

The EU-US Open Access Area: How to realise the radical vision

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Talks are due to begin in September on the European Community proposal to create an EU-US "Open Access Area", whereby any airline established in either the EU or US would have equal, open access to any aviation market within that zone, and non-discriminatory access to third country markets. The EC is proposing to abandon the historic approach by which governments regulated international airline competition and move to a framework where airlines could be organised on a multinational basis, like financial institutions and most other global service industries. By initially negotiating with the US, the EC hopes to quickly establish a large foundation that can be steadily extended to other countries and regions, where Open Access could be an especially powerful driver of competition and increased efficiency.

While some recognise a historic opportunity, others have been more cynical about the possibility of ever reforming the old system. It promises to be one of the most interesting stories in aviation in the coming year. The EC faces enormous obstacles, including the sheer audaciousness of its concept and the extent to which the current system is totally ingrained into industry-wide processes and thinking.

In this review we will discuss Open Access in the context of the major economic constraints within today's framework, and the alternative paths to structural reform under discussion. It is unclear whether the EC and other supporters of Open Access fully appreciate the enormous challenge of uprooting long-standing practices and moving global aviation to a totally new approach. In particular, there are issues as to whether the EC can

- Demonstrate that the new framework can fully meet all of today's safety, consumer and other legal requirements and deny defenders of the status quo the opportunity to block reform by raising a wide range of doubts and concerns;

- Offer solutions for today's outstanding market entry and competition problems and for the ongoing issues of slots and future competition at capacity-constrained airports, so clearly establishing the pro-consumer objectives of Open Access;

- Keep the upcoming negotiating process focused on the possibility of reaching a breakthrough agreement on long-term structural reform, and prevent competing short-term claims from airlines and other vested interests from dominating or subverting the basic reform agenda.

The November 2002 European Court of Justice decision that invalidated bilateral provisions inconsistent with the Treaty of Rome left a number of aviation jurisdictional issues unresolved. However, we are assuming that these intra-European matters are being, or will be, sorted out, and the Europeans will be in a position to negotiate a major new treaty with the US and other third countries that will be binding on all the Member States.

The Gordian Knot

Every commercial airline in the world has been rigidly tied to a single, specific nationality since the earliest days of the industry. The US Aviation Act of 1938 established the 75% US citizen rule for ownership and control of US airlines that remains in force today. The Chicago Convention of 1944 established national accountability for safety, specifically sanctioned the state role in limiting and managing competition, and enshrined the fundamental right of every state to prohibit foreign carriers from entering their domestic market. The airline/nationality link was extended across the globe by the ownership provisions of original US-UK Bermuda 1 treaty and the thousands of subsequent Air Services Agreements modelled

after :

Every airline must meet three tests of nationality. It must receive an Airline Operators Certificate and be subject to the safety oversight of a specific government, it must have its principal place of business and be subject to the commercial law (pertaining to finances and contracts with customers, and many other matters) of the same government that issues the AOC, and controlling ownership is limited to citizens of that nation. This in effect prohibits mergers across national borders, and makes any commingling of operations or marketing with airlines of other nations extremely difficult.

The airline/nationality link is now a Gordian Knot, extending far beyond the regulatory control of safety oversight that was the key objective of the Chicago Convention. Ownership and control provisions limit access to capital. Consumer protection and accident liability laws all rely on this strict national framework, so that CRS codes and other airline branding devices are as rigidly tied to nationality as the regulation of aircraft maintenance programs. Under Bermuda-type ASAs airlines can only operate international routes when governments have granted and traded reciprocal "rights" of market entry, and every country has the right to block any airline not meeting these three nationality tests. This not only gives governments considerable scope to limit airline competition, but also creates leverage that can be used to further other diplomatic objectives.

All past efforts to reduce government interference in airline markets (including deregulation and privatisation) were strictly within the traditional "national airline" framework, which remains as rigid as ever. Countries have always had the ability to pool nationalities, as Sweden, Norway and Denmark did in 1951, but this requires the specific agreement of every trading partner, and the pooled nationality still functions within the traditional system. Airlines from different countries cannot freely integrate marketing or operating assets, as companies in most other industries can, unless (like SAS) their governments have implemented worldwide agreements that recognise pooled nationality.

