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INTERNATIONAL AVIATION

Measures by European Community Could Limit U.S. Airlines' Ability to Compete Abroad

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The Honorable Ernest F. Hollings
Chairman
The Honorable John C. Danforth
Ranking Minority Member
Committee on Commerce, Science,
and Transportation
United States Senate

The Honorable Wendell H. Ford
Chairman, Subcommittee on Aviation
Committee on Commerce, Science,
and Transportation
United States Senate

The Honorable John McCain
United States Senate

In response to your request, this report assesses changes to air transport regulation that have been undertaken by the European Economic Community and the effects of those changes on U.S. and European airlines.

As arranged with your offices, unless you publicly announce its contents earlier, we plan no further distribution of this report until 15 days from the date of this letter. At that time, we will send copies to the appropriate congressional committees and the Secretaries of Transportation and State. We will also make copies available to others upon request.

If you or your staff have any questions about this report, I may be reached at (202) 512-2834. Major contributors to this report are listed in appendix III.

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Executive Summary

Purpose

With nearly 30 million passengers flying to and from Europe annually, transatlantic service is the largest international market for U.S. airlines. The European nations that are the principal destinations for U.S. airlines are members of the European Economic Community (EC), which is changing the way the individual aviation markets of its member nations are regulated. The Senate Committee on Commerce, Science, and Transportation and its Subcommittee on Aviation asked GAO to describe and assess (1) changes to air transport regulation that have been undertaken by the EC; (2) the effect of those changes on competition in the European air travel market; and (3) the implications of those changes for U.S. airlines, including the possibility of granting cabotage rights to a unified EC, which would allow EC airlines to provide air service between points in the United States in exchange for allowing U.S. airlines to serve additional routes within the EC.

Background

The EC was created in 1957 by the Treaty of Rome to facilitate economic growth in Western Europe and to enable European countries to compete better in world markets. The EC's membership includes Belgium, Denmark, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, and the United Kingdom. In 1986, these countries passed the Single European Act, which set the end of 1992 as the target date for creating a single European market for exchanging services (including air transport services), goods, labor, and capital. The EC Commission, the primary executive institution of the EC, is responsible for implementing the 1986 act, including the provisions concerning air transport.

International aviation is controlled by bilateral air service agreements in addition to national laws and regulations. These agreements can address issues including routes, fares, and the amount and frequency of service between two countries. The United States has a bilateral air service agreement with each EC country.

Results in Brief

Since 1987, the EC has been phasing in measures that reduce the ability of individual countries to control airlines' pricing and access to markets and the amount and frequency of service offered on routes within the Community. With these measures, the Community has made modest progress in giving EC airlines increased freedom to respond to market forces, but it has not yet created a single air transport market or significantly enhanced real competition. Some member countries still want to protect their airlines from competition and have delayed until 1997 or beyond some necessary changes, such as allowing airlines of any EC country to operate on routes within other EC countries.

Measures adopted in 1987 and 1990 did not lead to an increase in competition from new airlines entering the market or to lower airfares, and because the third set of measures was not implemented until January 1993, it is too soon to assess their effect. Instead, mergers and acquisitions may be leading to less competition in the EC aviation market. These activities may result in the EC market being dominated by as few as three major airlines that will be in a stronger position to challenge U.S. airlines.

The EC's measures have focused on EC airlines operating within the Community and have had little direct effect on U.S. airlines. However, U.S. airlines' ability to compete in the EC could be limited by some measures, such as a prohibition against non-EC airlines' introducing low-fare initiatives on routes between EC countries. In addition, some EC governments are trying to restrict U.S. airlines' services to their countries as they renegotiate their bilateral air service agreements with the United States. To improve aviation relations with the EC countries, the Department of Transportation (DOT) has undertaken several initiatives, such as offering these countries the opportunity to establish agreements that could ease restrictions on their airlines' access to the United States. However, the EC Commission has proposed limiting the ability of individual governments to establish less restrictive agreements with the United States. The Commission has also proposed gaining the authority to negotiate multilateral agreements on behalf of all of its members after 1998. But as long as some EC members oppose this proposal, aviation relations between the United States and EC countries will continue to be governed by bilateral agreements.

Cabotage is currently prohibited in the United States. Attempts to legalize cabotage would face strong opposition in this country because of concerns that this air service could be detrimental to U.S. airline workers. Even if cabotage were legalized and the EC were able to negotiate as a bloc with the United States, both the EC and U.S. aviation markets present constraints to significantly expanding service, such as difficulties in obtaining access to EC airports and the high cost of establishing competitive service in U.S. markets.

Principal Findings

EC Proceeding More Slowly Than Hoped in Liberalizing Air Transport

The EC adopted measures in December 1987 and July 1990 that modestly reduced the regulation of EC airlines. The 1990 measures were replaced by measures that went into effect on January 1, 1993. The 1990 measures widened the range of fares that were exempt from governments' review and allowed airlines operating scheduled flights to match the fares of low-price charter airlines in an effort to lower airfares in the EC. To increase the number of airlines competing on most routes within the EC, the measures also allowed a route to be served by more than one airline from a single country and gave EC airlines the right to carry traffic between their home country and other EC countries.

