

Airline Deregulation

Legal and Administrative Problems

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Preface

An outline and a questionnaire were sent out at the beginning of this exercise. They were drafted to be part of a general brainstorming. National and personal reporters were invited to pick and chose between the issues involved in the outline and to make contributions according to their own choice. When people respond to this kind of appeal the likely result will be a galaxy of reports, each written to cover a special field, but the reports will seldom be parallel in their structure or even overlapping. And so it happened in this case too. Had a more strict framework been set up in the outline and questionnaire, no doubt the general report had been easier to draft, but on the other hand it is less likely that so many reports would have been received. As it is, the reporter general is now blessed with next to 500 pages of reports coming from 16 different reporters and covering often widely differing fields. In this situation, the task of the general reporter is not to recapitulate them or digest them. The task is to build a coherent picture from the materials which they supply. In a way, they are replete with 'loose ends' and coherence can be found only by discovering connections of cause-and-effect between the various elements. Such connections make clusters and those clusters have been chosen to be the backbone of chapters, and each chapter means a discussion of a problem of a legal or administrative kind, brought about by deregulation. So creating deregulation is not the problem, that is largely something of the past. The general report deals with the *effects* of deregulation in the civil aviation world that saw the phenomenon being born.

As is natural, many of the reports center on Europe and the United States - after all, Americans represent about 40 % of all airline passengers, and Europeans about 30 %.¹ The major players on the scene, the United States,²

¹ Edwin McDowell, *BA and Chase Offer Air-Mile Credit Card*, International Herald Tribune 22 June 1993, p 2.

Germany,³ France, and the United Kingdom⁴ are all represented by National Reports, and so, too, are two minor European players, Greece and Sweden. Furthermore reports have been forthcoming centered on the European Community (now the European Union) and on the AMADEUS computer reservation system,⁵ i.e. one of the major CRS actors. What thus emerges has been put in the global perspective by National Reports from Argentina on the one side, and from the Far East and the countries “Down Under” on the other side, i.e. Japan, Australia⁶ and New Zealand. Unfortunately, some reports were received pretty late, one as late as in March 1994, and as a result their contents could not always, for lack of resources, influence fully the structure already erected when they were received. At times, too, the Reporter General resorted to supplementing the picture emerging from the report materials by collecting information on his own from available sources (mainly newspaper clippings and internal airline reports).

The General Report attempts to convey the accumulated information in a somewhat impressionistic overview of the field of problems assigned to the Reporter. It is thus not attempted to convey a complete picture and as to many more detailed issues it has been felt that they are much better studied in the National or Personal Report devoted to the issue, than in a - necessarily brief - restating of same in the General Report. It should be recalled that particularly extensive reports on the history of deregulation have been provided by Professor Reitz (U.S.A.), Professor Basedow (Germany), Professor Prosser (U.K.), Professor Jacqueline Dutheil de la Rochère (France), Mr Harbison (Australia) and Professor Brown (NZ).

The Term

1 The Term “Deregulation”

Deregulation is a misnomer.

No doubt, this study will substantiate that proposition in many ways. Nevertheless, we will keep the term “Deregulation”. This is so simply because the period in civil aviation history under discussion was initiated by the Airline Deregulation Act, 1978, in the United States, and even if deregulation is a misnomer it is certainly an identifying term for a great attempt at achieving more

² United States: see John C. Reitz, *Legal and Administrative Problems of Airline Deregulation*, 42 Am. J. Comp. L. (Suppl.) 419-451 (1994).

³ Germany: see Jürgen Basedow, *Airline Deregulation in the European Community - its Background, its Flaws, its Consequences for E.C.-U.S. Relations*, 13 J.L.Com. 247-277 (1994).

⁴ United Kingdom: see Tony Prosser, *Legal and Administrative Problems of Airline Deregulation in the United Kingdom*, in John W. Bridge et alii, eds., *United Kingdom Law in the Mid-1990s*, (United Kingdom Comparative Law Series vol. 15) 1994, pp 315-338.

⁵ M. and C. Caballero, *CRS Regulation versus Airline Deregulation*, Madrid, December 1993.

⁶ Australia: see Peter Harbison, *Legal and Administrative Problems of Airline Deregulation: Australia*, in Alice E-S Tay & Conita S.C. Leung, eds., *Australian Law and Legal Thinking in the 1990s*, (Faculty of Law, The University of Sydney) 1994, pp 299-324.

airline passengers at lesser ticket prices by leaving the marketplace to itself. But the Deregulation period did not mean that you got rid of regulations. Firstly, the field opened up for the application of more generic economic controls known as antitrust law which is a form of regulation although of a different character than the one with which the civil aviation authorities used to grapple. Secondly, by deregulation's own very success it brought about shortages at the airport and the ATC level which had to be addressed by the creation of regulations in the nature of rationing rules for the use of scarce resources. Thirdly, a new system of regulations was brought about by the arrival of a new technical instrument that was not there before, the computerized reservation system or CRS, essentially a distribution service, but the availability of this distribution service has become a matter of survival for airline companies worldwide (Caballero).

In this way, deregulation came to mean reregulation, by antitrust law, by airport slots law, and by CRS law.

In the process between deregulation and *reregulation*, however, one major achievement seems to get general support: the effect was "to expose much more clearly those shortcomings in the system which tend to limit overall system efficiency".⁷

Deregulation

2 *American Deregulation*

The Airline Deregulation Act of 1978 was one of a number of pieces of legislation which the U.S. Congress passed in the late 1970s and 1980s to reduce or eliminate governmental regulation of the economy. Economic deregulation was then seen as a generic cure to problems of American business and problems of economic regulation. Deregulation was introduced gradually, starting even before the passage of the Deregulation Act with a change in CAB policy in favour of giving carriers more flexibility to reduce fares. Looked at in retrospect in 1988, its history may be divided into three different periods: a "boom" period from 1977 to 1979, a period of proliferation from 1980 to 1985, and a period of consolidation from 1985 to 1987.⁸ During the "boom" period, fares came down, traffic increased significantly, and industry profits increased as more empty seats were filled. During the next period, new entrants kept up the pressure for low prices by introducing air carriage with fewer service amenities. By 1985, more than 20 new carriers had inaugurated interstate service. The last period has been a period of consolidation through merger and bankruptcy. By 1988, only a handful of the newly formed carriers were still operating independently.

Deregulation brought with it a change in the general pattern of domestic civil aviation in the United States by the development of hub and spoke route systems instead of criss-crossing city-pair flights. Normally, flying will include a stop at a hub between departure and destination. This arrangement offers passengers arriving at the hub relatively quick connections to many destinations, thus

⁷ Harbison, op. cit. (note 6 supra) p 300.

⁸ Reitz, op. cit (note 2 supra) p 421.

permitting the airline to serve a large number of city pairs with at most one-stop service through the hub in a manner far more efficient for the airline than maintaining a criss-crossing route system of direct flights between individual city pairs.

This system favours large airlines, because the number of city pairs that can be served through a hub and spoke system is increased. A carrier has to be fairly large in order to operate a hub at a major airport successfully. The hub and spoke system permits large airlines to realize very sizeable economies of scale. But hubbing also contributes to airport congestion because of its reliance on bunching arrivals and departures as close together as possible in order to maximize the number of convenient connections that can be made through the hub.

The eight largest airlines' share of the market grew from 80 % in 1978 to 95 % in 1992. The market share of the three major airlines - American Airlines, United and Delta - grew from 35 % in 1985 to 56 % in 1992. By 1992, the American airline industry had suffered more than 150 bankruptcies and 50 mergers.

The new system also affected American international aviation. TWA and Pan Am had been the major U.S. long-haul carriers. Both were replaced by the successful winners in the domestic deregulation game, the "Big 3". When Delta bought Pan Am's 32 transatlantic destinations, including its Frankfurt hub, Delta's frequencies on the North Atlantic doubled overnight from 92 to 195 a week. American Airlines which had only a handful of European services until its purchase of TWA's three main routes to London Heathrow, expanded to operate 234 weekly flights on 27 routes between European and American cities. Moreover, the Big 3 were different from their predecessors. Pan Am and TWA had had relatively skimpy U.S. route systems and thus resembled much their European counterparts in structure. The Big 3 had extensive domestic networks from which they could channel passengers onto their international flights to Europe. Delta could e.g. feed its trans-Atlantic services from more than 300 American cities.⁹

3 *Europe*

One of the visions which has inspired European civil aviation in the postwar period has been Europe as an entity equal to the United States at the other side of the Atlantic. Some of this vision has come to realization in the 1993 "internal market without frontiers". What remains in the blurred future is Europe as a single "negotiating entity" vis à vis the outside world. And that is the heart of the matter.,

What here is in issue has been labeled successively EEC, EC, and - now - EU. Sometimes it will here, when precision is not affected, just be called Europe, although this terminology does not do justice to the European fringe countries such as those organized in EFTA or belonging to the now defunct Socialist Camp.

⁹ Ron Katz, *U.S. Bilateral Agreements Hit Worldwide Turbulence*, International Herald Tribune 11 June 1993, p 11.

The basic instrument of this Europe is, of course, the Rome Treaty. Member States kept air transport out of the Treaty integration process as long as it was legally possible, thereby immobilizing civil aviation as far as integration was concerned. The period came to an end with the ECJ's judgment in *the French Seamen's Case*, 1974, in which it was suggested that the competition rules of the Rome Treaty should be applied by the Commission in the area, i.a., of air transport. This ruling gave rise to a number of complicated moves, and in the end the Council of Ministers was brought into action. At the Milan Summit of 1985, the Member States committed themselves to achieve the single European market by 1992, air transport being expressly included.

Overall plans for the development of an EEC air transport policy were presented by the European Commission in two so-called packages. It appears however that these two did little to set the process of liberalization in motion. Nothing is reported. "The truth of the matter is probably that the silence reflects that little did indeed happen" writes Mr Bruzelius.¹⁰ He finds the major reason for that in "that the first two reform packages did not cut the umbilical cord between the governments and their airlines, so that if two governments were not really committed to change - as rather few appear to have been - then not much could happen on the routes between the two countries."

The Third Package entered into force on January 1, 1993. It consisted of three EC Regulations. The first concerned the licensing of air carriers and set out uniform criteria for the issue of operating licenses to Community air carriers. Those meeting the financial and ownership requirements set out in this first Regulation were entitled to receive an operating licence from the EC Member State in which they were established. Member States were prevented from favouring particular carriers by issuing licences on a discriminatory basis. The operating licence in this way has turned into an all-purpose licence for provision of civil aviation services in the EC/EU. The second Regulation concerns route access within the EC for scheduled and non-scheduled air services. In general, Member States must allow EC carriers to exercise traffic rights on any routes within the EC. The bilateral network of capacity sharing agreements and discretionary route licencing disappeared in this context. The third and final Regulation concerned fares and introduced free pricing for scheduled services.

Various national efforts on the American pattern of deregulation - e.g. in Germany - were bypassed by the Third Package since being EC Regulations they had direct effect. No national measures of transposition were required. As a result the EC rules on access of EC air carriers to intra-EC routes, the licensing of EC air carriers, and air fares for services provided within the EC, apply in England, France and Germany, no less than in Greece.

The three Scandinavian countries, Denmark, Norway and Sweden, were however in a peculiar position. With SAS being viewed as an EC undertaking and Denmark being party to the first EC packages, air traffic operations of the same airline between the EC and Denmark were subjected to different rules than those applying to the airline operations to and from the other two Scandinavian

¹⁰ Nils Bruzelius, *Deregulation of Air Transport and Scarce Airport Capacity*, Paper for Conference on 'Legal and Administrative Problems of Airline Deregulation', February 23, 1994, p 14.

countries. Sweden and Norway therefor in 1988 approached the EC with a proposal for extending the EC aviation policies to be valid throughout the whole of Scandinavia. An agreement was reached in 1992, making some 20 EC legal instruments applicable in Sweden and Norway plus those parts of the Treaty of Rome required to operate the EC system, i.e. Articles 85, 86 and 92 with minor modifications. In 1993, a supplementary agreement was concluded providing for the incorporation of the third package. The supplementary agreement is to remain in effect until the EES Agreement has been expanded to incorporate the third package.

