28/8/2001

THE BASIC PHILOSOPHY BEHIND AND THE DEVELOPMENT OF THE EU ECONOMIC AIR TRANSPORT POLICY AND OTHER POLICIES WHICH AFFECT IT

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A. Introduction

The European Communities were created in 1958 by the Treaty of Rome. Its institutions should guarantee that coherent decisions are taken, implemented and legally enforced in all Member States. Its general rules include, inter alia, provisions on right of establishment, freedom to provide services, competition, state aids and approximation of legislation. However, the Treaty included Article 84, which in its paragraph 2 stated that the Council could take any appropriate decision as to policy for air and sea transport. This was in contrast to what was stated in respect of the other modes of transport. On that basis practically everybody in air transport thought that until such a decision was taken air transport was excluded from Treaty provisions. Consequently while policy was developed for other modes of transport nothing happened in air transport until 1974. In this year the European Court of Justice took a decision concerning the application of social rules in the maritime sector. In this context the Court stated, contrary to the general belief, that the general provisions of the Treaty did apply to sea and air transport and that the exclusion contained in Article 84 only applied to the provisions contained in the transport chapter. It took some time for the Member States to get over the shock but in 1978 they had become convinced that an application of the general principles of the Treaty without attention being given to the specific characteristics of air transport would be too dangerous. They were also to some extent under the impression of the US deregulation, which came into effect in 1978. Therefore, a priority list for air transport was approved[1] in 1978 by the Council. This was followed up in 1979 by a memorandum (the first) on air transport (A Community Approach) issued by the Commission.

This was the start to a process where the European Union in the course of a number of years (14) developed an economic air transport policy for its internal market. This policy introduced, step by step, not only a liberal system but also safeguards and harmonization measures with a view to permit time for adaptation and to achieve a level playing field. As a consequence, essential provisions included in the bilateral agreements between the twelve Member States were therefore automatically replaced. This development is described in the following and also illustrated in annex 1. The liberalisation concerned the scheduled air transport but ultimately all types of air carriers were covered.

B. Past liberalization measures

Inter-regional Air Services

After a detailed and extensive discussion, which started in 1980, agreement was reached in 1983 on a limited policy initiative, in the form of a directive on inter-regional air services (No. 8 on the priority list).

[1] See annex 2

The initiative was intended as a first experiment and the scope of the text, therefore, was rather cautious covering only air services between regional airports. Account was taken of an ECAC[2] study (Compas report), which underlined that a competitive environment would be seriously impaired unless provisions on market access, capacity and air fares would all be made more liberal. This document had a very important effect because it convinced the middle management in the national administrations that liberalisation had to come and that action had to be taken in all three areas. The resistance to this development came from most of the Directors General of Civil Aviation (incl. DK). The Netherlands and the UK supported the initiative very strongly. The resistance from the national air carriers was muted since the initiative was so limited.

The directive opened market access for scheduled air services between all regional airports for any Community air carrier designated by its Home State and capacity control was relaxed completely. With regard to air fares, the principle was adopted that they had to be viewed in the light of the air carrier's own costs and not against any kind of industry average which had been the approach until then. In fact if an air carrier could demonstrate that a proposed air fare was reasonable in the light of the air carrier's own costs then it would have to be approved by the responsible authorities.

Restrictions were included. In particular the Home States maintained their discretionary powers to designate or not their air carriers. Furthermore, receiving States were not obliged to accept multiple designation by other Member States and could refuse to authorize services by other European Union carriers on routes where a reasonable indirect service already existed. Only aircraft of up to 70 seats could be used.

In view of the above limitations it is not surprising that, while new activity resulted from this policy, no "dangerous" developments took place. On the other hand it should be remembered that Maersk Air used this Directive as a starting point and established a scheduled service between Billund and London by in fact mislabelling Southend airport. Officially Denmark was rather horrified about this misuse of the Directive. However, the Directive created a belief among regional air carriers, that if they wanted to they could easily enter new markets. When the first package was approved they therefore began to really take advantage of the new framework.