The 1993 measures have aimed at further liberalizing the EC air transport market by removing many remaining restrictions on fares, on access to markets, and on the amount and frequency of service. But because these measures have been implemented so recently, it is too soon to know what their ultimate effect will be. Even with the 1993 measures, though, EC members retain significant control over their domestic air travel markets. For example, member states may restrict access to their markets if they believe that competition by airlines from other nations has seriously damaged their national airlines financially. Furthermore, EC countries do not all agree on limiting the subsidies some governments give to their airlines—assistance that provides an advantage to those airlines by artificially lowering their financing costs. The EC has no timetable for dealing with this issue.

EC Air Travel Market May Become Less Competitive

EC officials hoped their measures would lead to increased competition from new airlines entering the market, which, in turn, would lead to lower fares. This has not happened as a result of the first two phases of liberalization. Several independent charter airlines, such as Air Europe and TEA, tried to move into the market for scheduled service but failed because they were unable to compete successfully with established EC airlines.

Three major EC airlines—Air France, British Airways, and Lufthansa—have been consolidating their positions in the EC market through mergers, acquisitions, investments, and marketing alliances. These activities may impede competition in the EC market, because partners are not likely to compete directly with each other, and may result in the EC market eventually being dominated by as few as three major airlines. These activities will also help EC airlines to expand their global route networks and could make them more competitive with U.S. airlines in the transatlantic market.

Liberalization Measures Could Limit U.S. Airlines' Ability to Compete in the EC

Although the first two sets of measures have had little direct effect on U.S. airlines, current and proposed measures could limit U.S. airlines' ability to compete in the EC. In January 1993, the EC adopted rules to redistribute takeoff and landing slots at congested EC airports in an effort to open up markets to additional airlines. Although the new rules appear to be nondiscriminatory, they do discriminate against non-EC airlines and will make it difficult for U.S. airlines to obtain additional slots, which could constrain the growth of U.S. airlines' service to the EC. In addition, the EC's measures prohibit U.S. and other non-EC airlines from introducing fares lower than existing ones on routes within the Community.

American, Delta, and United have been improving their competitive positions in the EC by acquiring routes and operations from Pan Am and TWA. The German and French governments, in response to these actions and in an effort to improve their airlines' competitive positions before the 1993 measures took effect, have tried to restrict U.S. airlines' access to their countries as they renegotiated their bilateral agreements with the United States.

DOT hopes that its initiatives to liberalize and improve aviation relations with EC countries will improve U.S. airlines' access to European markets. DOT has offered, among other things, all EC countries the opportunity to establish "open skies" agreements, which would give EC airlines unrestricted access to routes between their home country and the United States in exchange for permitting U.S. airlines free access to their markets. Only the Netherlands had accepted the offer as of February 1993. The EC Commission has proposed limiting the ability of individual EC countries to adopt open skies agreements or similar agreements with non-EC countries. The proposal, which is opposed by some EC countries, would also give the Commission the authority to negotiate aviation agreements for the 12 member countries after 1998. If enacted, the proposal could lead to a single aviation agreement replacing the existing bilateral agreements between individual EC countries and the United States.

Granting cabotage rights to EC airlines is not likely in the near future. Attempts to legalize cabotage would face strong opposition from U.S. airline unions because they believe that cabotage could ultimately result in lost jobs for their members. Furthermore, it would be difficult for U.S. airlines to significantly expand service in the EC because of ground and air congestion in the Community's aviation system. In addition, because of the large investment needed to establish competitive service in the United States, investing in or obtaining an ownership stake in a U.S. airline may be more important to some EC airlines than cabotage. With an ownership stake in a U.S. airline, a foreign airline gains access to the domestic route network of the U.S. airline and avoids the high cost of developing independent service in the U.S. market.

Recommendations

This report reviewed the activities of an international organization, the EC, and was not intended to make recommendations to it. Rather, the report is intended to provide the Congress with an overview of recent and emerging aviation events in the EC that have significant implications for U.S. airlines. International operations are important for the industry's financial well-being and are the subject of ongoing bilateral negotiations with EC countries.

Agency Comments

GAO met with the Assistant Director for Negotiations from DOT's Office of International Aviation and the Director of the State Department's Office of Aviation Programs and Policy to discuss the contents of a draft of this report. The officials agreed with the facts presented but noted that competition in the EC air travel market will probably increase as a result of the January 1993 measures and that some of GAO's conclusions may be premature. In response to these comments, the report now indicates that the first two sets of liberalization measures have not increased competition or lowered airfares in the EC and that it is too early to assess the results of the third set of measures. As agreed with the requesters' offices, GAO did not obtain written agency comments on the draft report.