Market access under the Open Skies policy advocated by the US Government is strictly limited to "national airlines" as defined under

the Bermuda framework. Under tightly controlled conditions airlines can use codesharing to sell other airlines' services, but only when the marketing carriers have the underlying right to operate the route; since alliances have no nationality, they are forbidden from directly selling services or controlling operating assets.

Two approaches to aviation reform

It is important to emphasise that the EC has explicitly rejected proposals to achieve incremental gains under the old framework, and is attempting to undermine, and eventually replace the old system. Open Access is much more than Open Skies, and it is much more than an attempt to pool the nationality of the 15 Member States into a single aeropolitical entity called "Europe". The US Government has clearly indicated its willingness to replace its 15 separate, somewhat inconsistent Air Services Agreements with a unified Open-Skies ASA, and these changes could have been easily implemented under the current system. Equally clearly, the EU has indicated that such an approach fell far short of what it was trying to achieve.

Two basic approaches to aviation reform are possible (see table, page 4). The first approach attempts to weaken the Ownership and Control (O&C) bilateral provisions to facilitate cross-border investment while protecting both safety oversight and traditional commercial and aeropolitical jurisdiction of national governments. Extensive work has been done by a range of organisations on exactly how more liberal ownership could be achieved without unravelling the Gordian Knot and compromising other elements of aviation's legal framework. IATA has done extensive work with its members on the merits of delinking ownership and regulatory oversight. Initiatives such as the APEC multilateral open skies negotiations, the OECD Cargo Open Skies initiative and ICAO Air Transport Regulation Panel (see note 2) have explored specific options for amending ASAs, such as linking airline nationality to its

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	Historic Framework	Liberalised Ownership and Control	Aviation Free Trade
Airline Nationality	3 criteria: (AOC/effective safety oversight, Principle Place of Business/effective commercial jurisdiction, citizenship of controlling shareholders)	reduced to 2 criteria: (AOC/effective safety oversight, Principle Place of Business/effective commercial jurisdiction)	reduced to 1 criteria: (AOC/effective safety oversight)
Access to Capital	Only own nationals can invest	Investment restrictions lifted	Investment restrictions lifted
Commercial Entity	Same entity/nationality as AOC holder	Same entity/nationality as AOC holder	Commercial restrictions lifted
Cross-Border Marketing integration/flexibility	No cross-border integration of marketing or operations	Limited cross-border marketing possible but not deep integration or common branding	Extensive cross-border marketing possible including common branding
Cross-Border mergers	No Cross-border mergers	Common ownership possible across borders, but brands, management strictly separate	Cross-border mergers possible as long as operating units strictly tied to AOCs/safety regulators
Aeropolitical barriers to entry and competition	Entry only when governments agree on reciprocal rights No access to foreign domestic markets	Entry only when governments agree on reciprocal rights No access to foreign domestic markets	All artificial entry limits eliminated All discrimination based on nationality lifted

"principal place of business" or where "effective regulatory control" exists, while eliminating references to the citizenship of its shareholders. The European Union has clearly taken note of these approaches (and even simpler ones, such as "permanent presence"). Provisions to prevent airlines from establishing "flags of convenience" or exploiting other loopholes to "free-ride" off of other third-country airlines' rights have also been proposed.

Ownership and control liberalisation creates the possibility of increased foreign investment and even foreign ownership but does not really break the core airline/nationality link and would not facilitate cross-border marketing integration, much less a true multi-national carrier. An airline based in the US and under effective regulatory control of the US Government could be owned by Germans or Singaporeans under fully liberalised O&C, but it could not combine its operations or marketing with airlines under the regulatory control of Germany or Singapore. It would be subject to the exact same legal and economic constraints as today's US airlines. The EC has not even broken this airline/nationality barrier within Europe. Virgin Express maintained separate operations under separate Irish and Belgian AOCs several years ago, but was strictly prohibited from co-mingling operations in order to protect clear lines of safety regulation. Lufthansa is permitted to take a controlling shareholding in Air Dolomiti, but operations,

branding, commercial activities and financial responsibilities must remain distinctly Italian. Air Dolomiti can use the LH-designator, but only on the same restricted terms as United or Air New Zealand. Lufthansa could integrate Air Dolomiti operations and branding with Lufthansa Cityline if it shifts operations to a German AOC and the higher costs of German legal requirements, or retain the Italian AOC and the higher cost of duplicate infrastructure.