First Package

The Directive on interregional air services was followed up by the Commission with a rather cautious second memorandum, which suggested further steps in respect of capacity control and air fares only with no proposal in respect of market access. These proposals were to be applied to the bilateral agreements between Member States. During the discussion in the Council of Ministers this cautious approach was rejected under the influence of the COMPAS report. Market access provisions was added and the approach was changed to that of the interregional air services Directive i.e. that the clauses would take precedence over similar clauses in the bilateral agreements.

Furthermore, after 1983 the pressure on the air transport industry and the Member States increased, basically because it became evident to the Commission that the situation existing at the time could not be accepted under the competition rules of the Treaty. In fact the Commission started a fact finding activity in respect of agreements between air carriers which might be contrary to Article 85[3] of the Treaty. On this basis and at the instigation of Commissioner Sutherland the Commission therefore declared in 1986 that all co-operation between airlines would have to stop unless a more liberal market framework would be decided by the Council.

Agreement on a set of Regulations was reached in 1987 to extend the liberalization policy to scheduled services between regional[4] and main airports, thus opening the possibility to Member States to designate air carriers for 3rd, 4th and consecutive 5th freedom services between these airports and

[2] European Civil Aviation Conference
[3] Now Article 81 in the Amsterdam Treaty
[4] Except Gibraltar

the receiving states would have to accept this designation. Multiple designation was introduced depending on the level of traffic and capacity controls were relaxed from the 50/50 actual practice in bilateral agreements to 55/45 and then two years later they became automatically 60/40. The provisions on the basis of which air fares had to be approved when a carrier could demonstrate that they were reasonable in the light of its own costs were maintained. Further liberalization was introduced by way of two flexibility zones for promotional fares (basically PEX and APEX) within which approval was automatic. Binding arbitration and right of matching were also introduced. With regard to the rules against anti-competitive behavior of the Rome Treaty, regulations of application were adopted in order to permit their effective enforcement in the air transport sector.

This package did give rise to considerable increases in activity for regional air carriers (the period of double digit growth started) but the traffic between the big centers was not touched. It was very important that we succeeded in using Regulations rather than Directives from this point on since these legal instruments have direct effect in the Member States while Directives need to be converted into national legislation. This not only saved time but also created a much greater legal certainty.

Second Package

Since the time of the First Package the Community developed the whole idea of the internal market as inspired by President Delors. When comparing the first package to this idea it was found that the First Package was too limited. In contrast to the Directors General of civil aviation the Ministers of transport increasingly became convinced that air transport as an economic sector would be a natural candidate for the application of this idea. Agreement was reached in 1990 to take further measures of liberalization and to finish the process by 1992. Before this agreement in 1990 there had been no official policy that liberalisation had to go the whole way in a gradual manner.

The second package itself opened up market access for all airports (except in two regions) for 3rd, 4th and 5th freedom services. Capacity limitations were relaxed to at least 60/40. Provisions were included allowing for a further automatic gradual relaxation of capacity limits where the existing bilateral capacity already were more liberal than 60%.

The principle of cost-relatedness for air fares for individual carriers was maintained. The zones for automatic approval of promotional fares were expanded. A zone for double disapproval of the lowest fully flexible fare was introduced. The right to match fares was kept.

The restrictions on (consecutive) fifth freedom services as well as traffic thresholds for multiple designation were relaxed. The possibility for Member States domestically to establish a public service obligation was introduced for situations where market forces could not function adequately. The possibility to stabilize capacity in cases of serious economic difficulties was maintained and so were the rules concerning airport congestion and operating provisions. An obligation to disapprove excessive fares was introduced.

This package was generally considered to be rather disappointing and weak. I do not think so since for the first time it looked at the whole Community air transport market for scheduled air services including the big markets between the main airports. It stipulated that a final liberalisation would have to come into existance by 1992. The package itself eliminated capacity and air fare restrictions. It was on the basis of this package that the low cost air carriers began to develop. While the growth rates of regional air carriers continued the high rates with the second package the growth rates on the main routes began to increase significantly.