Reregulation by Antitrust Law

Under a regime lacking any direct economic regulation, the principal legal restrictions on behaviours that affect competition are the antitrust laws. Thus deregulation has meant reregulation by the antitrust laws.

In a couple of reports it is being discussed what this means reduced to the world in which deregulation actually has taken place. Professor Reitz provides the American picture¹¹ and Professor Basedow the European one.¹² Some of the major points are worthwhile recapitulating in the General Report although as to detail and complete history the reader must be referred to the two national reports.

Leaving a problem to the antitrust laws in the United States, writes Professor Reitz,

has distinctly less of the feel of a regulatory solution than it may have in some other countries whose antitrust laws are administered by a regulatory agency with broad power to exempt certain practices or companies from the antitrust laws in order to further the public interest. In the United States, the chief administrators of the antitrust laws, the Department of Justice and the Federal Trade Commission (FTC), are essentially prosecutors with no power to exempt firms from the antitrust laws. In addition, one must bear in mind the importance of private suits, stimulated by the provision for treble damages for certain types of antitrust violations. The result is that in the United States the courts, not the administrative agencies charged with general enforcement of the antitrust laws, have the primary function to decide how the antitrust laws apply.¹³

Before deregulation, the CAB had the sole authority to approve airline mergers and acquisitions. When the CAB was eliminated in 1985, the U.S. Department of Transportation (DOT) received the authority to regulate airline consolidation. In 1989, Congress transferred that power from DOT to the Justice Department, one of the two general enforcement agencies for the antitrust laws.

The fact that the eight largest airlines' shares of the market grew from 80 % in 1978 to 95 % in 1992, and that the market share of the Big 3 grew from 35 % in 1985 to 56 % in 1992, speaks out loudly about the failure of this system to do

¹¹ Reitz, *op. cit.* (note 2 *supra*) pp 419-429.

¹² Basedow, *op. cit.* (note 3 *supra*) pp 251-257.

¹³ Reitz, *op. cit.* (note 2 *supra*) p 430.

much about the progressive concentration in the U.S. airline industry which produced the U.S. giants, also known as the American ‘powerhouses’, so much feared at the other side of the Atlantic.

Professor Reitz is pessimistic about the future although now, due to changes at the highest levels of the executive branch, the antitrust laws are in place to prevent anticompetitive mergers.

[T]he chief damage has probably already been done. The industry has become significantly concentrated and the apparent failure of the theory that airline markets are freely contestable suggests that it is unlikely that new competitors will spring up to challenge the current airline survivors.¹⁴

Reitz proceeds with price-fixing, and he finds that

under CAB regulation of fares, the government itself in effect sponsored price fixing, subjecting the actual prices to regulatory scrutiny, to be sure, but also in effect forcing the public exchange of pricing information and clothing the whole process with immunity to antitrust liability.

The chief argument that the airlines have engaged in price fixing in the deregulation era depends on the way in which airlines transmit information about intended changes in their fares on the industry-owned computer service known as the Airline Tariff Publishing Company (ATPCO). Because each airline’s proposed fare changes are instantaneously transmitted to all competitors ...[and] relying on ... reports how the airlines further used the electronic clearinghouse for fares to communicate threats of fare wars in order to convert competitors that threatened price-cutting competition into price followers, [Alfred] Kahn concluded that the airlines were apparently engaged in both price collusion and predatory pricing.¹⁵

No official enforcement resulted, however; but the void was to some extent filled by private action and particular attention may here be paid to the class action finally settled in *In re Domestic Air Transportation Antitrust Litigation* (148 FRD 297 (N.D. Ga. 1993)).

As to predatory pricing, the antitrust proscriptions do not appear to have functioned as a very significant restraint on airline behaviour. No governmental enforcement actions have taken place and the few private actions that came to light were not successful.

Consequently, to the extent that enforcement of the antitrust laws has meant reregulation, this reregulation has not meant much in practice.

On the European side, the antitrust equivalent is found in the Rome Treaty, Article 87, but it has been handled by way of block exemptions. Under the powers of Regulation 3976/87, the EC Commission in fact issued three block exemptions in 1988, one on CRSs, one on ground handling services, and the third “guided several issues which covered practically the remaining fields”.¹⁶

¹⁴ Reitz, *op. cit.* (note 2 *supra*) p 432.

¹⁵ Reitz, *op. cit.* (note 2 *supra*) pp 432-433.

¹⁶ Basedow, *op. cit.* (note 3 *supra*) p 262.

As an antitrust device, in the opinion of Professor Basedow, the block exemptions were counterproductive because they meant that the EC Commission itself got involved into the anticompetitive practices.

With regard to both tariff consultations and consultations on slot allocation and airport scheduling the Commission grants an exemption only on condition that it is given 10 days notice and is entitled to send observers. Such participation in the consultations and negotiations of the cartel is highly questionable. It will inevitably entail a very subtle involvement of Commission officials and will burden them with some responsibility for the resolutions of the respective conferences... The rules pertaining to the participation of the cartel office in the negotiations of the cartel appear to be taken from a textbook on regulation theory. Until they are finally offered a job on the board of an airline, the close contact between companies and agencies turns the investigating officials into captives of the industry.¹⁷

Professor Basedow observes that “the road towards a lasting exemption has already been paved”.

“Presently, a complete termination of all block exemptions is no longer being discussed, instead the Commission is drafting a final text which will allow for at least some formerly regulated market behaviour to be governed by airline agreement and cooperation. Therefore, a provisional exemption will be transform into a permanent exemption.”¹⁸

In fact, block exemptions are used as a functional substitute for market regulations and Professor Basedow thinks that such disguised regulations must not be enacted on the basis of Art. 87 of the Rome Treaty.

It is noteworthy, that the kind of consolidation that was experienced in the United States in spite of the reregulation by antitrust laws, has not occurred in Europe so far. It is however difficult to credit the EC regime for that. Rather the resistance appears to have something to do with the insistence on national ownership and control that lingers on under the protection of the remainders of the traditional regulatory system.

Slots

1 The Problem

The problem is relatively new. It follows from the gradual congestion of airways and airports. Traffic growth which after all is one of the goals of deregulation has not everywhere been matched by appropriate expansion of air navigation and airport facilities, rather there has been a certain diminution of the facilities by night curfews imposed for environmental reasons, and by the expansion of hub and spoke organization among airlines which deregulation has promoted.

¹⁷ Basedow, op cit. (note 3 supra) p 262, 263.

¹⁸ Basedow, op. cit. (note 3 supra) p 262.

Evidently the problem of slot allocation is to that extent a false problem inasmuch as if the scarcity of airport capacity is cured, this would also cure the problem. Nevertheless, today and for some time back slot allocation is a very real problem for airlines. To this, a number of pragmatical solutions have been tried, none with perfect success. The solutions have been partial and empirical, leaving a number of legal and other basic questions unanswered.

Scarcity creates value, and an economic value attached to a facility must enter a system of law, or alternatively, a system of law must be created to regulate the grant, withdrawal and usage of this facility. But this has not happened, and the lack of a clear legal assessment and definition has opened a broad spectrum of problems. The legal aspects are coupled with political and diplomatic difficulties, emerging from inconsistencies between the denial of slots and the traffic rights otherwise conceded to the airlines concerned, according to national licences and regulations, bilateral air services agreements, governmental air policies and the like. Evidently, suspicion of discrimination of various kinds can not be far away.

In fact, it has been suggested that 83 % of the United Kingdom market could not be deregulated for the simple reason that it is subject to *de facto* regulation by way of slot constraints.¹⁹ Slot constraints also tie down the smaller airlines by making them unable to build hub and spoke networks, which have been such an important result of deregulation.

2 IATA

The self-regulatory system built by the airlines within the framework of IATA also included a system with an IATA “scheduling committee” at major airports, created with a view to ensure a better spreading of the flights over the day. This system is believed to date back to 1947²⁰ and it was mainly a European system, also used in other parts of the world but less so in the United States. In the scheduling committee potential problems between airlines at particular airports were sorted out on a reciprocal basis. Resulting schedules were then submitted to respective aeronautical authorities for approval. The approval of the schedules almost automatically entailed the approval of the pre-arranged slot allocation at airports. Indeed, airport authorities generally rubberstamped the IATA draft which reflected agreement between the most interested parties: the operating airlines. The system was voluntary, and was undertaken entirely by the airlines themselves. At each major airport there was a coordinator responsible for the work, who was appointed by the major airline at that particular airport. At Arlanda, Sweden’s only slot-constrained airport, SAS used to provide the coordinator.

The main allocation principle of this IATA system was the so-called *grandfather right*. Under that system, an airline that held slots was entitled to retain them in subsequent seasons as long that it used them. Exchange of slots without a consideration was permitted. According to IATA guidelines, ‘no

¹⁹ Prosser, op. cit. (note 4 supra) p 335.

²⁰ Bruzelius, op. cit. (note 10 supra) p 17.

show' cases, i.e. failure to use a slot, were to result in a loss of the historical right during the following corresponding season, but it appears that this rule was never imposed. Few airports had any monitoring system in place to establish whether a slot was used or not. Such a system had little welcome for new entrants, privilege was reserved for the established operators.

3 *Europe*

Slot allocation is a major problem affecting market access in countries such as the United Kingdom, Germany, Italy and, to some extent, France. It was one of the problems affecting the negotiations between the United States and the United Kingdom for the conclusion of a bilateral air services agreement in 1991. It also naturally affected the EC developments.

Commission Regulation No 2671/88 of 26 July 1988 had established the principle that arrangements between carriers on slot allocation at airports can be accepted if all the air carriers concerned can participate in the negotiations, and if the allocation is made on a non-discriminatory and transparent basis. The conditions of the exemption from the prohibition set forth by Art. 85 (1) of the Rome Treaty were spelled out. It may perhaps be assumed that the EC decided on the IATA-system in this way as it entailed the preservation of a system that had worked satisfactorily in the past and was endorsed by most of the airlines. In effect, the IATA scheduling process with its shortcomings in relation to new entrants was not inhibited but transposed at an airport committee level for each coordinated airport and the coordinator takes the responsibility. Grandfather rights were protected and only unused right could be withdrawn.

Nevertheless, it was evident that the liberalization objectives could be frustrated by the congestion problem. Consequently, a Code of Conduct on slot allocation was produced almost instantly by the Commission and on December 18, 1990, it was sent to the Council.

When the 1988 Regulation was due to expire, it was replaced by another set of rules. Council Regulation No 95/93 of 18 January 1993 on common rules for the allocation of slots at Community airports provided a new set of "neutral, transparent and non-discriminatory rules". A novelty was that it is up to the national authorities to decide whether to coordinate an airport or not. The guiding idea was that Member States should designate some airports as "coordinated" and appoint a neutral coordinator for each coordinated airport, and avoid subjecting slot allocation to market forces or leaving it entirely to administrative arbitration. The Member State is thus responsible for the grant of airport slots on the basis of objective criteria following the principles of neutrality, transparency and non-discrimination. The independent coordinator thus appointed is charged with sharing out the slots among the air companies. The new Regulation provides for the establishment of a "coordination committee" to assist the coordinator in a consultative capacity. As to the process of slot allocation (apart from the slot pool situation), the grandfather rule remains in place; a slot that has been operated by an air carrier as cleared by the coordinator "shall entitle that air carrier to claim the same slot in the next equivalent scheduling period" (Art. 8 (1) (a)). At coordinated airports, a pool is set up to contain newly created slots, unused slots, and slots which have been

given up by a carrier during, or by the end of, the season or which otherwise become available. Slots not utilized are placed in the appropriate slot pool. A slot has to be used at least 80 % of the time during the period (season) in question, if the historical right to the slot during the equivalent next season is to be protected. The EC Regulation requires that 50 % of all available slots shall be earmarked for new entrants. The EC Regulation defines a new entrant as an airline with fewer than four slots for a particular non-stop service between two Community airports, which is also offered by at least two other carriers.

The EC procedures are today in operation at 21 of the 24 major EC airports. Not included are Schiphol, Nice and London Stanstead. A substantial number of the secondary airports such as Birmingham are also subject to administrative rationing. The privatization of the major UK airports has not changed the system for the allocation of slots. The international and national scheduling committees retain their roles.