The alternative "free trade" approach breaks the Gordian knot by separating national responsibility for operational licensing and safety oversight from any definition of commercial nationality, and prohibiting market discrimination based on any notion of nationality. This would allow airlines to separate their core operating/technical functions (which would remain tied to the national AOC) from other marketing and service functions, which could be organised across borders, or in other innovative ways. Alliances currently have no ability to obtain route rights or sell tickets since they are not "airlines" and do not have any nationality. With the denationalisation of commercial activities, Lufthansa would be free to organise and market Air Dolomiti and Cityline (and for that matter the Star Alliance) in any way it saw fit and would allow people to rethink the basic question of "what is an airline?"

Airlines would gain the same marketing flexibility as multi-national banks that can adapt global brands, retain historic national

brands, or use multiple product line brands, without petitioning dozens of governments for regulatory approval. Under the "free trade" approach, airlines would still be fully subject to normal consumer protection and other commercial laws, just like software and soft drinks companies. Airlines with sales or airport staff in any given country would be subject to all local labour laws and social requirements. Governments would continue to play a key role in areas like airport capacity and competition law but they would lose the ability to distort markets by explicitly discriminating between airlines on the basis of nationality.

Aviation reform under Open Access - how far, how fast, which path?

The EU clearly aims to achieve a major breakthrough that would facilitate cross-border integration and mergers. Public statements emphasise the need to destroy "long embedded commercial restrictions and archaic ownership rules so that investment may flow freely and airlines can create truly international businesses" and the specific goals of facilitating "mergers between European airlines from different countries and between US and European airlines" and the overall "consolidation of the industry". EU statements claim that the initial establishment of the EU/US Open Access Area would "produce a more competitive market than today generating a greater choice of services and lower airfares" and "direct consumer benefits of at least €5bn a year and would boost airline/nationality employment on both sides of the Atlantic". (see note 1)

These statements would not be consistent with simple ownership and control liberalisation and the EC appears anxious to eliminate the type of barriers to operating and marketing efficiency that Virgin Express and Lufthansa/Air Dolomiti face. This more ambitious approach is a logical extension of the free trade objectives of the Treaty of Rome to international aviation. The Treaty clearly envisions a multinational economic space, where companies have the right of establishment and are free from discrimination based on nationality.

Under this concept, national governments must abandon their historic role "designating" and protecting national companies and negotiating with other national governments for "reciprocal" trading "rights".

It is not yet clear whether the EC's mandate recognises the worldwide scope of changes needed to fully establish a free trade-type regime or the long-term negotiating and implementation challenges of this ambitious approach. An initial agreement covering the EU/US zone would be largely symbolic in many ways; no large international carrier will be able to even entertain ideas about seriously integrating operations or marketing across borders until Open Access agreements cover a significant portion of the global market. Until that time, carriers will avoid any move that could undermine their old national identity and the route rights to countries like Japan and Russia that are linked to it. Yet claimed benefits of the EC proposal focus narrowly on the EU/US zone and there has been little discussion of how aviation discussions with less liberal third countries might be aligned with the major changes envisioned for the US talks, or the multi-year diplomatic effort that will be needed extend Open Access more widely.

Since safety and a wide range of other laws are involved, it will be critical to work out exactly how a new free trade framework would work in practice. These are certainly not insurmountable challenges, but it is not sufficient to merely suggest that solutions are possible. Any vested interest or entrenched bureaucrat wishing to block reform need merely suggest that safety accountability could be confused or compromised. If Europeans are not yet satisfied that there is a framework that would permit Virgin Express complete cross-border flexibility under multiple AOCs, then Americans and others have a right to demand stronger evidence. Alternative approaches must be worked through in considerable detail, with active consultation and discussion with a wide range of airlines, unions and other interested parties.