Air cargo

A Regulation of 1991 liberalized the air cargo market except for domestic air services and right of establishment. It might therefore be said that with this decision by the Council point 2 of the priority list from 1978 had been given attention.

The Regulation did not have much influence on market developments since the third package followed so rapidly. It served to prepare the air cargo carriers but most of all it showed how an air cargo liberalisation could be achieved without at the same time liberalising passenger air transport.

C. Present measures

Third package

The third package was approved in 1992 and entered into effect January first 1993. It created an economic regulatory framework for a common air transport market based on the freedom to provide air services. This package has replaced all the above mentioned measures. It was being resisted by a number of the big national air carriers but they were too late since the decision to liberalise fully had in fact been taken in the context of the second package. Since the new legal measures were to cover all air carriers and not just scheduled air carriers some resistance was encountered from the charter air carriers because they were afraid that the new rules would be less liberal than the existing situation for them. This resistance fell away when it became clear that the charter air carriers would also experience increased liberalisation.

On the basis of the new provisions, a Community person (an individual or a company) irrespective of his Community Nationality can create an air carrier anywhere within the Community. A Community Air Carrier has the right to operate wherever opportunities might exist within the single market[5]. The distinction between scheduled and non-scheduled air services has practically been eliminated in a regulatory sense in particular for the licensing of air carriers and access to the market. The discretionary powers of Member States in respect of their own air carriers were eliminated.

This means that it is up to the air carriers themselves to decide in which mode they will operate. Air carriers are able to set prices freely and decide on the amount of capacity that they want to offer in the market. In other words the third package has given Community air carriers commercial freedom.

The competition rules continue to apply so that useful types of co-operation are permitted but cartels and other agreements of that nature as well as abuse of dominant positions are forbidden. The Community in particular pays close attention to the possibility of predatory behavior and should be able to stop serious cases of that nature. State aids are to be avoided except in a number of instances where they are considered to be in the common interest.

A number of safeguards and conditions were introduced or maintained. Operating licenses can not be granted unless the air carriers concerned demonstrate to their competent authorities that they are financially fit. These licenses may also be revoked or suspended when the air carriers are unable to meet their actual and potential obligations. An insurance to cover liability in case of accidents is compulsory. Safety standards should be ensured. When the market mechanisms do not result in needed services for example to peripheral regions possibilities exist to impose public service obligations. However, any exclusive concession which might result from this will have to be given on the basis of a competitive process, namely a tendering procedure, in which air carriers from the whole of the EU can participate. Where overcapacity has created serious economic difficulties for scheduled carriers of a given Member State, the capacity to and from that State can be stabilized for a limited period. Fares decreases can be stopped when they have resulted in wide spread losses among all carriers for the services concerned.

Accompanying measures

It was found necessary to take a number of actions leveling the playing field for the operators.

Normally CRS rules are mentioned as part of consumer protection but there are also quite a few concerns of air carriers in the context of CRSs. Air carriers need to be present in the CRSs and to have

[5] Certain geographical limitations existed until 1998

their products presented in a non-discriminatory way compared to their competitors. It is also useful to have competition between the systems so that fees are not unreasonable. Whether or not there is competition among air carriers the consumers are interested in having the services presented which are closest to their desiderata be that in respect of schedules or price. The presentation must be as comprehensive as possible and truthful. For all these reasons a code of conduct for CRSs was developed in 1989 and revised in 1993 and 1999. The code ensures non-discrimination and equal rights of access to the services of the CRSs for air carriers and travel agents. For the consumers the code prescribes a neutral and comprehensive display.