The Code of Conduct being an EC Regulation is directly applicable all over the Community.

4 *The United States*

Discussions between airlines relating to routes and services raise issues under the American antitrust laws. Scheduling committees of the IATA type consequently cannot work unless given antitrust immunity. The CAB used to grant such immunity pursuant to Sec. 414 of the Federal Aviation Act, 1958, under certain conditions, essentially to the effect that it could not be proven that the practice constituted a direct barrier to entry but it did entail public benefits. As a result, the allocation of slots was governed by the historic operating pattern and no problems were felt since it all took place in a tightly regulated environment.

In 1969, a slot system was imposed upon the American mega airports Washington National, O'Hare International, LaGuardia, Kennedy International and Newark International (but Newark was dropped from the list in 1973) by the FAA's High Density Traffic Airports Rule. In terms of the Rule, limitations were imposed on the number of IFR operations which may take place during a given period of time, and each such operation - a landing or a take-off - during a specified period of a day each day of the week, became known as a *slot*. Airport scheduling committees, comprising representatives of the airlines making use or wishing to make use of the airport, were established in order to allocate the slots. The main criterion for a decision on allocation was that of unanimity - all the participants had to agree on a proposed schedule. The committees worked under the supervision of the FAA, which had the power to step in and decide on an allocation, in the event of a committee not reaching an agreement.

Like lease rights to gates, the right to slots came to function as a type of operating certificates, preventing carriers without slots from operating at airports where they were required.

The work of the committees was put to severe tests by deregulation, 1978. The CAB's reaction was not to permit the antitrust laws to restrain abuses by the scheduling committees but to give them antitrust immunity in spite of recognizing their anticompetitive effects. Despite their immunity, difficulties in

agreeing on slot allocations resulted in scheduling committees ceasing to function.

The ATC conflict in 1981 put the system under more strain. The dispute between the air traffic controllers and the Federal Aviation Authority in 1981-1982 forced the FAA to suspend the High Density Rule and implement an Interim Operations Plan which applied to all in all 22 airports during the period up to 1984. In terms of the Interim Operations Plan, allocation of slots was determined on the basis of grandfather rights, i.e. an airline could retain its slots as long as it wished to. During the period 1981-1982, the airlines were also allowed to sell slots, but during the period 1982-1984 only voluntary transfers without considerations were allowed.

In 1984, the High Density Rule was reactivated at the four mega airports, and the airport committees resumed their work. New stresses developed, and with effect from 1 April 1986, a new system was introduced for the allocation of slots in domestic aviation. Two features of the new approach stand out, viz. (a) that the initial allocation would be 'grandfather' slots to airlines holding them at the time, and (b) that a relatively unrestricted aftermarket in slots would be permitted. As a result, the FAA's rules meant that the slot allocations each airline had on 16 December 1985 from then on were permanent. Instead of an administrative allocation, a market allocation of slots was introduced providing that the slots may be "bought, sold or leased for any consideration and any time period". In order to induce sales of underutilized slots, the "buy-sell" rule included a "use-it-or-lose-it" provision, pursuant to which an underused slot reverts to the FAA to be redistributed by lottery.

In this way, slots became valuable rights which dominant airlines at hubs were tempted to hold. The lotteries, that were created in an attempt to correct the system, were made for new entrants and based on slots taken from the dominant carriers. The use-it-or-lose-it rule meant that slots not used 65 % of the time in a two-month period were to be returned to the FAA which put them into the lottery procedure. In the lottery procedure, 25 % of the new slots were earmarked for new entrants. "Slot committees" soon became trading markets, from which winning new entrants could benefit financially. The freedom to buy, sell and lease slots granted to the airlines, had no time limit. The slots obtained by new entrants consequently could be resold for good value whenever the new services turned out to be uneconomic. As a result, slots kept ending up in the hands of large airlines.

Since no other specific measures were taken in the United States to address the problem of traffic congestion, the system meant that at all other airports than the four abovementioned mega airports, the scarce capacity was in effect allocated through queuing. While this queuing long was airborne, incoming aircraft being stacked up in the air, the U.S. Federal Aviation Agency in response to the air controllers strike in 1981, developed the system of *Flo Control* to battle backups caused by a shortage of airport gate space on the ground. The Flo Control means that queuing is normally confined to the ground ; an aircraft is not allowed to depart until it can be established that it can proceed all the way to the next airport without delays en route., The rationing of take-off and landing is done on a "first-come-first-served" basis. Outgoing aircraft line up on the taxiways, and incoming aircraft are delayed at their departure airports.

In such a system, one might say that informal slots are allocated according to which airline is willing to waste the most time and fuel.²¹

The “buy-sell” rule did not work as expected. Few airlines were willing to sell their slots. Most transfers were by lease for limited periods of time. In order to avoid losing slots under the “use-it-or-lose-it” rule, airlines were tempted to operate flights even if unable to cover variable costs. Although such behaviour would seem to raise issues under the antitrust rules against monopolization, no public or private enforcement actions have been reported. It has been advocated to scrap the system of slots altogether, and replacing it with a system of variable landing fees.

Finally, it should be mentioned that slots for international operations were subject to special allocation provisions due to the obligations imposed by the bilateral air services agreements.

CRS

1 Introduction

A pocket size printed timetable which is easily reprinted when necessary, will suffice in a small air passenger market coupled with newspaper advertising as the main way of distributing information about new fares. Dr Caballero describes the old pattern:

Until relatively recent times, distribution facilities in the air transportation industry have been quite simple. Once the traveler had selected a specific carrier, he would go to the sales office of the Airline, get information on the available flights for the chosen destination, make his reservation and purchase his ticket. He could also go to a Travel Agency, where he would usually get advice on the existing alternatives for his planned trip based on the information provided by travel guides, schedules and fares published, individually or collectively, by the Air Carriers. Before the appearance of the CRSs, Travel Agencies would usually use the Official Airline Guide (OAG) or the ABC World Airways Guide as their main source of information, to plan and provide fare quotation of air transport services required by their clients. Once a decision was made, the Agent would phone the Airline(s) so as to make the necessary reservations, and issue the flight ticket(s) by filling in the requested information manually.²²

In today’s world, it is rather different.

During the 1960s, breakthroughs in the computer industry and the availability of high speed telecommunication networks radically changed the work conditions. In the United States, the emergence of CRS technologies transformed the playing field of commercial aviation. The rest of the developed world followed. The CRSs became an irreplaceable working tool for Travel Agencies, which got immediate access to a wide inventory of services offered by companies involved in the travel and tourism industry, most importantly offering

²¹ Reitz, op. cit. (note 2 supra) p 424.

²² M. & C. Caballero, op. cit. (note 5 supra) p 4.

them the ability to immediately carry out commercial transactions with the users of those services, thereby increasing their sales volume to an extent otherwise unattainable. The CRS phenomenon has resulted in a substantial amount of direct reregulation, and to the extent that its appearance is coupled with deregulation of air services this reregulation is most relevant to our topic. Writing the following account of what happened has been very much facilitated by the extensive reports on the matter contributed by Professor Caballero (AMADEUS) and Professor Reitz (U.S.A.).

2 *A Bit of American History*

American and United Airlines pioneered industry-wide computer reservations systems (CRSs) in the early 1970s, investing heavily in software and subsidizing both training and hardware costs for travel agents. American Airlines' system was called *Sabre*, United Airlines' was called *Apollo*. As defensive measures, rival systems were created by Eastern (System One), Delta (Datas II) and TWA (PARS). The bewildering competitive pressures spawned by deregulation in the United States made it imperative to develop those sophisticated reservation networks. One may say that the CRS became very important in the deregulated period because only through a CRS could a travel agent keep abreast of rapidly changing rates, especially in light of the industry tendency toward proliferation of special fares with many special conditions. Moreover, the CRSs enlarged their applications and field of activities. To the task of booking seats on flights was added to calculate fares, issue and print tickets and boarding cards, carry out combined reservations in hotels or ground transportation, arrange specific terms and conditions for payment of services, etc. And on the top of this, the CRS became an essential tool for establishing the most suitable marketing policies, and identifying the most convenient global strategies, based on the resources available and the objectives of each company.

Equally important to the growth was that American and United Airlines came up with the *Co-host* concept, because that altered many carriers' plans to enter the market with their own CRS systems. In essence these CRS owners said to the major non-CRS airlines: Too many systems will simply confuse your travel agent in an already complicated situation. These systems are expensive to develop and difficult to market. We will share our systems with you. We will make you participating carriers. When it was agreed to share true ownership with certain U.S. air carriers at such time as those carriers brought the agency base and revenue up to certain stated levels, the sense of partnership increased.²³

These Co-host agreements had important effects. They inhibited the development of potential competition while they increased the value and functionality of the host carrier's CRS. As each Co-host (or participating airline)

²³ Cf R. Fahy, *Regulation of Computerized Reservation Systems in the United States and Europe*, in F. A. van Bakelen & R. Fahy, *Rushing Into a New Area – Airlines' Computerized Reservation Systems*, Seminar on Aviation Law, Rotterdam 10 October 1986, (Aerovision Consultancy Publishing) 1987, p 22. See also Paul V. Mifsud, *A Short Course in Automated Airline Marketing - Can U.S. Antitrust Laws Keep the U.S. Air Transportation Distribution System Open?* (paper delivered at same seminar) p 5.

added its displays and technical support, the host CRS became more universal, and the fees paid by the co-hosts enabled the CRS owners to finance more development of the system. Sabre and Apollo grew into true industry systems as a result of the co-host concept

When these massive investments were made in the new computerized system, it was done on the assumption that a company owning a CRS had the right to display, with a certain superiority, its own 'offer' as compared to the offers inventoried by third parties who are users of the system. It was assumed that the owner had the right to freely accept or reject 'third parties' who might wish to display their offers through their systems, and it was assumed that the owner had the right to establish, at his own discretion, terms and conditions for the participation of third parties in the system, following the rules of supply and demand in a totally free and deregulated market.

However, other forces rose to challenge these assumptions. Among these forces, the interests of the *consumer* became the epicenter. The consumer is privileged inasmuch he need invest no effort, nor bear any responsibility or obligation. His interests nevertheless attract attention and find protection. The interests of the owner are also challenged by those of the travel agency and they include, naturally, to get a bigger catalogue of products, higher productivity and more sophisticated administrative and business controlling tools, for free if possible at all. The third bunch of challenging interests belong to the third party 'suppliers' who offer their services through the CRS without any risk attached.

The interaction between all these forces resulted in reregulation, and the reregulation in turn forced some of the actors into rethinking the usefulness of such investments.

Ownership of a CRS gives substantial benefits to an airline because it will charge the other airlines and travel agencies (third party 'suppliers') a booking fee for each reservation made for one of their flights and these fees are thought to be well in excess of the cost of the service provided. That a CRS in this way is a very lucrative business does not seem to be in dispute. Looking at it the other way round, getting dependent upon somebody else's CRS without being able to control price must be dangerous. Moreover, a number of seemingly secondary features have become strategically important in the aviation world and have transformed the playing field. It is the world *as seen on the display in the CRS terminal* that has become the reality, much more than the actual flying up in the blue. And it is the transparency to the CRS owner of all the operations of those who offer their services through the CRS that makes the latter apprehensive of the new dimension and governs their behaviour.

In its "last significant regulatory act" the CAB adopted CRS regulations in 1984. They were originally set to expire on December 31, 1990, but the U.S. Department of Transportation - DOT - succeeding to the CAB's power in the area, has amended and extended them a number of times, most recently at the end of 1992.

From the outset, the regulations have prohibited *display bias*, i.e. the practice of putting the owners' flights first. What is in issue is perhaps best conveyed by a quote from Mr Jeffrey N. Shane, U.S. deputy assistant secretary of state for transportation affairs, made in an exchange with the Europeans back in 1988.