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Abbreviations

AEA	Association of European Airlines
ATA	Air Transport Association of America
CRS	computer reservation system
DOT	Department of Transportation
EC	European Economic Community
ECU	European Currency Unit
FAA	Federal Aviation Administration
GAO	General Accounting Office
GDP	gross domestic product
IATA	International Air Transport Association
KLM	Royal Dutch Airlines
SAS	Scandinavian Airlines System
TAP	Transportes Aereos Portugueses
TAT	Transport Aerien Transregional
TWA	Trans World Airlines
UTA	Union de Transportes Aeriens

Introduction

With nearly 30 million passengers flying to and from Europe annually, transatlantic service is the largest international market for U.S. airlines operating scheduled flights. The European nations that are the principal destinations for U.S. airlines are members of the European Economic Community (EC), which is in the process of changing the way the individual aviation markets of its member nations are regulated. These changes could have profound implications for U.S. airlines, especially if the changes restrict U.S. airlines' access to the EC market.

Over the last decade, international operations have become increasingly important for U.S. airlines. From 1980 to 1990, major U.S. airlines' revenues from such operations grew 160 percent, while the number of passenger miles U.S. airlines flew on international routes more than doubled. The Federal Aviation Administration (FAA) estimates that these passenger miles will more than double again from 1991 through 2002.

The U.S.-Europe market is an important source of revenue for U.S. airlines. Of the $16.8 billion in revenue generated from international operations by U.S. airlines in 1990, 44 percent came from the transatlantic market.[1] Furthermore, from 1980 to 1990 U.S. airlines increased the number of passengers carried to and from Europe by 103 percent, almost double the rate at which the number of domestic passengers grew (55 percent).

The European Community and Its Air Transport Market

The European Economic Community was established by the 1957 Treaty of Rome to facilitate economic growth in Western Europe and to enable the European countries to better compete in world markets. Since then, the Community has expanded from the original 6 members (Belgium, France, the Federal Republic of Germany, Italy, Luxembourg, and the Netherlands) to the current 12 members (see fig. 1.1).[2]

In the three decades following the Treaty of Rome, the EC gradually reduced trade barriers among member states and established new institutions to govern economic integration. In 1986, the EC enacted the Single European Act, which set the end of 1992 as the target date for

[1]The transatlantic market, though consisting predominantly of service to Europe, also includes service to the Middle East and Africa. Forty-three percent of the revenue from international operations came from the Asian/Pacific market, and the remainder came from the Latin America market.

[2]Denmark, Ireland, and the United Kingdom joined the EC in 1973, followed by Greece in 1981 and Portugal and Spain in 1986. With a population of 344 million and gross domestic product (GDP) of $6.0 trillion in 1990, the EC is comparable to the United States, which had a population of 249 million and a GDP of $5.5 trillion at that time.

eliminating all trade barriers within the Community and thus creating a single European market for exchanging services (including air transport services), goods, labor, and capital. In December 1991, the member states signed the Maastricht Treaty, which would create a common European currency by 1999 and establish common foreign and defense policies among the 12 members. The treaty must be approved by all member states before it becomes effective, but it has recently run into difficulty with European voters—the Danes voted to reject it, and the French approved it by only a narrow margin. However, the measures to integrate the aviation market are unaffected.

Figure 1.1: EC Member States

Source: European Economic Communities

Role of the EC in Regulating International Air Transport

The EC is a supranational organization whose regulations and directives bind its member states. The European Community Commission—the EC's executive institution—initiates and implements policies and enforces provisions of the Treaty of Rome. The EC Commission is responsible for implementing the Single European Act of 1986, including the provisions creating a single air transport market. The EC Commission consists of 17 Commissioners chosen by member states and a staff of about 12,000 divided among 23 Directorates-General responsible for various areas, such as agriculture, energy, and financial institutions. Two Directorates-General—DG-IV (competition) and DG-VII (transport)—have primary responsibility for aviation.

The Council of Ministers consists of representatives of each member state. For any given issue being discussed, member countries are represented by the appropriate responsible minister. For air transport matters, the Council consists of transportation ministers from the member countries. The Council adopts legislation that applies to all member states and can give the Commission the authority to adopt implementing regulations.

The Commission has the authority to enforce the Community's competition laws as well as to investigate and seek to remedy government assistance that distorts or threatens to distort competition within the EC.[3] In 1988, the European Court of Justice held that the EC's competition rules apply to activities outside the Community so that any such activities that affect trade among EC countries are subject to the rules.[4]

The European Air Travel Market

Although Europe is the second largest market in the world for scheduled air travel, the U.S. market is much bigger.[5] Furthermore, the European air travel market differs from the U.S. market in several ways.

Fares for European scheduled flights are relatively high compared to fares in the United States, in part, because European airlines offering scheduled

[3]Article 85 of the Treaty of Rome prohibits agreements and concerted practices that have the objective of preventing, restricting, or distorting competition within the EC. Article 86 prohibits the abuse of a dominant position in a market within the EC or a substantial part of it, insofar as actions in the market affect trade among member states. Articles 92 and 93 deal with aid granted by governments to business.

[4]Similarly, the Sherman Antitrust Act's international application is limited to activities that have a "direct, substantial, and reasonably foreseeable effect" on the U.S. market (15 U.S.C. section 6a).