The commercial issues represent relatively uncharted territory and may actually be trickier to solve. Swissair, Sabena and Austrian considered using a common two-letter CRS code several years ago as a means of marketing their Qualifyer Alliance. The US Government

had no bilateral, competitive or safety concerns, but objected to the concept on the grounds a multi-national identifier could obscure critical information (what nation is providing safety oversight?) and confuse consumer rights (what law applies if there is a dispute?). Obviously, hundreds of other industries have found solutions to these problems and efficiently market on a multi-national basis, but this illustrates the depth of the traditional airline/nationality mindset. The EC must be in a position to answer all possible legal objections in situations far more complex than the *Qualiflyer* case, including *true multi-national mergers*, and recognise that many governments could use these types of claims of legal uncertainty to protect incumbents and block new competition.

Market entry and competition issues

The EC expects Open Access to directly spur expanded service and increased competition (it forecasts 17m incremental passenger trips annually), although the specific changes to existing constraints that might stimulate new entry and traffic growth have not been described in detail. Today's major US-EU competition problems centre on airports with serious physical capacity constraints, and transatlantic service to London, where historical bilaterals have seriously distorted competition and artificially blocked entry.

The EC explicitly acknowledges a government role in airline markets where physical capacity constraints can limit the efficacy of "free" competition. "The Open Aviation Area will have to offer all community carriers equivalent opportunities as regards access to traffic. The ability of the principal Community airports to accommodate new service is, in this regard, decisive. If problems of airport capacity were to hinder the opening of new transatlantic services for community companies, the Commission would examine the situation, take the appropriate measures, and make ... proposals to the Council and the European Parliament to allow fair market access... to be restored" (see note 3). It is not yet clear how policy statements such as this will translate

into concrete market rules, but given the degree of capacity constraints across Europe, it will be impossible to judge the potential impact of an Open Aviation Area on competition and consumers without a detailed consideration of specific proposals, including clear rules on slot distribution and "ownership".

Under current EC rules, airlines have an absolute right to continued use of historic slots at no cost, but cannot be paid to trade or relinquish them, and have no rights if they stop using them. These rules have been challenged by UK court decisions upholding grey market trades of slots for money, and by recent market interventions to extend grandfather right to slots unused during the current market downturn. Under an Open Aviation Area, the EC could reaffirm and more strictly enforce the traditional IATA-administered rules, or adapt a wide range of alternate rules. These include granting historic users full slot ownership rights (including the right to buy or sell at open-market rates), granting airports or governments all slot ownership rights with proceeds earmarked for capacity expansion, and various forms of narrower, targeted interventions to support new entrants or other perceived needs (see note 4).

Every one of these alternatives will create a "bias" in favour of some competitors and against others. The status quo places new entrants (who have no access to slot trades and can not buy slots) at a clear disadvantage but may limit the ability of dominant carriers to aggressively acquire slots in the hopes of reinforcing that dominance. More open, transparent slot exchange markets can accelerate the shift slots from weaker to stronger uses but can also create serious speculative distortions during the initial transition to a new system. Several approaches can create disincentives to needed capacity expansion. This is an exceedingly complex issue; there is no obvious solution that will enhance competition without putting some existing economic interests at risk, and there is always the danger that interventions to maximise consumer interests could adversely affect industry efficiency.