Just to test the efficacy of Iberia's CRS, "he said,"we pretended that a business traveler in Madrid was booking a long and complicate itinerary, one segment of which required travel from New York to Paris. In a matter of seconds, the computer produced the booking; it put the traveler on Iberia from New York to Madrid; and then on Iberia from Madrid to Paris. The CRS offered not even a hint that French and U.S. airlines also offer some service in that market.²⁴

There is evidence that travel agents generally book the first suitable airline flight they can find on the CRS. Display bias meets this by putting the owners' flights first in the lists of flights displayed on the computer monitors for a given market. Before 1984, CRS owners in the U.S. sold display bias as a separate, optional service to other carriers listing their flights on the owner's CRS, and it happened that the profitability of a CRS was openly attributed to display bias.

CAB's 1984 regulations tried to ban the practice by prohibiting CRS displays from ordering flights on the computer screen on the basis of carrier identity and requiring that the ordering be done according to service criteria that are consistently applied to all carriers. This remains in the regulations. However, the CRS owners found a way around the rule by creating a second screen that was fully biased in favour of the CRS owner's flights plus an optional device to permit travel agents to lock on the second screen, thereby totally bypassing the first. Using this device was tempting inasmuch it made it easier for the agency to earn travel agent *commission overrides* - a term that calls for an explanation.

Commission overrides are the bonuses offered to travel agents for booking in excess of certain predetermined levels of sales. Travel agent compensation comes principally from commissions paid by each airline on their tickets the agent sells. Commission overrides are extra commissions the airline pays as an incentive for the travel agent to sell more of its tickets. Incentives for travel agents to use a particular airline are important because the percentage of airline tickets sold through travel agents has substantially increased since deregulation.²⁵

The regulations have been amended to prohibit also biased second screens.

Since travel agents are known to make the vast majority of bookings from the first few lines on their screens, airlines consider it crucial to get to the top of the list. There are various ways to do this. One of them is *code-sharing*. This is the practice whereby two airlines combine to put the same code on a flight involving a change of carrier and aircraft. To the passenger, it appears as a direct flight or a transfer within the same airline. More importantly, however, it appears that way to the computer, which then gives a priority listing ahead of flights involving a change of carrier. Code-sharing has become the keyword to the new scenery of international civil aviation.

The turning to *hub-and-spoke* organization of airlines has also come to affect the CRS picture. The keyword is here *connecting point bias*. Every CRS has to have a system for choosing connecting or double connecting flight combinations to list in answer to a query for flights between two given cities. But the hub-and-

²⁴ Barry James, *Airlines Gird for Battle Over Booking Systems*, International Herald Tribune 21-22 May 1988, p 1.

²⁵ Reitz, op. cit. (note 2 supra) p 426.

spoke route systems reduces the number of city pairs served by direct flights and therefore increases the importance of connecting flight combinations. This is particularly so in the United States, where the hub-and-spoke system has become much more deeply entrenched than in Europe. In Europe, hub-and-spoke operations existed long before deregulation, but they were of a different kind. SAS would combine all its major routes at its Copenhagen hub, thereby succeeding to feed in particular its transatlantic routes by the connecting flights and bypassing fifth- freedom limitations. But, as Basedow points out,²⁶ when such feeder services only extended to the national markets, the spokes of the European hub-and-spoke systems were short and domestic and not very important. If this were to change in the new European context - as Basedow discusses²⁷ - it will any way encounter the effects of the European air policy promoting direct interregional hub-bypass routes.

It has been different in the United States. Major U.S. carriers have concentrated their resources at relatively few hub locations and, therefore, have a vested interest in funneling passengers through them for onward connecting flights, rather than bypassing them with direct services between smaller towns. Now, CRSs generally use a limited number of connecting airports or pairs of connecting airports to construct the alternative connecting flight combinations for consideration and it is an easy matter for the CRS owner to bias the selection of connecting airports to favour its hubs.

The U.S. regulations seek to prevent connecting point bias primarily through the same rule as in the case of screen bias. A CRS is not permitted to use "any factors directly or indirectly relating to carrier identity in constructing the display of connecting flights in an integrated display." Moreover, the selection of connecting flights must be based on "service criteria that do not reflect carrier identity and that are applied consistently to all carriers..." To police this rule, the U.S. regulation also requires CRS owners to disclose the method used to choose connecting points for their CRSs and gives non-owner airlines listing their flights on a given CRS rights to influence the choice of connecting points.

A look at the latest U.S. regulation - DOT Computer Reservation Systems Final Rules, issued 17 September 1992 to be in effect through 1997 - will convey some understanding of other believed abuses and how they are counteracted in the American system.

The revised rules will prevent CRS vendors from denying their subscribers the option of using hardware and software acquired from independent firms for CRS services as well as the option of using agency-owned CRS terminals to access other systems and databases. DOT hopes that this will allow travel agencies to operate more efficiently and obtain better information for their customers. The new rules also will allow carriers to set up direct links between their internal reservations systems and travel agencies, thereby creating an alternative means of obtaining bookings without paying booking fees.

²⁶ Basedow, op. cit. (note 3 supra) p 267.

²⁷ Basedow, op. cit. (note 3 supra) p 268.

3 *Fighting the U.S. Giants - The World Seen From Europe*

The American experiment with deregulation resulted in the three U.S. giants being born: United Airlines, American Airlines and Delta Airlines, the Big 3. Everything seemed to work to their advantage. They emerged from deregulation with enormous domestic networks into which they suddenly were able to plug also international networks. They were very different from their grand predecessors in the international field, Pan American and TWA which only had operated international networks and had almost no domestic route system. When the Europeans tried to draw the proper conclusions from what had happened, what emerged was the need for a very strong home market where the European airline in question was supreme. Only in this shape could a European airline hope to be able to compete with the U.S. giants – “One of Five, Ninety-Five” was the SAS slogan coined to bring this truth to the airline employees. Only five big European airlines would survive and the SAS should be one of them. But building such giants was exactly the opposite to the goal set for the European common air market, a place envisaged as being full of competing airlines where competition depressed the air fares to the benefit of the European air travellers.

The advent of the American CRS systems must be seen in this context.

In 1986, *Apollo*, the CRS owned by United Airlines, and *Sabre*, an equally large CRS owned by American Airlines, together commanded about 75 % of the U.S. travel agency market. According to a report made by the U.S. Department of Justice in 1985, the Sabre system received 46 percent of the revenues from the travel agency market and the Apollo system received 28 percent.²⁸ These two mega-systems launched an assault on the European travel industry. By that time, Apollo and Sabre represented a decade of work apiece and at least US\$500 million of investment by each airline. Sabre had 50.000 terminals in 12.000 travel-agency offices worldwide. An agent looking into Sabre could find schedules of 650 airlines around the globe and make reservations on more than 300 of them, with direct access to the internal data banks of 13 airlines, including British Airways, KLM and Air France. By 1986, European airlines feared that Apollo and Sabre would seize control of the travel-booking business at European agencies which after all arranged some 80 % of travel for the European industry. They were far behind in developing competing systems of their own. What they had was largely internal inventories allowing access for outsiders at a price (Lufthansa’s START, SAS’s SMART, BA’s and British Caledonian’s Travicom, Sabena’s and Air France’s Saphir).

In November 1986, some 20 European airlines agreed to start a feasibility study of the possibilities of creating in common a system of their own envisaged as the GDS or Global Distribution System. The airlines soon fell apart however and out of the turmoil came two systems: *Amadeus* that was set up in August 1987 by Air France, Iberia, Lufthansa and SAS, later joined by four smaller carriers (Braathen, Finnair, Linjeflyg, Air Inter, Icelandair, Adria Airways and JAT); and *Galileo* which was formed about the same time by British Airways,

²⁸ Martha M. Hamilton, *U. S. Airlines: The Digital Dogfight. Battle Heats Up Over Computer Reservation Systems*, International Herald Tribune 9 July 1987, p 9.

KLM and Swissair and later joined by Alitalia, Austrian Airlines and Air Portugal, and in 1988 by Olympic. Both systems considered teaming up with American partners, Amadeus with Sabre although the plan eventually collapsed (1991). System One taken over by Texas Air from Eastern, provided software for the Amadeus system. Galileo bought a half-share of the Apollo system, the other half of the joint venture being held by Covia Corp., and changed name to Galileo International.

A similar development took place in the Far East. Early plans by countries in Asia and the Western Pacific to develop a common airline and travel booking network to counter the power of giant CRS's in the United States and Western Europe were aborted. Instead of a single Asia-Pacific CRS, at least two rival groupings emerged, each of which was connected to competing American networks. The *Abacus* system was founded by Singapore Airlines and Cathay Pacific Airways (Hong Kong), later joined by a number of smaller airlines. Qantas Airways of Australia started the second CRS, known as *Fantasia*. Abacus acquired a share of PARS, the CRS operated by Northwest Airlines and TWA. Qantas' *Fantasia* was based on Sabre, the CRS operated by American Airlines.

One of the dominating considerations behind this activity was the fear that if one of the big American CRSs became dominant in Europe, e.g. American Airlines' Sabre, that might force a European carrier to sell its services via the foreign system, thus losing control over its distribution costs. It might also give American Airlines an insight into all the marketing strategies and possibilities of the European carrier.

Not only would the U.S. carrier be able to boost their own ticket sales and charge the European airlines for making bookings on their own flights, but also they would gain valuable information on the European carriers' schedules, fares, routes and traffic patterns. Such information could give them a huge advantage in competing with the European carriers.²⁹

The American CRS looked like a Trojan horse.

Thus the European airlines were racing to install their two systems that between them were expected to handle business valued at US\$ 1 billion by 1992, when the European Single Market should enter into force. In the meantime, it was attempted to prevent American Airlines from expanding the Sabre system into the European market. One way of doing this was by refusal to allow European tickets to be issued on the Sabre system.³⁰

²⁹ Susan Carey, *Europe's Airlines Find U.S. Booking Systems Are Making Inroads. Carriers Agree to Study Plan To Develop a Program As Rivals Gain Advantage. But Efforts May Be Too Late; Terminal Battle: Europe's Airlines May Be Too Late To Meet Challenge From U.S. in Booking Systems*, Wall Street Journal 21 November 1986 p 1, 22.

³⁰ Fahy, op. cit. (note 23 supra) p 31.

4 *CRS Regulations in Europe*

The first draft regulations of the European Commission, concerning the application of the Rome Treaty to the air transport industry, did not even mention CRSs. At the time when the Council's Air Transport Policy was born, however - the 1987 civil aviation package - the Commission could not help see the need to support the enormous efforts required for the creation of systems capable to compete with the American giants. The result was a *block exemption regulation*. Council Regulation (EEC) 3.976/87 of 14 December 1987, concerning the application of Art. 85 (3) of the Rome Treaty to certain categories and concerted practices in the air transport industry, enabled the Commission to declare, by way of Regulation, that the provisions of Art. 85 (1) should not apply to certain categories which have as their object the common purchase, development and operation of computer reservation services. Commission Regulation (EEC) 2672/88 of 26 July 1988, was the result. Mr Caballero is of the opinion that

the main reason of granting a block exemption to this category of agreements is based on the fact that no European airline is capable, on its own, of making the investment and achieving the economies of scale required to compete with the more advanced existing systems ; therefore, the only alternative to foment the creation of European systems was to authorize the cooperation between interested carriers.³¹

This Regulation entered into force on 30 August 1988 and expired on 31 January 1991. It was replaced by Commission Regulation (EEC) 83/91 of 5 December 1990 which renewed the block exemption with minor changes.

The coverage of the exemption was not 100 percent however. In the *Sabena Case* (Commission Decision of 4 November 1988 relating to a proceeding under Art. 86 of the Rome Treaty (88/589/EEC) an investigation was initiated as a consequence of London European Airways claiming that Sabena, by refusing to grant access to the Saphir system, was using its powers in the CRS market in Belgium to impose minimum fares on London European, or was attempting to make entry to the Saphir system subject to acceptance by London European of services which had no connection with the CRS system. The Commission concluded that Sabena had infringed Art. 86 in that, holding a dominant position on the market for the supply of CRS in Belgium, it abused its dominant position on that market by refusing to grant London European access to the Saphir system on the ground that the latter's fares were too low and that London European had entrusted the handling of its aircraft to a company other than Sabena, adding also that trade between Member States had been affected by Sabena's abuse of its dominant position, and imposing a fine of 100.000 ECU on Sabena.