[5]Scheduled air service, in contrast to charter service, is available to the public and is operated according to a published timetable.

flights have relatively high operating costs.[6] For instance, in 1989, the last year for which comprehensive data are available, the unrestricted economy fare for a scheduled international flight between European cities was about 1-1/2 times the fare for a comparable flight in North America.

Because fares for scheduled flights in Europe are relatively high, many leisure travelers, who normally fly on scheduled flights in the United States at substantial discounts, travel on charter flights in Europe. Charter airlines carry about 50 percent of the airline passengers in Europe. In contrast, charter airlines carry less than 3 percent of the airline passengers in the United States.

Airlines also face more competition from railroads in Europe than in the United States. For example, in 1989, EC railroads operated over 142 billion passenger miles, while Amtrak operated only about 6 billion passenger miles.[7]

In Europe, 22 airlines provide about 90 percent of the scheduled service,[8] while 8 major airlines provide about 90 percent of the domestic scheduled service in the United States.[9] Most European airlines are largely owned by their government (see table 1.1). U.S. airlines are all privately owned.

[6]EC airlines have relatively high operating costs in part because navigational and landing fees are high in Europe, as are the taxes on airlines and the average wages paid to airline employees. Furthermore, the rates at which crews and aircraft are utilized are relatively low compared to the rates in the United States.

[7]The data on Amtrak are for the fiscal year, while the data on the EC are for the calendar year.

[8]These 22 airlines are members of the Association of European Airlines (AEA), a trade association. Of the 22, 12 are operated out of EC countries: Aer Lingus, Air France, Alitalia, British Airways, Iberia, KLM, Lufthansa, Luxair, Olympic Airways, Sabena, Scandinavian Airlines System (SAS) Group, and TAP Air Portugal.

[9]The U.S. Department of Transportation (DOT) defines major airlines as having an annual operating revenue of over 1 billion dollars.

Table 1.1: Governments' Ownership of Selected EC Airlines

Airline	Country	Percentage ownership by government
Aer Lingus	Ireland	100.0
Air France Group	France	99.5
Alitalia	Italy	86.4
British Airways	United Kingdom	0
Iberia	Spain	99.8
KLM	Netherlands	38.2
Lufthansa	Germany	56.9
Luxair	Luxembourg	36.5
Olympic Airways	Greece	100.0
Sabena	Belgium	95.1
SAS	Denmark, Norway, and Sweden[a]	50.0
TAP Air Portugal	Portugal	100.0

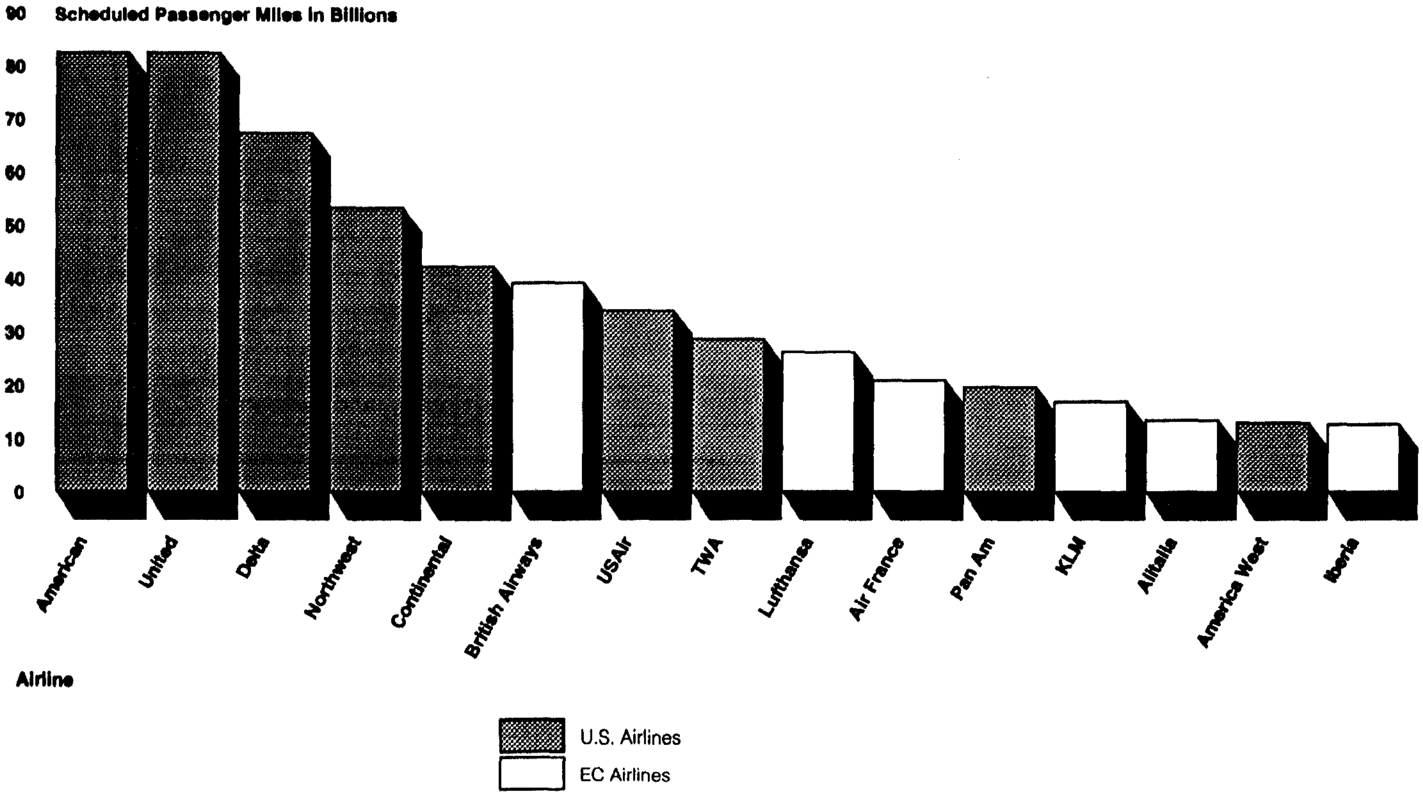
[a]Of the three countries, only Denmark is an EC member.