It will be difficult to negotiate major breakthroughs in the name of enhanced US-EU competition without clearly addressing its impact on transatlantic service at London

Heathrow, the market widely regarded as the furthest from anyone's ideal of competitive efficiency. At every other large transatlantic gateway EU-flag service is totally integrated into a large, comprehensive hub network, and a range of US carriers offer service from their respective hubs. At Heathrow, UK-flag service is much more fragmented, most US hub carriers are prohibited from serving the market, and US flag routes have been largely frozen in place since the 707 era. Deliberate government intervention designed to help specific incumbent airlines has hurt consumers and reduced overall industry efficiency. Historical distortions in other EU transatlantic markets have been resolved by a combination of Open Skies and new entry. US attempts over the past decade to replace the Bermuda 2 treaty have been firmly rebuffed by the UK, and the lack of capacity at Heathrow would preclude new entry in any event. It will be difficult to take the EC's professed interest in consumer benefits from expanded competition seriously if the new US-EU Open Aviation Area fails to find the best possible solution for consumers at Heathrow. Unfortunately, the problems facing any solution to the slot issues also apply to Bermuda 2: it is very complex, there are powerful entrenched positions, absolutely any solution will damage some legitimate (consumer or airline) interests, and things can get worse during the transition to any new system.

Cabotage - finally time to attack the sacred cow?

The elimination of cabotage and discriminatory access to US Government and military contracts (such as Fly America and the Civilian Reserve Air Fleet (CRAF)) is a critical element of the EC proposal. Free trade within an Open Access area requires the freedom for any airline to enter any market on equal terms and that governments do nothing to limit market access or competition based on traditional definitions of ownership or nationality. There are different ways that the legal framework supporting this could be arranged, but under any scenario all airlines operating US domestic service would be subject to the same commer-

cial and labour laws as any other domestic US operator. The US Government and military could set specific requirements for airline participation in these programs (such as the aircraft availability and cargo payload requirements of CRAF, or security clearance requirements) but could not discriminate among airlines that met those requirements solely on the basis of the nationality of the airline shareholders. Most of the ships requisitioned by the US military during the Iraq War, under the marine equivalent of CRAF, were from shipping lines owned by foreign citizens.

The EC proposal is fully consistent with its larger goals of destroying all remaining protectionist aspects of the Bermuda framework and moving to a system where airlines work across national borders in the same way that most other industries do. However, both US cabotage and government discrimination have organised, vocal support, and past attempts to raise the issue in negotiations (including recent US-UK Open Skies talks) have failed on political grounds.

Estimating the benefits of Open Access

Quantifying the economic impacts of changing basic elements of an industry's structure is a thankless task. The EC's Open Access proposal would radically alter aeropolitical constraints that are over half a century old, but aeropolitical constraints are only one of many factors influencing the structure of the industry. It is difficult for anyone in aviation to grasp the opportunities those changes might create, and it is very difficult to isolate the value of those aeropolitical changes from the dozens of other variables that drive industry competition and profitability. There is a fundamental difference between long-term benefits (huge potential, but hard to identify, much less quantify, with any precision) and short-term benefits (smaller, but easy to document using concrete examples). Open Access has been explicitly designed as new model for global aviation. Any initial US-EU agreement would be a pilot program, not an end in itself, and it is likely that initial US-EU impacts could be tiny compared to

what might be possible if the approach worked globally.

Nonetheless, the EC commissioned The Brattle Group to estimate the economic value of Open Access, and their study (see note 6) developed the €5bn estimate of direct consumer benefits cited earlier and widely quoted by Open Access supporters. All of Brattle's forecasts are for near-term impacts in the EU-US zone, and do not assume any extension of Open Access beyond that zone. Brattle claims that the major benefit of Open Access (€3bn) would result from massive productivity gains as more efficient carriers pushed weaker ones out of the market and carriers adapted more efficient procedures in order to compete. Brattle focuses narrowly on quantifying its hypothetical productivity burst, but provides little explanation or evidence to explain why Open Access would be directly responsible for creating it. It suggests that European airlines will take much greater advantage of scale economies without providing examples of these unexploited opportunities or attempting to explain why airlines do not exploit them today. Brattle claims additional benefits (€0.6-1.5bn) from extending Open Skies to the UK, Ireland, Spain and Greece, with (as would be expected) almost all of the benefits occurring in the US-UK market. US Government negotiators might plausibly claim that they have trying to achieve these gains for the past decade, and any linkage with Open Aviation is artificial. It also fails to explain how the Heathrow capacity problem would be solved.