In July 1989 the EC Council adopted a Regulation on a *Code of Conduct* for CRSs intended to eliminate discrimination in access to and participation in all CRSs used for scheduled passenger services in the EC. This Code, which much

³¹ M. & C. Caballero, op. cit (note 5 supra) p 28.

reflects the rules of the U.S. DOT, requires any airline to be allowed to participate on equal and non-discriminatory terms, on a non-exclusive basis. The Code of Conduct came into force on 1 August 1989, but one of the main objectives of its enactment, specifically the introduction of the so-called neutral primary display, built according to a precise algorithm which should rank the flights according to the criteria set forth in the Annex to the Regulation, had to be postponed because no CRS operating in the Community was able to meet such requirement from the very first day of the application of the Regulation. As a result a blanket waiver was introduced in the Code concerning the obligations related to the required neutrality of the principal display.

This Code of Conduct has subsequently been substantially amended with the notions of *de-hosting*, both in a technical and a legal sense, as well as *compulsory participation* now being fully incorporated in its text. These two principles intend to ensure that airlines owning CRSs do not have access to commercially sensitive information of other air carriers and that CRSs having a dominant position in a certain market do not refuse the participation thereto of airlines willing to have their schedules displayed in such CRSs, if such airlines agree to pay an appropriate fee. In addition, air carriers owning a CRS with a strong market position are compelled to have their schedules displayed in competing CRSs, if this is important for the viability of such CRSs.

The Code does not, however, govern the agent-traveler relationship although it has been maintained that the problem of bias is not the CRS but that of override commissions to the agent. It has been suggested that agents should be obliged to reveal to customers the commissions and incentives they get.³²

After a long consultative process, the Council adopted Regulation (EEC) No 3089/93 of 29 October 1993, amending Regulation no 2299/89.

But if the CRS no longer meets the assumptions made when it was decided to invest the vast amounts needed to develop the CRS systems, i.e. that the product would bring sufficient benefits to the investing CRS-owner to make the exercise worthwhile in financial terms, then the conclusion will easily be that you may be better off not having made the investment but being able to profit from the 'neutral' system as a mere customer, in fact, the same conclusion that the owners of Apollo and Sabre succeeded inculcating into their fellow American carriers so that they were talked out of developing competing CRSs (see above). In May 1991, SAS sold its stake in Amadeus Holding believing that this was called for by the then current CRS neutrality policy.

Bilaterals

1 Introduction

The system created by the Chicago Convention was headed for bilateralism. States concluded bilateral agreements between one another, providing for the exchange of traffic rights. Mostly these agreements were standardized according to the *Bermuda Agreement* of 1946 between the United States and the United

³² Roger Collis, *Looking for a Fair Deal On Airline Reservations*, International Herald Tribune 23 September 1988, p 10.

Kingdom. Within this system of bilateral agreements, governments decided access to the market, designating airlines and exchanging routes and rights. Governments determined the nature of any capacity allocation, and they approved, disapproved or conditioned the air fares to be charged. Moreover, in bilateral agreements you would normally find the substantial-ownership-and-effective-control clause, ensuring that the airlines concerned were vested in nationals of the respective contracting states.

2 *Bilaterals as Distortion of Competition*

It must be kept in mind that third state traffic is highly significant for the European airlines and third state traffic is normally governed by bilateral air transport agreements. Intra-EC services represent less than 30 % of their total operations; the remaining 70 % are controlled by bilaterals. In the bilateral air transport agreements one will find clauses which encourage or require carriers to agree on pricing, schedules, capacity and revenue sharing. From an economic point of view it appears highly unlikely that competition can work among the European airlines if they are subject, with regard to the greater part of their business, to competitive environments which display notable differences.

Since the EC, under Art. 3 (f) of the Rome Treaty, has a mandate to institute “a system ensuring that competition in the common market is not distorted”, the Community must do something to harmonize the competitive framework created by the bilaterals. There is an outright contradiction between the bilaterals and the basic notions of competition which have inspired the establishment of the European single market.

3 *Code-sharing and Bilaterals*

The technical evolution, however, - in particular the economic potential of the CRSs - meant resetting the stage for what airlines could do. What they did may be headlined *globalisation*. It has been thought that something called synergy would be achieved in the process of building airline empires on the basis of airline alliances.

To become a *global* airline in the meaning of a single corporate entity was of course asking for too much, but what was possible was to become a key members of a global grouping of airlines, typically linked by shared CRS. The CRS made it possible to integrate two different carriers' route networks and flight schedules. The key instrument was *code-sharing*. This is the practice whereby two airlines combine to put the same code on a flight involving a change of carrier and aircraft. Code-sharing allows carriers to sell each other's services on selected routes. It allows flights to be booked on one carrier and continued on another, and this means more feed and more onwards services. What it means may be illustrated by the recent case when Delta got “the right to new capacity to Heathrow without the capital costs of having actually to fly the planes”, as it was put .

While Delta's planes will still be barred from Heathrow, a new link-up with Britain's Virgin Atlantic Airways will mean that at least Delta's passengers will

not be. Through a code-sharing agreement, the American carrier will show Virgin flights to London from seven U.S. cities as part of its own route network on computer reservations systems.³³

Code-sharing agreements are considered to affect the bilateral services agreements much in the same way as wet leases used to be seen as a way of circumventing the traffic rights exchanges in bilaterals. These new sublevel agreements fell prey to the existing network of bilaterals. Code-sharing undermined the current bilaterals, and the natural defence was to consider that the bilaterals could prevent the use of code-sharing.

4 *Globe-girdling Alliances*

The new world of global airlines 'BA style' is perhaps a confusing one.

You are flying from London to Pittsburgh. The plane, the crew and even the gate wear the navy blue and scarlet livery of British Airways, yet the accents of your pilot and crew and even their style seem more Lincoln, Nebraska, than London. In fact, both the plane and the crew are on lease to BA from its partner USAir.³⁴

The airline industry is treading on new ground trying to stitch the new fledgling global alliances together.

The alliance-building airlines felt the need of cementing their agreements and strengthening the ties between the participating airlines, even if it were only by acquiring minority stakes in each other's shares, at least better than only sharing the costs of such things as new booking systems. British Airways may be said to be leading in the movement among the world's carriers to construct globe-girdling alliances and it became one of the pioneers in building empires of minority stakes throughout the world. But minority shareholding was a rather risky way. A more powerful lever would of course have been preferred, but a minority share still means more than merely being able to make polite suggestions at board meetings. It means sharing profits so that the alliances do not turn into leonine pacts. Sometimes you also hear the justification that it should prevent a rival airline from teaming up with your chosen partner. However, the stumbling block is normally local restrictions on foreign ownership of airlines.

Foreign airlines were prevented from buying more than a 25 % stake in a U.S. airlines so the holdings must be less. British Airways acquired e.g. a 20 % stake in USAir.

³³ Erik Ipsen, *Delta Gains a Back Door to Heathrow*, International Herald Tribune 13 April 1994, p 11.

³⁴ Erik Ipsen, *BA: Will a Minority-Stake Empire Jell?*, International Herald Tribune 10 August 1993, p 9.

5 *Bilaterals Between the United States and Europé*

The relationship between the United States and Europe is a matter of bilateral agreements between the United States and the various European states, and it is not easy to make it a place for deregulation.

Mr Harbison explains why:

The reasons for establishing a deregulated domestic market are frequently different from those which would encourage the establishment of a deregulated market on a bilateral basis. The judgment in any particular international bilateral market continues to be - and will for the foreseeable future continue to be - a decision which is made on the basis of mercantilistic consideration. That is to say, if for example, one country considers that it will gain at least as great or greater benefits than the other country through deregulating the international market, then it will move to do so. If, on the other hand, the impact of deregulating the international market would be seriously to impair the economic viability of on country's airlines, this would in turn significantly undermine their domestic operations, thereby causing major policy problems and degrading the domestic system. To avoid such problems, it is not sufficient, as some commentators have suggested, to open the respective domestic market fully to operation by foreign carriers. These foreign carriers do not have the same vested interest in maintaining services as do locally-based carriers. In the Australian and New Zealand cases we have only to look at the recent examples of the withdrawal of Continental Airlines and Northwest from the Australian market - with virtually negligible notice - to understand the importance of commitment to particular markets. This commitment can only be generated by the national base requirement.³⁵

“Greece has concluded a rather liberal bilateral agreement with the United States favouring US carriers” it is stated in the Greek report, illustrating, as it happens, Mr Harbison's observations. “This has taken place because of the necessity to maintain very close air transport links between Greece and the United States and the resulting benefits for Greece.”³⁶

Professor Prosser describes the process.

A recent example of negotiations which had some effect in gaining liberalising concessions was that of the negotiations leading to the revision of Bermuda II in March 1991. The background was that the serious financial problems of PanAm and TWA led them to wish to sell their routes to Heathrow to American Airlines and United Airlines. The resulting requirement to amend the Treaty (in which only the former two airlines were designated from the US) enabled the British Government to secure a number of [U.S.] concessions, including some fifth freedom rights, power to designate further UK airlines, permission for joint ventures with other EC airlines and some seventh freedom rights between other EC countries and the US. [By seventh freedom rights is meant the right to operate

³⁵ Harbison, *op. cit.* (note 6 *supra*) p 302.

³⁶ Prodomos Dagtoglou & Konstantinos Adamantopoulos, *Administrative Problems of Airline Deregulation: The Greek Perspective*, September 1993, p 46. Cf. *Revue hellénique de droit international* 1994 pp 289-305, at 299.

totally outside the flag state of the aircraft, i.e. flying into another state's territory and unloading or taking on board passengers, freight or mail coming from or headed for third states.]³⁷

The incorporation of "deregulation" in bilateral agreements would evidently undo this basic contradiction with the Rome Treaty. But this, writes Professors Dagtoglou and Adamantopoulos, would appear to be only possible in the framework of an international agreement providing for such principles generally and, at the same time, incorporating the necessary safeguard clauses and dispute settlement proceedings in cases where economic injury is caused thereby, traffic imbalances appear, etc.³⁸

That would seem to mean a multilateral agreement, but such an agreement is far away. The best that can be done is concluding a number of more or less uniform new bilaterals, imbued with the desired new spirit. Some new bilaterals may perhaps look like this, but they are in fact not necessarily made for the purpose of undoing the contradiction.

What is needed in order to overcome the distortion-to-competition aspect is, unavoidably, joint European bilaterals, or the conceivable, but unreachable global multilateral treaty. None is in sight.

6 *The Bilateral Air Negotiations Game at a New Level*

A great number of the U.S. bilaterals are from the immediate post-war period, when it was easy for the war-winning Americans to obtain fifth-freedom rights in Europe. The U.S. Germany bilateral air services agreement (1955) was of this kind, a relic from the occupation, the Americans being given the right to pick up passengers in Germany and fly them to third countries.

This was a phenomenon not limited to Europe but rather a reflection of the dominant role of the Americans in civil aviation generally. The U.S. Japan bilateral was very much the same. It was concluded in 1952, when Japan was still recovering from the war and nearly all the passengers crossing the Pacific were Americans. These and other U.S. Asia pacts were in the mercantilistic perspective not very balanced. Asian airlines were restricted to flights to and from 9 U.S. cities, while American airlines could fly to and from Asia through 21 U.S. cities.

But the matter can also be seen in terms of feed and onwards services. Professor Basedow discusses the Frankfurt airport problem in these terms:

The trunk route and the continental feeder services may be operated by the same airline. If this is not the case there is a great potential for cooperation agreements concerning joint operation and joint marketing which enable the joint venture to avail itself of both the European and the American hub and spoke systems of the participating carriers. From this perspective a hub like Frankfurt which is served by all major American carriers would have a competitive advantage as compared with another European hub such as London Heathrow which is served by only

³⁷ Prosser, op. cit. (note 4 supra) p 331.

³⁸ Dagtoglou & Adamantopoulos, op. cit. (note 36 supra) p 13.

two or three American carriers. Lufthansa, therefore, would be equally favored over other European carriers...the fierce competition with nine American airlines on all North American routes serving Frankfurt ...is some advantage to Lufthansa in terms of the infusion of more passengers into Lufthansa's European network. In other European countries where the access to the national hub is restricted to a small number of American airlines, the national carrier acquires a greater share of the bilateral traffic with the United States than Lufthansa's thirty percent. However, the national carrier will have less passengers fed into its European network of connecting flights.³⁹

It was certainly not unnatural that the U.S. bilateral agreements came under attack generally in the 1990s.