Source: AEA.

EC airlines generally have smaller aircraft fleets than major U.S. airlines and operate fewer passenger miles. In 1991, American Airlines, for example, with 622 aircraft, had the largest U.S. fleet, which was larger than the fleets of the three largest EC airlines combined.[10] Although British Airways, Lufthansa, Air France, and KLM rank among the world's largest airlines in terms of international operations, they operate far fewer passenger miles than the largest U.S. airlines (see fig. 1.2).

[10]In 1991, British Airways had 230 aircraft, Lufthansa had 177, and Air France had 158.

Figure 1.2: Passenger Miles Flown on Scheduled Flights by Selected U.S. and EC Airlines, 1991



Note: In October 1991, DOT approved Delta's purchase of Pan Am's New York and Frankfurt hubs and transatlantic and European routes. Pan Am ceased operations on December 4, 1991.

Source: Air Transport World (June 1992).

Regulation of Air Transport Between the United States and EC Countries

Since the Chicago Convention of 1944, international air transport has been governed by bilateral air service agreements in addition to national laws and regulations. Bilateral agreements, negotiated between two countries, permit airlines of these countries to offer service between the two countries. Some agreements delineate the routes that may be operated and the amount and frequency of service and provide for regulation of prices by the governments. Once signed, an agreement remains in effect until it expires or, if it is renounced by a signatory, for a year after the renunciation while the two countries attempt to renegotiate, according to DOT. After it is renounced, according to DOT, the agreement remains in effect for another year while the two countries attempt to renegotiate. The United States has a bilateral air service agreement with each EC member country.

Bilateral agreements are based on the principle that nations have sovereignty over their airspace. This sovereignty is defined by nine "Freedoms of the Air" that outline possible aviation rights between countries:

- The first and second freedoms establish the right of an airline to overfly and, if needed, stop in another country for technical reasons, such as refueling or allowing a crew to rest.
- The third and fourth freedoms establish the right of an airline to pick up and discharge passengers between its home country and another country.
- The fifth freedom confers the right of an airline to carry passengers or cargo between two foreign nations on flights beginning or ending in its homeland.
- The sixth freedom establishes the right of an airline to carry passengers or cargo between two foreign countries by way of its homeland, while the seventh freedom is an airline's right to carry passengers or cargo between two foreign countries without stopping in its homeland.

Additional aviation rights, sometimes referred to as the eighth and ninth freedoms, allow an airline to provide air service within a foreign country. The so-called eighth freedom, also known as "fill-up" or "consecutive" cabotage, allows a foreign airline to pick up and discharge passengers or cargo on the domestic segment of an international flight originating in the airline's home country, such as a Paris-New York-Miami flight. On the other hand, "full" cabotage, which is independent of international service, allows a foreign airline to pick up and discharge domestic passengers or cargo. Sometimes referred to as the ninth freedom, full cabotage would allow an EC airline, for example, to operate shuttle service between New York and Washington.

Bilateral agreements are negotiated principally by the U.S. Departments of State and Transportation and their counterparts in other countries. Under the Federal Aviation Act of 1958, as amended, DOT seeks to ease operating and marketing restrictions when negotiating bilateral air service agreements, as well as to obtain equal opportunities for U.S. airlines to increase their access to foreign points when exchanging aviation rights.[11]

[11]49 U.S.C. app. section 1502.

Before a foreign airline can begin flying into the United States, it must obtain approval from DOT, including the Federal Aviation Administration (FAA). To obtain DOT's approval, the airline must provide information about its license in its homeland, management, insurance, operating history, aircraft maintenance, and finances. From the information provided, DOT must, by law, determine whether the airline is fit, willing, and able to operate in the United States.[12] As part of DOT's determination, the agency asks FAA whether any safety concerns about the airline exist. FAA approves the conditions (such as the equipment to be used) under which the airline can operate in the United States.

