There's No Place Like Home," Air Transport World, November 1995, 44-54.

45 Robert Ayling, chief executive of BA, quoted in John D.Morrocco, "BA defends pact with American," Aviation Week and Space Technology, 15 July 1996, p.44.

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.[46] 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 disintegrated, and the North Atlantic market has been sliced laterally between a set of corporate alliance systems. These systems have been 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.

The negotiations to which the EU transport ministers have finally agreed 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 provide 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 on 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.[47]

Indeed, the focus of discussion on transatlantic aviation now seems to be shifting toward issues of competition policy and consumer protection, and away from the emphasis on protecting national markets and national carriers. The markets are penetrated, on both sides of the Atlantic: that is how the national carriers have protected themselves in the face of the liberalization and the deregulation that governments have forced on them. Instead, policy-makers will now have to face the implications of highly-rationalized alliance systems in which traffic is fed through a selection of international "fortress hubs" on both side of the Atlantic.

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[46] As one observer notes, the French government has recently vetoed any increases in services to Paris: "If this attitude persists, the US-France market will simply stagnate and more traffic will be diverted via other European gateways"(Nuutinen, "Rationalising to profitability," Avmark Aviation Economist, April 1995,4).

[47] "EU-US ASA principles," Avmark Aviation Economist, April 1995, p.9.

Through the electronic manipulations of codesharing, small towns will now 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 via Amsterdam to 107 European cities. This strategy offers altogether 21,708 permutations for connecting flights between "beyond" cities.[48]

Uncomfortable as travel on such a system may be for travellers required once more to pass through congested hubs, 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 that mileage.[49]

Such figures 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 be considering 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 travellers to enjoy the benefits of competition - the promise of both deregulation in the US and liberalization in the EU.

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[48] Perry Flint, "If you can't beat 'em," Air Transport World, May 1996, p.42. "Beyond" cities are cities lying beyond the main gateway hubs. The Delta/Austrian/Sabena/Swissair system will eventually offer 17,420 city-pair combinations - for example, Macon, Georgia, to Salzburg, Austria.

[49] John D.Morrocco, "BA defends pact with American," Aviation Week and Space Technology, 15 July 1996, 44.