On the North Atlantic, the problems were compounded in 1991 by TWA and Pan American, designated American carriers under then current bilaterals, being replaced with the three American "powerhouses", American Airlines, United and Delta. As already mentioned above the consequences were dramatic because the profitability of their European competitors suffered dramatically.

In May 1992, France renounced her bilateral agreement with the United States which had been in place for 46 years, claiming that U.S. airlines were flooding the French market with too much capacity. The German government came under pressure from Lufthansa to do the same, unless more restrictions could be agreed on capacity and on U.S. carriers' fifth freedom rights out of Germany. Canada and Japan joined the turmoil. And so did Australia, the conflict escalating into a confrontation with orders to cancel flights and retaliatory such orders.

On the side of the United States, on the other hand, American deregulation had a spillover effect inasmuch as the Americans started to plead for *Open Skies Treaties*. By this was meant bilateral treaties doing away with most barriers to airlines setting up new international routes and services. This was called the idea of "open skies" between Europe and the United States. It meant renegotiating the bilaterals.

In July 1992, the United States signed an open-skies treaty with the Netherlands. Looked at narrowly, the treaty appeared lopsided. The Dutch gained access to the huge American market; the United States gained access to one tiny country. But it was part of what has been called "a shrewd administration policy to pry open closed European airline markets". It was shrewd because it released a chain reaction. KLM proposed joining forces with Northwest. To keep pace, other European carriers began to seek U.S. partners. Bargaining power shifted toward the United States. The British government, fearful that KLM would take business from British Airways, may now be willing to negotiate a version of open skies. Ditto the German government on behalf of Lufthansa.⁴⁰

³⁹ Basedow, op. cit. (note 3 supra) p 268.

⁴⁰ *Prying Open the Skies*, editorial, The New York Times, as reprinted in International Herald Tribune 21 October 1992, p 4.

European carriers with small domestic markets, such as British Airways, KLM Royal Dutch Airlines and Scandinavian Airlines System, tried to plug their big international networks into U.S. carriers' huge domestic operations.

In March 1994, the American idea of 'open skies' came closer to reality after the signing of a Memorandum of Understanding in Bonn that broadened the code-sharing agreement between Lufthansa and United Airlines. By this agreement Lufthansa was granted unlimited access to the American market and to other destinations including the Caribbean. The switch would allow Northwest and KLM to expand their code-sharing agreement to serve six German cities from 11 U.S. cities and would allow Northwest to double the number of flights to Germany jointly operated with KLM. Also, Delta was allowed to operate its own ground service at the Frankfurt airport.⁴¹

The German agreement came a day after a code-sharing agreement between British Airways and USAir had been extended for another year. The British Airways-USAir arrangement was the third major investment by a foreign airline in a U.S. carrier during a few weeks.

The U.S. Department of Transportation (DOT) approved a link between KLM and Northwest under which their schedules and some operations would be closely connected. Northwest had an extensive American domestic network and a strong Asian route system; KLM had extensive European routes. The DOT also allowed Air Canada investing US\$ 200 million in Continental Airlines. Between the United States and United Kingdom, Bermuda II, limited the number of carriers that each party could designate on a particular route, and also limited capacity increases and fare initiatives. In May 1993, negotiations started up to amend Bermuda II. Orders were to hammer out a more liberal agreement within a year, but the philosophical gulf remained between the United States and its European allies. American spokesmen insisted that deregulation and market forces should be allowed to handle questions of capacity and price.⁴²

But it was British Airways acquiring of a stake in its partner USAir, that brought the matter up to the level of almost a textbook case. On the American side, the Big 3 (United, American and Delta) raised competition-based objections to British Airways plans to acquire a 44 % stake in USAir.⁴³ The deal was stymied by the opposition. The first plan would have integrated many operations of the two airlines and would have given British Airways veto power over many of USAir's critical business decisions. A powerful campaign by the Big 3 forced the withdrawal of the offer. A new accord was thereupon announced in which the veto power was missing, although the accord provided for further British Airways investments if U.S. laws were changed to permit it. A new campaign was thereupon started to try to block the USAir-British Airways alliance, even urging the U.S. government to renounce the bilateral if necessary. It was argued that no further foreign investment should be allowed in U.S. airlines if that investment would give foreign carriers access to the huge

⁴¹ *U.S.-German Air Treaty Near* (AFP-Extel News) International Herald Tribune 18 March 1994, p 11 ; Brandon Mitchener, *German-U.S. Pact Aloft. Airline Agreement Is Signed in Bonn*, International Herald Tribune 19-20 March 1994, p 9.

⁴² Robert Bailey, *Germany Spreads Its Wings*, International Herald Tribune 11 June 1993, p 11.

⁴³ *New BA Deal Stirs Old Complaints*, International Herald Tribune 24-25 October 1992, p 11.

American market without giving any further openings in foreign markets to U.S. carriers.⁴⁴

The deal with USAir had been too far ahead of its time. Two fundamental issues were involved, both challenging the postwar Chicago Convention structure of international aviation, founded on a network of bilateral agreements between countries to serve cities in each of them. One is who controls each nation's airlines (substantial-ownership-and-control principles), and the other is which airline gets access to its airports (the traffic rights issue). If the United States had approved British Airways acquiring control of USAir, the latter would have no longer been a U.S. carrier but still would have been serving U.S. domestic airports.

That would have been a precedent undoing the Chicago structure. Other countries might feel tempted to raise legal challenges to their bilateral agreements with the United States. It would open up questions that, so it seems, most countries are not yet ready to tackle. British Airways had to scale down its investment before the deal could be approved (in March 1993).

Europe is far away from the point where the Europeans could offer landing rights in their cities in exchange for rights in many American ones. Were the Europeans ready to strike that kind of a deal, access to Heathrow would be the crown jewel that the Europeans had to offer.

If the British had bargained it away prematurely for access to USAir routes, they would have exposed themselves to European criticism.

The EC-Commission's Competence to Negotiate Member States' Treaties

1 The Constitutional Issue

Professor Dagtoglou and Dr Adamantopoulos write in their report:

Indeed, according to ICAO, in order for the EC to be able to enter bilateral agreements with individual third countries, a formal authorisation is required by its members. Such authorisation will declare the European Community a single air transport area. This has not happened yet, therefore, the problem of the proper representation of the EC countries by the EC Commission internationally arises in a similar fashion as this has been the case during the last 40 years with respect to GATT.⁴⁵

The GATT codes were negotiated by the EC under Art. 113 of the Rome Treaty and here the EC Commission effectively represented the EC Member States (Dagtoglou & Adamantopoulos). Then, how about air transport? Is there agreement on the establishing of Community powers in this context on the basis of Art. 113? Greece is reluctant to agree to it, we are told by the Greek Report,

⁴⁴ Richard Weintraub, *USAir Receives Scaled-Down BA Investment*, International Herald Tribune 22 January 1993, p 11.

⁴⁵ Dagtoglou & Adamantopoulos, *op. cit.* (note 36 supra) p 10.

but this still remains an open question. Professor Basedow discusses the matter at length:

The Commission takes the position that Article 113 of the Treaty, which confers the exclusive power for the negotiation of trade agreements with nonmember states on the Community, may be extended to the area of services. Language contained in an opinion of the Court of Justice which holds that Article 113 has to be interpreted in a dynamic way encourages the Commission to pursue the above mentioned course. The view is further strengthened both by the observation that the law relating to freedom of services within the Community, under Article 59 of the Treaty, is becoming more consistent with the law relating to the freedom of trade under Article 30, and that this parallel should be extended to external relations.⁴⁶

Professor Basedow is not convinced.

In order to establish Community powers in the field of air transport negotiations with nonmember states, Article 113 is not required. Under the so-called AETR Doctrine the Community gains implied powers to negotiate treaties with third states in all areas where it has adopted internal measures to pursue a mandate of the EEC Treaty. In pursuing a treaty mandate. Recent case law does not require the actual adoption of internal measures prior to the negotiation with third states. According to the Court of Justice, “the Community enjoys the capacity to enter into international commitments over the whole field of objectives defined in Part I of the Treaty, which Part VI supplements”. The powers of the Community to enter into international agreements with third states in the field of aviation cannot be questioned because the mandate to adopt “a common policy in the sphere of transport” which is conferred upon the Community by Article 3 (f) is contained in Part I of the Treaty and the mandate covers the whole field of transportation, including aviation.⁴⁷

In one case the Community took over the responsibility from the member states and conducted negotiations with third countries direct. This was practiced when the Community, as such, signed a bilateral air transport agreement with Norway and Sweden (Council Decision 92/384 (EC) of 22 June 1992). The Council decision implementing that agreement was in fact based upon Art. 84 (2).⁴⁸ The Commission asked for a mandate to conduct negotiations with all EFTA states, but not as a group, and when that was granted it became possible to make separate agreements with selected states, among them Norway and Sweden, with Denmark - the SAS companion state - as their principal spokesman in the EC environment.

⁴⁶ Basedow, *op. cit.* (note 3 *supra*) p 273.

⁴⁷ Basedow, *op. cit.* (note 3 *supra*) p 274.

⁴⁸ Basedow, *op. cit.* (note 3 *supra*) p 272.

2 *Exclusive or Concurrent Powers?*

The European Road Transport Agreement, known as AETR after its French name - *Accord Européen sur les Transports Routiers* - brought some light to the problem. In the judgment of the European Court of Justice in Luxembourg in the case *Commission v. Council*, rendered 31 March 1971 (1971 ECR 263), the Court made it clear that the treaty-making powers of the EC “exclude the possibility of concurrent powers on the part of Member States, since any steps taken outside the framework of the Community institutions would be incompatible with the unity of the Common Market”.

Although exclusive, however, Community powers do not entirely foreclose all activities of the member states as long as the EC has not fully exercised its functions in a certain field. Member states thus have *transitional authority*, but this authority must be used in accordance with member state obligations under EC law (ECJ 14 July 1976, Cornelis Kramer, 1976 ECR 1279).

Since the EC’s treaty-making powers are exclusive in nature, they do not come under the purview of the principle of subsidiarity. The EC is not even allowed, except for the transitional period, to waive the exercise of its powers for the benefit of member states.

3 *EC Negotiations for Air Service Agreements With Non-EC Countries*

The degree to which the European Commission has competence to undertake common EC negotiations for air service agreements with non-EC countries is the currently controversial question. Assuming such competence means a formidable task for the Commission since there exist approximately 800 bilaterals with third countries.

In 1969, the EC asked the Commission to verify that member states’ treaties with outside countries did not clash with the obligations under EC law.

We are advised by Mr Balfour that the Commission is proposing legislation to give it competence in the field of external aviation relations. The EC Council accepted EC jurisdiction in negotiating and concluding bilateral air services agreements with third countries only in those cases where a clearly defined EC interest exists. Professor Dagtoglou and Dr Adamantopoulos summarize the present situation as follows:

EC member states retain their jurisdiction to negotiate bilaterals with third countries provided that they do not thereby infringe existing EC rules, particularly those deriving from the Third Package. The Council underlined that the powers of EC Member States should not conflict with measures which may be adopted by the Council in this area in the future.

The Council did not rule out the possibility of the conclusion of bilaterals with third countries by the EC itself. However, EC activity in this respect should only be the result of (1) the existence of a clearly defined EC interest, and (2) a thorough analysis as to whether, under the specific circumstances, negotiations at a EC level “objectively” facilitate the achievement of a better result for all EC member states. In such cases, the Commission will have to be specifically

authorized by the Council to conduct negotiations with the third countries concerned.⁴⁹

What this means in actual life is not so easy to find out. There are some interesting cases. One concerns *telecommunications contracts*. Art. 29 in the EC utilities directive grants preferential treatment to EC companies in bidding for telecommunication contracts in EC countries. That article was cited by Washington, in 1993, as its reason for barring European companies from about US\$ 19 million of contracts in the United States. The EC responded with similar sanctions covering about US\$ 15 million of EC contracts. The EC Commission threatened to overturn treaties between 8 member states and the United States by refusing to approve renewal of any of these treaties unless they were modified to conform with EC law - which specifically meant Art. 29 in the utilities directive.