Brattle also claims the potential for increased pricing synergies on the North Atlantic (€0.6-1.3bn). The specific changes that drive these improvements are not explained, and it is not clear where new pricing synergies of this magnitude might come from. As with the Open Skies benefits, Brattle seems to believe that Open Access would create a second wave of benefits similar to those observed when the immunised alliances and Open Skies were first introduced across Europe. It is much more likely that the carriers participating in the first wave captured the predominant share of potential benefits from these innovations, and any future gains would be much, much smaller. Brattle further assumes that all of these gains would flow to consumers

in the form of increased service and lower prices, instead of flowing to labour or shareholders. The type of short/medium term changes that Brattle predicts have been observed in the past, but only when the industry had significant under-utilised capacity, major constraints to short-term pricing or route access were lifted, or when new airlines with significantly lower costs initially enter and establish viable positions. None of these conditions are present today.

The EC's public relations offensive relies heavily on the sales pitch that (to paraphrase) "Open Access will drive overdue industry restructuring and a productivity boom, resulting in a consumer cornucopia of increased service and lower prices". It seems unlikely that the politicians and airline executives that have been quoting Brattle's €5bn benefit estimate have actually read the study carefully or could explain the logic behind the estimates. Open Access will be debated in a political arena, the EC must work with a complex set of constituents and the attraction of a simple, sexy sales pitch is understandable. Unfortunately, it will not be difficult for defenders of the status quo to challenge these claims and thus the basic credibility of Open Access, and put the EC back on the defensive.

Open Access and industry restructuring

Open Access is widely heralded as the change that could trigger an industry shakeout. The *Financial Times* quoted EC officials as saying this "much needed consolidation...of the fragmented European aviation industry...could happen in months rather than years" and that the (Open Aviation) agreement would "pave the way for the creation of pan-European carriers...improv(ing) the dire state of profitability among the leading airlines" (note 5) Claims for industry restructuring of this sort, a short term phenomenon, must be distinguished from potential long-term changes that might occur under Open Access, such as efficiencies from totally new ways to organise traditional airline functions. The end of the strict airline/nationality link will facilitate changes that

cannot be foreseen today, but these payoffs are down the line.

The claimed near-term industry restructuring benefits only make sense if there was a clear-cut, well-documented efficiency gap between specific large European airlines today and what they could achieve after merger or some other defined restructuring. This evidence has never been provided by European consolidation advocates, and there is enormous evidence that the economics of consolidation via merger would be largely negative. More implausibly, the claim assumes that many intra-European mergers would have been profitably pursued except for identifiable aeropolitical barriers that Open Access would specifically remove.

The European airline industry is fragmented because markets are fragmented, and the growth of the low-cost sector has increased this fragmentation. Except for narrow categories of intercontinental connect traffic there are no meaningful scale economies when local networks consolidate. European carriers have problems with overcapacity, productivity and balance sheets, but these can be addressed by reducing capacity, reducing costs and financial measures. Mergers would make each of these problems worse. The large North American airlines in the worst financial shape were the ones that recently merged (AA, AC) or the ones that spent years attempting to (UA, US), and no sensible observers have seen mergers as a solution to the current US industry crisis. Swissair's core airline was viable but the company failed after multiple attempts at cross-border investment (SN, TP, OS, IW, PE, FU) failed to produce any meaningful synergies, and KLM walked away from its long planned combination with Alitalia. There are obstacles to the "free flow of capital" when one compares the internal European aviation market to the internal American market, but the main issues are labour immobility and poorly developed bankruptcy processes and not aeropolitical constraints within the EU-US zone. Global abandonment of the old link between nationality and traffic rights would create many new opportunities, but again, this will have no bearing on industry changes in the next two years.

There is a fundamental contradiction

between these industry consolidation arguments, and the increased service/consumer welfare arguments cited earlier. Open Access cannot simultaneously stimulate massive new entry and competition that drives down prices and generates 17m incremental passenger trips annually, while also driving pan-European mergers and an industry shakeout. Industry consolidation might enhance productivity and profitability (as with the US shakeout of the early 90s) or leave the industry much worse off (as with the US mergers of the late 90s) but they will not directly stimulate new entry or lower fares in either case. In today's environment they would strictly be a means to eliminate excess capacity, and would reduce consumer options and price competition.