Objectives, Scope, and Methodology

At the request of the Senate Committee on Commerce, Science, and Transportation and its Subcommittee on Aviation, we examined the effect that efforts by the EC to unify its aviation market would have on competition in the international airline industry, particularly on the international competitiveness of U.S. airlines. In discussions with Committee staff, we agreed to describe and assess: (1) changes to air transport regulation that are being undertaken by the EC; (2) the effect of those changes on competition in the European air travel market; and (3) the implications of those changes for U.S. airlines, including the possibility of granting cabotage rights to a unified EC in exchange for its allowing U.S. airlines to serve additional routes within the EC.

To describe and assess the changes being made in the EC's air transport regulation and to examine the effect of these changes on competition in the European airline market, we reviewed literature on the regulation of international air transport; analyzed the EC's current and proposed directives, regulations, and decisions regarding the liberalization of air transport; and interviewed officials from the U.S. Departments of Justice, State, and Transportation. We also discussed these issues with representatives from the Air Transport Association of America (ATA); Air Line Pilots Association; Allied Pilots Association; Association of Flight Attendants; and Global Aviation Associates, Ltd. In addition, we collected information on the effect of liberalization measures on EC airlines from officials of Air France, Alitalia, British Airways, British Midland Airlines, KLM Royal Dutch Airlines, Lufthansa, Sabena Belgian Airlines, SAS, Swissair, the British Civil Aviation Authority, the British Department of Transport, the Danish Ministry of Transport, the French Directorate-General of Civil Aviation, the German Ministry of Transport,

[12]We reviewed FAA's oversight responsibility for foreign airlines serving the United States in Aviation Safety: Increased Oversight of Foreign Carriers Needed (GAO/RCED-93-42, Nov. 20, 1992).

and the Italian Department of Civil Aviation. We gathered similar information through interviews with officials from the EC Commission's Directorates-General for Competition, External Relations, and Transport; the International Air Transport Association (IATA); AEA; and the European Civil Aviation Conference.

To describe and assess the implications of liberalization for U.S. airlines we gathered information on mergers by airlines, from DOT, the Department of Commerce, and ATA. We also obtained information on recently renegotiated bilateral air service agreements with EC member states to identify changes in response to the EC's liberalization measures. To identify U.S. airlines' views on cabotage and other possible effects of liberalization, we interviewed officials from America West, American, Continental, Delta, Northwest, Trans World Airlines (TWA), USAir, and United. From the Air Line Pilots Association, Allied Pilots Association, Association of Flight Attendants, International Association of Machinists and Aerospace Workers, U.S. Airports for Better International Airline Service, and the Aviation Consumer Action Project, we gathered additional information on the possible effects of cabotage on U.S. airlines.

We conducted our work between April 1991 and January 1993 in accordance with generally accepted government auditing standards. We met with the Assistant Director for Negotiations, Office of International Aviation, from DOT and the Director, Office of Aviation Programs and Policy, from the Department of State to discuss the contents of this report. We incorporated factual changes where appropriate. As requested, however, we did not obtain written agency comments on a draft of this report.

EC Proceeding More Slowly Than Planned in Liberalizing Air Transport

In 1986, the EC member countries agreed to create a single internal air travel market. To implement the terms of that agreement, the Council and Commission have been legislating changes since December 1987. These measures are aimed at liberalizing the EC air transport market by reducing the power of individual member states to intervene in airlines' pricing and access to markets and the amount and frequency of service offered on routes within the Community. The Single European Act called for implementing the measures by January 1993, but some measures have been delayed until 1997, and additional issues must be addressed to create a more competitive air transport market. Although it is too early to fully assess the effect of the most recent measures, which went into effect in January 1993, they are likely to have limited impact on competition because member state governments will retain significant control over their domestic air transport markets at least until 1997.

The Commission has made initial efforts to gain the authority to negotiate air service agreements with countries outside the EC on behalf of member countries, a step that could enhance the ability of EC airlines to compete internationally. Because member countries disagree on the amount of control they would retain over negotiations conducted by the Commission, it is unlikely that the Commission will obtain this authority soon. However, aviation analysts and officials in the United States and the EC expect the Commission to gain this authority in 5 to 10 years.

First Two Phases of EC's Liberalization Made Modest Changes in Regulation of Airlines

The EC Council adopted liberalization measures in December 1987 and July 1990 that have led to modest reductions in airline regulation.[1] Although the Council's goal was to liberalize the air transport market by reducing restrictions member states put in place to protect their national airlines, EC airlines remained subject to substantial regulation by both member states and the EC Commission.

Prior to the liberalization measures adopted in 1987, international air service among EC countries was largely governed by bilateral agreements between countries. In general, such agreements permitted each country to designate only a single airline—usually the government-owned airline—to fly a given route; restricted how many seats or flights the designated airlines could offer on that route; and allowed the airlines to share their

[1]The measures adopted in 1990 superseded those adopted in 1987 and governed the EC's air transport until further measures were implemented on January 1, 1993. In addition to adopting these sets of liberalization measures, in July 1989 the EC adopted a code of conduct for operating computer reservation systems (CRS) and in 1991 adopted regulations liberalizing air cargo services and establishing rules to compensate passengers who are denied boarding.

traffic or revenue, usually on a 50-50 basis. Under the auspices of IATA, airlines set standard fares for each route, subject to the approval of both governments.