Another case concerned a *restructuring plan for Aer Lingus, dropping compulsory stopovers at Shannon Airport*. The EC Commission said, mid-July 1993, that it would not interfere with aviation negotiations between EC states (such as Ireland here) and third countries (such as the United States here), about such a plan, but that the accords had to comply with EC law.

If the EC obtains external competence, meaning that the EC would be negotiating one agreement on a bilateral basis with a third country, in place of the existing twelve or so bilateral agreements, that would make the problem of reciprocity more acute, Mr Balfour observes. The matter calls for illustration.

At one time, the EC Commission proposed legislation that would give it a negotiating monopoly. It was proposed that the Commission be given the powers to negotiate air services agreements and to distribute the gains fairly between the EC countries. Thus, the problem was faced which was touched upon in the previous section. The Big 3 could not successfully barter the approval of British Airways' USAir deal for their receiving more gate space at Heathrow. In a European common policy for air services bilaterals with third countries, access to Heathrow gates would have been the European top card to play, and consequently the British could not be allowed to squander that asset for their separate British gain. The monopoly proposal at that time was coldshouldered by the member states. But the sudden bilateral between the United States and Netherlands, mentioned above, brought a change in attitude. It was evident that the U.S. policy was to play one European country against the other, and that counteracting such a policy called for a European common policy for bilateral air services agreements. In fact, it made sense that the EC Commission should also be entitled to negotiate for the EFTA states being included in the EC air policy through the EES treaty.

⁴⁹ Dagtoglou & Adamantopoulos, op. cit. (note 36 supra) p 11.

Substantial Ownership and Control

1 *Chicago Thinking*

In the era of deregulation, the system of bilaterals is getting uncomfortable. Bilaterals are based on the thinking underlying the Chicago Convention. This *Chicago thinking* is built on a number of more or less *hidden assumptions*.

Ownership by government is one of these hidden assumptions. Air transport in Europe has always been a sector strongly characterized by control and ownership by governments, and today most major airlines in the world are state-owned. There may be many reasons for this but one of them is certainly that the airlines are generally seen by their states to have more than a purely commercial role - e.g. a public service role, a role in promoting and supporting the development of the country's industry generally and in particular the tourist industry, a defence role and a role in maintaining the state's international status.⁵⁰ Giving a preponderant role to national governments has been a way of *securing control of the airline*.

But if so, then evidently privatization as such must be a rocking of the Chicago boat. Passing enterprises to the private sector and the market means that government no longer takes responsibility for their operation. Any step in the direction of private ownership will make it increasingly difficult to supervise control and ownership.

Privatization will necessarily involve issuing shares. Such shares may be registered shares but that seriously reduces the attractiveness for investors. When the need will be felt to issue bearer shares it will be extremely difficult to meet a requirement that the carrier shall at all times be able to demonstrate that it meets requirements of ownership and control. There is, e.g., no register for the shares of KLM. Therefore a special provision has been enacted which gives the Dutch Government the right to issue an amount of shares sufficient to retain the majority.

The issue of defining ownership and control thus raises fundamental questions.

Paradoxically, policies of privatization and of increasing competition are conflicting, not complementing. An enterprise is likely to be more attractive to private investors the less competition it is faced with. The sale of publicly owned British Airways to private investors bears this out in Prosser's report.

There is today no British publicly-owned airline, just as there is no publicly-owned U.S. airline. Professor Prosser reminds us that "the British Government has been the world pioneer in large-scale privatization", and the privatization of British Airways is part of this development.⁵¹

Professors Perucchi and Videla Escalada offer a discussion in their report of how to understand the notions of private and state-owned enterprises:

⁵⁰ John Balfour, *Legal and Administrative Problems of Airline Deregulation. Answers to Questionnaire*, 24th January 1994, p 1 para B.

⁵¹ This quote from the Report of Prof. Prosser is missing in the printed version, referred to in note 4 supra.

Commercialement on démontre le fait d'être "privée", en la propriété du capital qui soutient l'institution et dans le pouvoir de décision, qui doit rester, au moins dans la moindre majorité, dans les mains de participants privés. Dans ces conditions, elle cadre avec la législation qui règle les entreprises privées, ce qui ne signifie pas que cette dernière ne soit pas aussi appliquée aux entreprises de l'Etat, tel qu'il arrive avec la loi de sociétés anonymes de l'Etat en Argentine (No 20 705), figure juridique qu'Aerolineas Argentinas maintenait avant sa privatisation.⁵²

We are also reminded in the Argentinian report that "tous les pays limitent la pénétration de capitaux étrangers dans les compagnies nationales jusqu'à un pourcentage qui ne signifie pas une 'position dominante'".⁵³

The problem with the substantial-ownership-and-control clauses lies in the bilateral relations with third countries because it will be impossible for the government of one state to negotiate for and on behalf of airlines from other states.

When British Airways' private competitor, British Caledonian, fell into financial distress, a salvage was offered by Scandinavian Airlines System, which wanted to buy 26 % of BCal for £110 million. But at that moment, the British Civil Aviation Authority considered "that this would mean that the Company would no longer be under UK control and the Minister indicated that in that case he would review its route licenses and foreign governments might refuse to accept its designations". So, at the end of the day, BCal was instead swallowed up by British Airways.⁵⁴

On the other hand, the question of substantial-ownership-and-control can not be unaffected by the trend towards globalization and the alliances at a sub-level by means of code-sharing and minority stakes. In today's more global business environment the substantial-ownership-and-control rules look more and more outdated. It is this factor, perhaps more than any, which is likely to increase pressure for the modification of bilaterals with third countries. (Balfour) We may be facing a key to the likely change in the international system.

Lines are becoming increasingly blurred. Air France may only have acquired 37,58 % of Sabena, but there is a view that it has nevertheless acquired control. Iberia appears to be proposing to acquire control of Aerolineas Argentinas. In none of the cases does this seem to have caused any problems in practice in bilateral relationships. Mr Balfour elaborates:

It might be possible to argue, even at present, that Air France, although it only holds a 37,58 % shareholding in Sabena, effectively controls it, but so far as I am aware this argument has not been made by any of Belgium's bilateral partners.⁵⁵

⁵² Hector A. Perruchi & Federico Videla Escalada, *Les problèmes juridiques et administrative de la dereglementation en matière de transport aérien*, p 8.

⁵³ Perruchi & Videla Escalada, op. cit. (note 52 supra) p 11.

⁵⁴ Prosser, op. cit. (note 4 supra) p 325.

⁵⁵ Balfour, op. cit. (note 50 supra) p 4 para 19.

Once the airlines operating from a particular country are no longer necessarily connected by way of ownership with that country, however, the interests of that country in trading air traffic rights will no longer be identified solely with the interests of the airline as opposed to the interests of the country as a whole. Mr Brown, in the New Zealand report, illustrates the issue as follows:

New Zealand has already removed any limit on the foreign ownership of a domestic carrier. This was done in 1988 without any reciprocal benefit from the country whose carrier (Ansett) it was aimed at. The point was that preservation of two main trunk carriers in a small market required that step. Consequently the national NZ benefit was properly served by that step. No reciprocal benefit was asked, and if asked it would probably not have been granted.

The NZ government would probably put this public benefit first were control of either domestic carrier to go to a national of a country other than NZ or Australia. In international services we would see the public benefit in similar terms. The goal of more air services from more countries bringing more tourists is paramount.⁵⁶

While some countries might continue to insist on local national control of their airlines, it is likely to become difficult for them to object to an abandonment of these rules by their bilateral partners.⁵⁷

One way for the government to secure control is by subsidizing operations. In the Argentinian report some discussion is devoted to Art. 138 of the Argentinian Code of the Air, which allows subsidies in the following conditions: “dans le but de couvrir le déficit d’une exploitation saine, le Pouvoir Exécutif pourra subventionner la réalisation de services de transport aérien dans ces routes qui sont d’intérêt général pour la Nation”. It is observed that at the end of the day this means subsidizing cabotage.⁵⁸

Professor Basedow discusses in what way the substantial-ownership-and-control clauses in the bilaterals are compatible with EC law. He refers to Art. 4 of the U.S.-Germany bilateral of 1955, which article entitles each contracting state

to withhold or revoke the operating permission provided for in Article 3 of this Agreement from an airline designated by the other contracting party in the event that it is not satisfied that substantial ownership and effective control of such airline are vested in nationals of the other contracting party.

Such a clause, finds Professor Basedow, violates Art. 7 in the Rome Treaty which prohibits

within the scope of application of this Treaty, and without prejudice to any special provisions contained therein, any discrimination on grounds of nationality.

⁵⁶ Leslie J.M. Brown, [Replies to] Questionnaire, p 7 para 19.

⁵⁷ Balfour, *op. cit.* (note 50 *supra*) p 5 para 19.

⁵⁸ Perruchi & Videla Escalada, *op. cit.* (note 52 *supra*) p 9.

In the opinion of Professor Basedow, “there is no doubt that air transport relations between EC member states and third states, too, are within the scope of the Treaty as required by Article 6.”⁵⁹

This carries far, because the prohibition of all discriminations on grounds of nationality also covers disguised discrimination which may result from the use of criteria that are more likely to be fulfilled by the nationals of one member state than by the nationals of others.

The jump into the hypothetical situation in which *any EC airline* can be designated under a bilateral agreement by the government, party to the bilateral, augurs some adverse repercussions for the airlines of that state. This is so, because at that moment that airline will be only one competitor among various European airlines. No longer will the airline be the very influential member of the national treaty-making delegation which it used to be in the bilateral heydays when airlines controlled the states rather than states controlled the airlines.

2 *What next?*

One may thus conclude that the substantial-ownership-and-control clause in current bilateral agreements sits uncomfortably. What opportunities are there to get rid of it?

The solution is available on a bilateral basis, advises us Mr Balfour,

because, contrary to what is often thought, the rules on substantive ownership and effective control do not derive from the multilateral Chicago convention, but only from individual bilateral agreements. The rules find their origins in some of the basic features of international air transport... and some of these considerations will continue to be important for some countries.⁶⁰

Other contributors have however pointed out that the problem concerns the operation of *cabotage services*, which as a result of the Chicago Convention itself are reserved to carriers owned and controlled domestically. Otherwise the most-favoured nation clause would apply.⁶¹

We will now turn to the issue whether the substantial-ownership-and-control clause may serve a useful function in the relationship between two deregulated areas - say the United States and Europe - or between a deregulated area and a non-deregulated area. The latter case is the one mostly prevailing in the relationship between EC and non-EC countries.

Professor Naveau observes that “the regional definition is particularly necessary in addition to national frame in respect of cabotage”. He continues:

An ‘exclusive aviation area’ (not conceptually recognised under the [Chicago] Convention) has been created in the EEC. Rights have been exchanged between Member States like if this area had been a national territory subject to the exercise of cabotage rights, “quod non.”

⁵⁹ Basedow, op. cit. (note 3 supra) p 270.

⁶⁰ Balfour, op. cit. (note 50 supra) p 4 para 19.

⁶¹ Dagoglou & Adamantopoulos, op. cit. (note 36 supra) p 14.

On the other hand, the implications for third countries carriers should not be underestimated in case the EEC area was to be considered as cabotage area *and* paragraph 2 of article 7 would be maintained ... The exchange of (exclusive) proper (domestic) cabotage rights between Member States also may raise (unduly), in our [Professor Naveau's] view) the issue of the controversial paragraph 2, - which clearly should be deleted from the [Chicago] Convention altogether, to finally resolve the old standing issue of interpretation and restore legal security.⁶²

In the Greek report, too, these relationships are looked at. Professor Dagtoglou and Adamantopoulos see a positive function of the ownership clause.