While consolidation advocates emphasise that European aviation is "fragmented", there is no evidence whatsoever that mergers would address the problems of Europe's many small and mid-size carriers (TAP, Finnair, Olympic, Austrian, SN Brussels, etc). The scale of these companies reflects the local markets they serve, and investors have not shown any interest, although there would be few obstacles to any proposed acquisitions. Neither Swiss nor SN Brussels, despite ongoing efforts, have found a buyer willing to pay more than token amounts for their large networks and market positions. The proposed Lufthansa investment in Swiss is predicated on a major Swiss downsizing that would eliminate capacity directly competitive with Frankfurt and Munich.

Consolidation advocates appear much more interested in mergers between Europe's largest, intercontinental-focused carriers where fragmentation is clearly not an issue. Three years ago there were six large competitors on the North Atlantic (three alliances plus BA, AA and CO) and several serious mid-sized carriers (AZ, US, IB, SK). Subsequent combinations plus the proposed BA-KLM merger would have left only three plausible transatlantic competitors. There might be a valid business case for any specific merger but it is totally absurd to argue that Open Access is a wonderful opportunity for consolidating the North Atlantic down to three players while also claiming that Open Access will rapidly generate €5bn in consumer benefits through expanded service and increased price competition. A

merger between any of Europe's large long-haul airlines would face huge complications due to route rights to illiberal countries outside the EU/US zone. If Open Access succeeds in this zone and then spreads widely, mergers of global networks might become feasible but it is absurd to suggest this type of consolidation would occur anytime soon.

Can the EU and the US find common ground?

The negotiations on Open Access represent a fundamental fork in the road for global aviation: should the industry remain resigned to the Bermuda world of strict airline/nationality links for the coming decades, or should the EU and US take the leadership role in destroying that link, and moving aviation to a multinational framework similar to most other industries? The negotiating burden will fall almost exclusively on the European side. The US has little of immediate economic importance on the table in this negotiation, and no political risk if talks fail. Vested interests do not have to defend the status quo, but can block reform by emphasizing risks and logical inconsistencies with the EC's radical new concept.

As the process begins, it is important to understand that the US remains totally committed to the statutory 75% ownership and control rule for US airlines, and that there is no strong US political force demanding change. It will take enormous political effort to change the laws establishing those requirements, and to counter the political constituencies behind cabotage, Fly America, CRAF and other forms of discrimination. US officials would likely understand that Open Access offered limited near-term financial benefits for US consumers.

US airlines would not expect any material impact on the current industry financial crisis, and are not focused on any potential gains from longer-term reform. US airlines have ample access to capital, and can achieve very high degrees of competition and efficiency within the old system. Efficient workarounds (such as alliances) can be found for most cross-border issues. Europe will need to convince the US Government to voluntarily

change a system where it has the natural advantages of both the largest market and enormous political might. DOT and the State Department clearly value the basic right to intervene in international airline markets in order to block abuse or to further important national policies.

One possible key to a breakthrough would be to convince Washington that its current approach to aviation liberalisation (trying to get illiberal nations to agree to Open Skies) had passed the point of diminishing returns, and that Open Access was truly the best way to move the global industry forward in the coming decades. Washington is unlikely to accept Open Access as the new basis for liberal aviation reform until the EC puts its long-range, cross-border, free-trade objectives forward in a much more compelling manner, and demonstrates an absolute commitment to pro-consumer, free market issues in other areas. As a practical matter, this will require a package that develops pro-consumer Open-Skies compatible solutions for all the outstanding marketplace issues (Heathrow, Fedex/UPS/DHL, slot exchanges) on the table.

By emphasising the short-term consumer cornucopia and pan-European merger arguments, the EC has caused some observers to totally misunderstand the real objectives, and others to wonder whether those intentions might be compromised by other interests. Washington has clear memories of the UK government's simultaneous dedication to free market ideals and the crude protectionism of Bermuda 2. Despite sympathies with open entry, reduced government interference, freer flows of capital, enhanced productivity and lower fares, US negotiators are not very likely to invest political capital on a plan that would immediately reduce competition on the North Atlantic and permanently lock in Bermuda 2 distortions at Heathrow.