In an effort to lower airfares in the EC, the 1990 measures, according to Commission officials, widened the range of fares that qualified for governments' automatic approval and allowed airlines operating scheduled flights to match the fares of low-price charter airlines. To improve access to markets, the measures allowed a route to be served by more than one airline from a single country (multiple designation) and gave EC airlines the automatic right to carry passengers and cargo between the airlines' home country and other EC countries, subject to limits on the amount of traffic that can be carried. The 1990 measures also superseded and relaxed restrictions, contained in many bilateral agreements between EC states, that guaranteed airlines a given share of the seats offered on a particular route.

To enable EC airlines to adapt to a more competitive environment, the 1990 measures continued to exempt some common agreements, such as airlines' consultations about fares, from the EC's rules on competition.[2] The EC's rules on competition prohibit anticompetitive commercial practices and the abuse of a dominant position in the market. These rules apply only to services on routes between member states, not to services on routes within the boundaries of member states and on routes to non-EC countries. The 1990 measure governing airlines' pricing prohibited U.S. and other non-EC airlines from introducing fares lower than existing ones on routes within the EC, having the effect of making EC airlines the primary beneficiaries of the liberalization process. This measure limits non-EC airlines' flexibility to compete with EC airlines on the basis of fares. (Ch. 4 discusses the competition rules' impact on U.S. airlines in more detail.) Table 2.1 presents the major elements of the second phase of the liberalization of the EC air transport market.

[2]For certain types of common airline agreements, the Commission granted, in July 1988, "block exemptions" from its rules on competition. These exemptions remained in effect until December 31, 1992.

Table 2.1: Major Elements of Second Phase of the Liberalization of the EC's Air Transport Market (Effective Nov. 1, 1990)

Area of regulation	Regulatory action
Competition	Various exemptions from antitrust regulations extended until Dec. 31, 1992. These exemptions allowed airlines to consult with one another about interline fares, capacity planning and coordination, allocation of slots (takeoff or landing reservations), operations of CRSs, and ground handling services. Exemption for revenue sharing agreements not renewed.
Approval of fares	Zones for automatic approval of fares widened. Normal economy fares within 95 percent to 105 percent of the reference fare (the normal or average fare), discount fares within 94 percent to 80 percent, and deep discount fares within 79 percent to 30 percent automatically approved. Fares above 105 percent of reference fare subject to "double disapproval."[a] The governments of member countries shall disapprove excessively high or unjustifiably low fares.
Pricing	EC airlines operating scheduled service allowed to offer the same fares as charter airlines. EC airlines operating fifth freedom routes allowed to introduce fares lower than the existing ones in zones where approval is automatic.[b] Non-EC airlines permitted to match fares of EC airlines on fifth freedom routes in zones where fares are established, but are not permitted to have lower fares.
Access to markets	EC airlines are generally authorized to exercise third and fourth freedom rights at any EC airport if permitted by their own government.[c]
Number of seats	EC members must permit other member countries to increase their capacity by 7.5 percent over the prior corresponding season.
Multiple designation	Starting in 1991, each EC country was required to accept more than one airline designated by other EC countries to operate on routes with more than 140,000 passengers (or 800 return flights) in the preceding year. Starting in 1992, multiple designation applied to routes with 100,000 passengers (or 600 return flights) as well.
Fifth freedom	EC airlines allowed to exercise fifth freedom rights on any route within the EC. Limit on seasonal capacity increased so that as much as half of an EC airline's third and fourth freedom service during any given travel season may be used to exercise fifth freedom rights.

(Table notes on next page)

[a]For a fare subject to double disapproval, both countries at the endpoints of a route must veto the fare before it can be rejected.

[b]As explained in ch. 1, the fifth freedom is the right of an airline to carry passengers or cargo between two foreign countries on a route beginning or ending in the airline's home country.

[c]As explained in ch. 1, the third freedom is the right of an airline to carry passengers or cargo from the airline's home country to another country, and the fourth freedom is the right of an airline to carry passengers or cargo from another country to the airline's home country.

Source: Compiled by GAO from documents from the EC Commission; DOT; Global Aviation Associates, Ltd.; and IATA.

Third-Phase Measures Allow Significant National Control

The EC Council adopted the third set of liberalization measures in July 1992. They became effective on January 1, 1993. Although these measures remove many remaining restrictions on EC airlines, they contain numerous exceptions and provisions that could allow member countries to continue to protect their airlines from increased competition by intervening in the setting of airfares and awarding of routes.