In order to avoid that congestion at airports and in the airspace becomes a bottle-neck blocking the practical effects of the liberalization process, the Union has dealt with the issue of physical access to the infrastructure. Thus, a regulation on slot allocation was also decided in the beginning of 1993 which acknowledges existing "grandfather" rights and ensures that allocation is based on neutral, transparent and non-discriminatory rules.

The framework of the third package with accompanying measures has produced a great deal of development in the sector both in respect of growth and creation of reasonable air fares. It was remarkable to see Lufthansa introduce new low fares on January 1 1993 in order to fill seats, which would normally have been flown empty in the first part of 1993. This initiative by Lufthansa caught all the other air carriers flatfooted and made it very clear to everybody that a new market situation had come into existence. The regional air carriers have used the new framework most efficiently and they have as a consequence for many years achieved double digit growth. This is contrary to the US where deregulation led to a decline in regional (commuter) air services and then to the hub system for the big air carriers. In the EU regional services were stimulated from the beginning and this momentum has endured until today. The large EU Air Carriers have also enjoyed larger than normal growth rates i.e. 8-9% instead of the 5% predicted. The charter market has maintained its strength in the EU while it continues to be weak in the US. Air fares have come down but not uniformly so. The use of promotional air fares has increased substantially while normal air fares have only come down where competition exists. Low cost air carriers have taken root and are now in the process of developing networks which with time, I think, will cover the whole of the EU. Contrary to the US no real consolidation has taken place but, as seen below, there is a reason for that.

D. Concerns

The third package etc. has created a liberalised market framework in the EU. The concerns which I would like to mention relate to the possibility to maintain this competitive market in real life.

Alliances & mergers

The development of alliances and groupings has taken on a life of it's own unfortunately to the extent that competition largely has been eliminated in parts of the Community market. This is true for the big alliances but also for the smaller ones. I think that the laxity of the US authorities when it came to approval of mergers also influenced the approach in Europe at least in the beginning. Unfortunately perhaps the first big merger in Europe took place in the most competitive national aviation market namely the UK. This development started in the EU with the approval by the Commission of the merger between British Caledonian and British Airways. The Commission approved this merger although it was clear that it would lead to a sharp reduction in competition. It is true that British Caledonian was close to bankruptcy but a competing offer did exist from SAS and that combination would have if anything increased competition. In retrospect this made it difficult for the Commission to say no to the merger between Air France, Air Inter and UTA and other mergers. This activity concerning mergers has been followed by alliances. The Commission also in this context is in a weak position because it can say no but it cannot indicate what it would be willing to accept. This is unfortunate because on the one hand it is quite clear that European aviation needs to consolidate in order to be competitive with the huge US air carriers. On the other hand elimination of competition

should not be allowed. An illustration of this dilemma can be found in the situation surrounding Austrian Airlines. With this air carrier joining the STAR alliance the quasi elimination of competition in a part of the EU market will be reinforced. If Austrian had joined another grouping such as One World, Skyteam or Wings it would have got the necessary boost in the market while competition would have been better preserved. The recent action of the Commission against SAS and Mærsk Air is encouraging.

This development towards elimination of competition is reinforced by the so-called code-sharing agreements[6]. Code-sharing in itself is probably not too bad but a code-sharing agreement contains other elements in particular pool agreements which are not acceptable in many situations and which were specifically singled out by Commissioner Sutherland in the eighties as absolutely contrary to the competition rules. In this respect it should also be noted that code sharing agreements exist between air carriers in different groupings thereby reducing the competitive element between these groups. Until now the Commission has not taken any action against code-sharing. This is not good because there is an enormous number of such agreements which in many cases eliminate competition in a smaller or more substantial part of the market. Sooner rather than later action will have to be taken against many of these agreements. It should be noted that the socalled blocked space agreements with separate financial responsibility does maintain the competitive element.

It would be useful if users of all kinds would take part in this discussion and indicate to the Commission that they are concerned. Complaints by users to the Commission are also possible.