Europe must convince Washington to take two steps back from its longstanding focus on reciprocal "rights" and quid pro quos, and get Washington to agree to the central objective of a reduced government role and eliminating the very concepts of reciprocal "rights" and quid pro quos. Washington assumes that the UK raised cabotage in Open Skies talks knowing it was politically untouchable, and thus a sure-fire way

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to sabotage meaningful competitive improvements the US was seeking. If Washington continues to look at things this way, Europe's renewed demand for cabotage will be taken as either insincere or foolish, since Europe could not possibly offer any reciprocal benefits equivalent to opening up the US market, and golly, who would want to invest in US airlines these days anyway?

Again, old aeropolitical habits die hard, but if the EC can make its central case more clearly, Washington may recognise a unique opportunity. There may be different ways to put the package together in light of the political concerns, but if you agree the primary objective is to (eventually) destroy the old system, you would quickly recognise the (eventual) need to destroy cabotage as well.

If the EC can convert Washington to the core objective of destroying the strict airline/nationality link, the challenge then becomes to develop detailed solutions for how the new framework would meet the needs of rigorous safety oversight, consumer protection, accident liability, collective bargaining rights and the myriad other aviation legal issues that would be reopened once the Gordian Knot is cut.

It must be demonstrated that governments can relinquish the right to refuse airline operating rights on strict ownership/nationality grounds without losing the leverage needed to drive other important policy objectives. It is not sufficient to suggest that solutions to these challenges could be found, the EC and the US Government must be in a position where they can demonstrate that solutions have been found. Only at that point can the debate be shifted from the danger of safety (or other legal) risks to the desirability of moving away from an

archaic system. Only at that point can the burden of proof be shifted to the vested interests fighting to maintain the status quo. While individual carriers or unions or military procurement officers may have a clear preference for the current framework, those preferences should not determine the basic structure of global airline competition.

A successful negotiation will mean either that the EU and US agree on a framework for abandoning Bermuda and supporting multinational and other innovative airline structures or the EU and US agree that, no matter how well-intentioned, Open Access just won't work, and reform will need to follow a totally different path. In either case, the path to success will be slow and difficult. Failure could occur much more quickly, as the negotiators could simply talk past each other, and fail to understand or deal with the central issues. As always, the process could be co-opted by narrow interests attempting to manipulate short-term economic issues at the expense of the larger reform agenda. There will be considerable pressure to achieve some "quick harvests" of intermediate agreements, and simultaneous pressure to focus strictly on the "big bang" of a comprehensive breakthrough.

Elected leaders on both sides will be looking for the former but intermediate steps could reduce the US appetite for larger changes, and the US is highly unlikely agree to anything major that was stated in vague, general terms. Participants advocating the "big bang" could have a sensible focus on the most important objectives or could be hoping that over-complexity leads to collapse and preserves the status quo. Nothing important is ever simple.

note 1 -Loyola de Palacio, "Troubled airlines need open skies", Financial Times 29 June 2003

note 2 -Alan Mendelsohn's article "The US, the European Union and the Ownership and Control of Airlines" Issues in Aviation Law and Policy, March 2003, March provides a much fuller discussion of O&C issues than is possible here

note 3 -DG C III, Draft Council decision authorizing the Commission to open negotiations with the US in the field of air transport, Brussels 28 May 2003

note 4 -"A Market in Airport Slots", a recent paper by the UK Institute of Economic Affairs discusses the pro and cons of many of these alternatives, noting the differing views about underlying property rights in slots and with particular reference to the funding of capacity expansion

note 5 - Financial Times, 13 June 2003

note 6 -The Economic Impact of an EU-US Open Aviation Area, December 2002; this includes appendices that usefully summarise EU responses to US concerns about labour and national security issues. The study is available at http://www.brattle.com/_documents/Publications/ArticleReport2198.pdf