Ownership restrictions may be necessary in order to ensure that only airlines of the respective parties to an inter-deregulated-agreement benefit from such deregulation. Therefore, it would appear that even in inter-deregulated markets the elimination of ownership restrictions may only take place on the basis of reciprocity, be strictly applicable to carriers of both countries and will still need approval or a waiver under the ICAO [Chicago] Convention.⁶³

Finally, there is the argument that as long as the Chicago Convention stands, there are certain duties that the state cannot delegate away. If the state cannot get rid of the duty it must secure so much control over the airlines that the state can fulfil its duty. If so, the substantial-ownership-and-control clause may have a function. In the Argentinian Report, this is discussed at some length.⁶⁴ Perhaps it will suffice here to remind readers of the clause in Art. 44 of the Chicago Convention which says that one of the aims and objectives of ICAO is to

meet the needs of the peoples of the world for safe, regular, efficient and economical air transport.

In the opinion of Professors Perucchi and Videla Escalada, this is also a duty of the single state, and a duty which it cannot get rid of by delegating it to another organization.

The Flag Carrier

1 A Concept in Decline

The *flag carrier* is a term meant to meet the idea that an airline is an instrument to maintain the state's international status. In many places, particularly in Europe, the prevailing pattern is one major airline, governmentally owned or partly in private hands but certainly with very close government ties, which is called the flag carrier and which is designated in the bilaterals to fly the routes set out in the Agreement. Of course, there are variations. Scandinavian Airlines

⁶² Jacques Naveau, *Legal and administrative problems of airline deregulation*, 19 September 1993, p 8 f.

⁶³ Dagtoglou & Adamantopoulos, op. cit. (note 36 supra) p 14.

⁶⁴ Perruchi & Videla Escalada, op. cit. (note 52 supra) p 5-8.

System has been the flag carrier in common for three Scandinavian states and the designated airline in the bilaterals entered into by these three states. The United States, on the other hand, never had a flag carrier in the European sense and its bilaterals on the pattern of Bermuda II could have several U.S. airlines designated to carry out the traffic.

The prevailing opinion seems to be, however, that the notion is on its way out. "Privatization has removed one reason for the preferential treatment of flag carriers by the public authorities" writes Professor Prosser.⁶⁵ "In all likelihood the concept will disappear within the coming years" writes Mr Balfour.⁶⁶ Professor Naveau agrees: "A remodeling of the national carrier concept is necessary, but unlikely to be made rapidly."⁶⁷ Professor Brown agrees even more:

The sole reasons for a carrier having a national identity should be because there is a marketing advantage in that. In this way air travel is the same as soft drinks and automobiles. Any other way must extract an excess fare from travellers.⁶⁸

Mr Balfour even sees current efforts at globalisation in this perspective:

"Even if governments are slow to dismantle the regulatory barriers, airlines are, at the commercial level, quickly going as far as they can to reduce them, by way of marketing alliances, minority shareholding links and code-sharing and other similar arrangements."⁶⁹

In Europe, however, the concept in decline reappears in another dimension in the form of "the EEC brand-new concept of Community air carrier". "It is interesting to note that the concept of 'Community air carrier', unlike the concept of 'Community shipowner' in maritime EEC regulations refers to the financial control of the company but not to the registration of aircraft used, much less to the nationality of the crew operating said aircraft."⁷⁰ No common view seems to have developed on the subject, however, apart from the legal definition, and the political approach is expected to develop only slowly. So Professor Naveau concludes that "the substance of national rules will largely be maintained for a certain time."

In the Greek report, there is some discussion of the situation, should the national flag carrier concept disappear, and Professors Dagtoglou and Adamantopoulos offer the following scenario:

Airlines design their commercial activities, commit themselves to a certain market, make considerable investments, etc., taking into account the existing bilateral or multilateral agreements and regulatory framework. It is therefore

⁶⁵ Prosser, op. cit. (note 4 supra) p 316.

⁶⁶ Balfour, op. cit. (note 50 supra) p 4 para 17.

⁶⁷ Naveau, op. cit. (note 62 supra) p 7.

⁶⁸ Brown, op. cit. (note 56 supra) p 6.

⁶⁹ Balfour, op. cit. (note 50 supra) p 4 para 17.

⁷⁰ Naveau, op. cit. (note 62 supra) p 7.

likely that a change in the regulatory environment will have to take into account any distortion and disadvantages these changes may entail for such airlines. The principle of “grand-father” protection has been widely recognised on an EC level, for example, with regard to the qualification of air carriers as well as for the purposes of slot allocation at airports.

The benefit of the so-called “grand-father clause” will be of major importance in dealing with this matter.⁷¹

Mr Balfour, on the other hand, looks at the matter from another angle:

a favourable flag carrier status, bringing with it a legacy of international routes and, perhaps even more importantly, slots at congested airports, creates great advantages which any efficient carrier ought to be able to exploit effectively.

Consequently, to Mr Balfour

The important policy question is to what extent should positive discrimination be exercised against such carriers in favour of new carriers, particularly within a domestic context, in view of the competition which the carriers from any one country increasingly face from carriers from other countries, which might continue to be so advantaged and hence not face such competitive pressures in their own countries.

Clearly, major problems. It is still too early to tell from the experience in the EC, but indications already are that those carriers which have been exposed to competition within their home or neighbouring markets are in a better position to compete more widely.⁷²

“Grandfathering” is suggested by Professors Dagtoglou and Adamantopoulos as the solution to also another problem in the expected transition era.

US airlines who currently benefit from fifth freedom rights as a result of the bilateral agreement between Greece and the US are endangered of being considered as operating cabotage flights as far as their operations between Athens and other parts of the EC are concerned. It is unlikely that this situation would result in the complete elimination of such rights.

A likely solution would be the “grand-fathering” of the fifth freedom rights regardless of the creation of a single market, taking into account the principles of reciprocity. The creation of the single market and the notion of cabotage will essentially prohibit, in the future, third country carriers from obtaining equal status as the existing “grand-fathered” ones.⁷³

As to the developing countries, however, Professor Naveau sees no reason why they should modify their identification of flag carriers if that concept basically serves their purpose in commercial aviation.⁷⁴

⁷¹ Dagtoglou & Adamantopoulos, *op. cit.* (note 36 *supra*) p 12.

⁷² Balfour, *op. cit.* (note 50 *supra*) p 3 para 16.

⁷³ Dagtoglou & Adamantopoulos, *op. cit.* (note 36 *supra*) p 13.

⁷⁴ Naveau, *op. cit.* (note 62 *supra*) p 7.

⁷⁵ Naveau, *op. cit.* (note 62 *supra*) p 1-4.

Concluding Observations

This is a comparative law exercise and that brings automatically limitations unknown of in other fields of law. Comparative law is descriptive and not normative. Perhaps comparative law studies may pave the way to, some time, a more uniform law as some have hoped, perhaps indeed to a uniform world law far away in the blue, blue Utopia. But in the world of civil aviation, today, comparative law is only description and has little place for conclusions in a normative sense. What it does allow for is observations - observations which perhaps would be heresy if made in the atmosphere of a national law system and banned as a matter of politicking. Comparative law is spared such visitations and that is a good thing about it.

What strikes you most when looking at what deregulation brought about is the unexpected rise of the U.S. giants, a certainly unplanned phenomenon but nevertheless today a most solid and unquestionable fact. The turmoil which the advent of the Big 3 with their sophisticated CRS gadgets brought to worldwide civil aviation is widely felt and many boats are no doubt being rocked in the wake. It is too early for a full assessment.

All this happened to take place at a time when another event of great dimensions was occurring, viz. the rise of Europe as such to the status of an actor in its own right in a fragmented world. The plans of the Europeans were certainly disturbed, no less than those of those Americans behind deregulation, but in another way. Competing with the Big 3 called for equally big European airlines, while the blossoming of a hundred flowers which had been on the minds of those bringing down the borders in Europe and doing away with the obstacles to a liberalized intra-EC civil aviation was *not* supposed to bring giants to life.

Professor Naveau summarizes sovereignly today's picture on both sides of the North Atlantic.

[T]he context created by the economic situation is not favourable to a serene examination of the facts of deregulation and liberalization of air transport, and to an assessment of proper remedies to the present difficulties experienced by many Western and other air carriers... The financial crisis hits most airlines in a comparable manner in the U.S.A. and in Europe. Consequences are not similar, on account of the differences in approach to liberalization, and different stages of progression towards a fully market-oriented environment. Despite the temptations to reconsider the trend, and strong concerns expressed by trade unions, on neither side of the Atlantic can be found serious political attempts at re-regulation as such...

The application of competition rules to air transport and related activities (such as reservation systems) is still open to much soul searching. The question of state aids is politically charged yet legally unclear... Given the national prerogatives and the Community legislation, one cannot properly speak of a substitution of antitrust authorities to civil aviation authorities in the EEC. The difference in approach with the U.S.A. has consisted in the endeavour to

76 Brown, op. cit. (note 56 supra) p 7-8.

77 Naveau, op. cit. (note 62 supra) p 2.

liberalize rather than deregulate, meaning that civil aviation authorities in effect continue and will continue playing an important role in applying rules but that those rules will be considerably more permissive and their exercise will be placed under permanent control of the European Commission with the possible ultimate review by the Council of Ministers... On the other hand, the competition authorities of the EC Commission (Directorate General IV) exercise the authority which the Commission derives from the EEC treaty in competition matters ; they have full jurisdiction in all relevant instances. Those authorities are the driving force behind the regulation applying the competition rules of the treaty to the air transport sector.

The EEC system of air transport has been worked out as a liberal transport policy, under the terms of article 84 (2) of the EEC treaty, and at the same time as a practical method to gradually introduce the single European market in aviation, so as to fulfill the obligations undertaken by the Member States in the Single European Act. At the cost of much argument and compromise at Commission's and Council's levels, the competition policy has been developed to be fully consistent with the air transport policy. The result as it emerges from the "third package" of 1992 is a rather balanced system which calls upon different authorities to safeguard the principles at stake and apply the rules as the case may be. Yet the balance is more apparent than real and important gaps remain. In a number of "grey" areas, no methodology let alone policy can be found to redress existing distortions of competition within the internal market, and the effect is felt on the forces called upon to interfere in the process.

Externally, the regrettable absence of regulations applying the competition rules to extra-Community relations and more generally of a coherent external policy renders operators from non-Community countries vulnerable to court actions for alleged violations of either article 85 or article 86 (abuse of dominant position) of the Rome Treaty, without any of the safeguards and procedures set out in the regulations for intra-Community transport. There is indeed an inherent risk that the courts substitute for the regulator if no remedy to this abnormal situation is rapidly found...

Legally speaking, for all its shortcomings the regulations adopted in the EEC (notably on airline licensing) has introduced revolutionary concepts, the long effects of which will be important, even though they may be somewhat blurred under current circumstances... There is widespread concern that the "third package" re market access, airline licensing and air fares will generate additional and cumbersome bureaucracy. If regulation and deregulation must be appraised in terms of administrative paperwork burden the issue is uncertain in Europa and probably in the US as well...⁷⁵

Professor Reitz however points out, in a comment to this, that U.S deregulation certainly resulted in getting rid of all the paperwork that had to do with previous CAB economic regulation. He thinks that the remaining paperwork that had to do with licensing requirements, in fact concerned safety and should not be blamed upon deregulation.

Professor Naveau's observations do also get a soul-searching complement in Professor Brown's more basic analysis of "the nature of the business" and his provocative question:

⁷⁵ Naveau, *op. cit.* (note 62 *supra*) p 1-4.

How long before we find a ‘McDonaldisation’ of the air as investors wanting to try aviation buy a franchise from a master franchisor to gain a name, CRS access and a business system. Such a development should allow businesses in this industry to cross borders two ways. Firstly, by allowing entry into smaller markets of a business not meeting national ownership requirements. Secondly, by allowing smaller investors to reduce the enormous risks in this industry in the same way as investors entering the fast food business do. If property investors think of airports as a shopping mall with a gimmick, then to chefs an airline is indeed just a restaurant on the move... The business of business is business. We may speak of global companies or industries. But companies to succeed must continually ask what their competitive advantage is, and move in and out of markets accordingly.⁷⁶

Aviation lawyers are muddling along with their instruments, but these instruments alone cannot make it without political will, nor can political will alone make it without the lawyers’ instruments. “Nothing is needed more than legal security, with a prerequisite of political will” writes Professor Naveau.⁷⁷

⁷⁶ Brown, *op. cit.* (note 56 *supra*) p 7-8.

⁷⁷ Naveau, *op. cit.* (note 62 *supra*) p 2.