FFP

The development outlined under alliances and mergers is accentuated by the use of FFPs, which give the big carriers and their alliances an extra weapon in the competition. It is very difficult for small air carriers to devise a competitive incentive. In fact a number of air carriers have been forced to enter an alliance in order to gain access to a competitive FFP. The example of Sun-Air is illuminating. Such incentive programs are normal in many economic sectors but they may have an excessive effect in air transport especially if combined with codesharing agreements. Taxation of such employee benefits, when the ticket is paid for by the employer, would reduce some of this disadvantage. However, it is difficult to introduce such a scheme with effect for all air carriers. It is likely that only the national air carrier would be hit. This would be unfair in the competition with the other air carriers in the worldwide market. Perhaps it is because of this difficulty that taxation until now has only been tried in very few cases and should not be tried unless the difficulty can be eliminated.

The combination of codesharing and FFP can be used in a predatory manner. This becomes dangerous because it can make it possible for a group of airlines to eliminate real competition in a substantial part of the market. On the other hand it should not lead to a situation where general economic regulation is introduced. I have no doubt that the dangers of combining FFPs with code sharing can be used by some countries as a pretext to reintroduce regulation (to protect their own air carrier). The competition rules constitute the main and appropriate instrument to deal with these concerns. However, normal market behaviour should not be excluded. Negotiated fares are normal in the market and not only for air transport. If an express service buys a large number of Mercedes vans it gets a substantial rebate. I see no reason why such behaviour should be excluded in air transport. There is also reason to warn that government ownership of air carriers should not lead to a relaxation of the application of the competition rules.

Congestion

Increasing congestion was recognised as a problem in 1992/93 and slot allocation was formally

[6] Including franchising agreements

introduced. These congestion problems have increased substantially since then since the policy of liberalisation has led to sharply increased growth.

The present slot allocation system is based on the preservation of the socalled Grandfatherrights and only new or unused slots are available to new or increased activity by other air carriers. I believe that we will soon have to decide whether we will continue with the present system which protects the existing air carriers or introduce new procedures which might either be in the nature of a rationing system or based on market forces. I am basically sceptical about rationing since it would seem to involve public authorities in secondguessing market needs. I will therefore limit the following remarks to the introduction of a market mechanism.

Market mechanisms are applied in the US by virtue of a buy and sell rule. This has increased market domination at some of the main airports in the US. Perhaps this is unavoidable but it is clear that a number of weaknesses exist in the US i.e. no transparency and no guarantee that slots will not simply move from an air carrier to its good (not competing) friends. This argues in favour of a system where slots may have a price either directly or by way of an auction. This then further leads to the question who will get the revenue from such pricing. In the US the air carriers are considered as owners of the slots once they have been allocated and the revenue of any sales stay with the air carriers. In Europe the airports considers themselves to be the providers of the infrastructure and therefore also the normal recipients of revenue from slot sales. However, it might be argued that airports as recipients of revenue from slot sales would be tempted to maintain capacity at a minimum and not construct new capacity which would eliminate or reduce significantly the revenue from slot sales. Furthermore, under international rules (ICAO[7]) airport fees must be cost related. Any revenue from slot sales would therefore have to be used to reduce other airport fees. This would be contrary to the whole purpose of introducing a pricing system for slots which is really to encourage some air carriers to reduce their activity at the airport, to use larger aircraft or to move to another less congested airport.

A secondary question then becomes whether the market alone should decide which type of air carrier should have to leave an airport. It is clear that the air carriers which can best afford to pay for slots are the long haul scheduled air carriers because airport costs constitute a rather low percentage of their total costs. They would therefore tend to squeeze out in particular regional air carriers. But some regional air services might be needed to get to the main airport. For this reason a straight market based system might have to be modified so as to establish a pricing system for the different types of traffic or it might be necessary to constitute two or more slot pools for pricing or auctioning.

The internal market externally

While an internal market has been created for the Community in air transport it must be underlined that it only covers transport between and within Member States. This has an unfortunate effect since externally the Member States continue to negotiate bilaterally according to the classical model without taking the Community internal air transport market into consideration. It means that cross-border investments are not very attractive. For example Deutsche BA, in which British Airways has a controlling shareholding, finds it very difficult to get traffic rights to third countries since it is not owned and controlled by German nationals, which is required under the German bilateral agreements. Part of the difficulties for Swissair can also be accounted for by this phenomenon since Swissair acted too early i.e. before an air transport agreement with the EU had been ratified.

The Commission has taken legal action before the Court of Justice in order to try to resolve this problem but today it is not known whether it will be successful.

Vulnerability is different for US and EU air carriers. US air carriers depend overwhelmingly on their domestic home market and to them the international acitivities are a welcome but marginal bonus. For the EU air carriers the international market is their bread and butter market. This weakness of EU air carriers makes it tempting for Member States' governments to continue to protect their own air carriers and not to allow EU air agreements with third countries in general. The effect of this is that needed

[7] International Civil Aviation Organisation

consolidation in the EU is not taking place. This will remain so until the internal market is established as a home market for the Community Air Carriers and the existance of the EU is recognised as such by third countries in the context of air transport. In this regard government ownership constitute a barrier to progress.

Conclusion

The basic philosophy in the beginning was arm twisting but it gradually changed to the liberal philosophy of the internal market but there it stopped.

The benefits are not in doubt. Substantial decreases in most air fares, increase in choice, growth of low cost air carriers and market based commercial behaviour. Badly managed air carriers, which normally included government controlled air carriers, find life difficult. The resulting growth of air transport has been substantial.

The challenge now is threefold. First of all there is a danger that protectionism may come in through the back door and to counteract this the competition rules must be applied vigilantly, secondly the international framework must be changed to accomodate the EU and thirdly market mechanisms must be developed to cope with congestion problems.

This presentation has been of a socio-economic nature or psychohistory as Asimov would have termed it. The reason is that straight economic arguments are not sufficient to explain what has happened between 1978 and 1992 and will not be enough to explain the development of air transport in the future either.

Annex 1

GRADUAL DEVELOPMENT OF EU AIR TRANSPORT POLICY

	Interregional	1st pckge	2 pckge	cargo	3 pckge
	1983	1987	1990	1991	1992/93
Geographical scope					
Regional airports	x	x	x	x	x
Regional/Main airports		x	x	x	x
Main airports			x	x	x
Domestic					x
Traffic Rights					
Multiple Designation		x	x	x	x
3/4 freedom	x	x	x	x	x
5 freedom		(x)	(x)	x	x
6 freedom	x	x	x	x	x
7 freedom				x	x
8 freedom					x
9 freedom					1997
Public Service			(x)		x
Tariffs					
Cost relatedness	x	x	x		(x)
Flexibility zones		x	x		
Double disapproval			(x)		
Matching		x	x		
Free pricing				x	x
Capacity					
(60-40)		x			
60-40+			x		
Free	x			x	x
Air carrier licensing					
Economic fitness					x
Technical fitness					x
Ownership					x
Leasing rules					x

	Interregional 1983	1st pckge 1987	2 pckge 1990	cargo 1991	3 pckge 1992/93
Carrier rights					
Against foreign state					
tariffs	x	x	x	x	x
capacity	x	x	x	x	x
access	x	x	x	x	x
licensing					x
Against home state					
tariffs	x	x	x	x	x
capacity	x				x
access					x
licensing					x

Annex 2

Priority list for air transport approved by the Council in June 1978

1. Common standards restricting the emission of nuisances due to aircraft;
2. Simplification of formalities (facilitation), particularly those relating to air freight;
3. Implementation of technical standards (JAR);
4. Provisions regarding aids and competition;
5. Mutual recognition of licenses (aircrew and ground staff);
6. Working conditions (aircrew and ground staff);
7. Right of establishment
8. Possible improvements to inter-regional services;
9. Search, rescue and recovery operations, and accident enquiries.