Furthermore, opposition by some member states has delayed until 1997 the implementation of a regulation allowing EC airlines to operate routes without restriction in EC countries besides the airlines' home country. By permitting EC airlines to establish domestic operations in any EC country, this measure could have created a true single market. However, DOT and State Department officials believe that delaying this measure does not significantly affect the EC's liberalization because only a small number of domestic routes within individual EC countries have traffic levels large enough to attract additional competitors.

As a result of negotiation and compromise among the 12 national transport ministers, third-phase measures continue to permit national governments to exercise significant control over their domestic aviation markets and to restrict competition in their markets. For example, member governments may request the Commission to limit access to their countries if they believe that competition by airlines from other nations has seriously damaged their national airlines financially. In addition, until April 1, 1997, governments can continue to regulate access to routes within their countries and have the right to divide traffic among airports serving a city, such as Heathrow, Gatwick, and Stansted in London. This means that EC countries can continue to protect national airlines with a monopoly on domestic routes from competition from other domestic airlines or airlines of other EC countries. Governments may also restrict access to routes between their country and other EC countries because of safety concerns, environmental effects, or congestion. Such decisions by member countries, however, are required to be nondiscriminatory and are subject to review by the Commission. Similarly, although beginning on January 1, 1993, EC airlines were free to set fares without their governments' approval, governments can provisionally disapprove fares or ask the EC Commission to investigate fares that the governments consider excessively high or unjustifiably low, with the final decision resting with the Commission and Council. Finally, each EC government retains the responsibility for licensing airlines in its own country.[3] Table 2.2 presents the major elements of the third phase of liberalization.

[3]An operating license issued by an EC government authorizes an airline to engage in air transport for remuneration and/or hire. Licensing by one EC country is supposed to be recognized by all other EC governments. DOT similarly authorizes airlines to operate in the United States.

Table 2.2: Major Elements of Third Phase of the Liberalization of the EC's Air Transport Market (Effective Jan. 1, 1993)

Area of regulation	Regulatory action
Approval of fares	Airlines are free to set fares on routes within the EC without governments' approval. A member country cannot stop fares from taking effect, but can reject fares in effect that are excessively high or too low. The EC Commission and the other country concerned must concur with this rejection.
Pricing	Only EC airlines can introduce fares lower than existing ones or introduce "new products" on routes within the EC.[a]
Access to markets	No restrictions exist for licensed EC airlines on routes among EC countries except when reduced safety, environmental degradation, or congestion are concerns. Member countries can regulate access on domestic routes until Apr. 1, 1997.
Number of seats	Limits on capacity eliminated on routes between EC countries except when reduced safety, environmental degradation, or congestion are concerns. A member country may appeal if a limit enforced on these grounds financially damages one of its airlines operating scheduled flights.
Multiple designation	No restrictions exist on the number of EC airlines that can be designated to serve international routes within the EC.
Fifth freedom	Restrictions eliminated, except when reduced safety, environmental degradation, or congestion are concerns.
Cabotage	An EC airline may operate between points in an EC country besides the airline's home country. Service must be part of a flight beginning or ending in the airline's homeland, and only 50 percent of the airline's seasonal capacity may be made available to passengers traveling within the country besides the home country.[b] All restrictions to be lifted on Apr. 1, 1997.
Licensing	Operating licenses issued in one member country are valid in all others. In issuing licenses, member countries must use common technical, financial, and managerial criteria. Majority of shares and effective control of EC airlines must be in hands of EC nationals, and airlines' principal place of business must be in the EC.
Right of establishment	Any EC airline has the right to establish operations in any EC country.

[a]"New products" are not defined in the EC's rules, but most likely are marketing practices such as frequent flyer programs.

[b]For example, British Airways is allowed to establish a London-Paris-Nice route, but is only allowed to sell 50 percent of the seats available on this route during a particular season for the Paris-Nice segment.

Source: Compiled by GAO from documents from the EC Commission; DOT; Global Aviation Associates, Ltd.; and the State Department.

The most far-reaching liberalization measure, which would have allowed airlines of any EC country to operate domestic routes in other member countries without restriction ("full" cabotage), has been delayed until 1997. Instead, the EC Council approved the more limited right of "fill-up" cabotage, under which any EC airline may provide service within any member state as long as the flight begins or ends in the airline's homeland. For example, British Airways is allowed to establish a London-Paris-Nice route, but not a Paris-Nice route alone. The EC's rule also sets limits on the service provided. On this London-Paris-Nice route, British Airways is allowed to sell only half of the seats and cargo space available on this route during a particular season for the Paris-Nice segment.

Some EC countries—such as France, Germany, Italy, and Spain—oppose granting full cabotage rights to other members' airlines because of strong financial ties to their national airlines and their desire to reserve their relatively large domestic markets for their airlines by protecting them from foreign competition. Other countries, such as Belgium, Denmark, Luxembourg, the Netherlands, and the United Kingdom, support exchanging full cabotage rights among EC countries because they feel their airlines are competitive or they have few domestic routes to protect.

Additional Issues Limit Creating a More Competitive Air Transport Market

Many aviation analysts, industry representatives, and government officials believe the EC's liberalization measures will have little effect on airline competition until the Community addresses several problems that constrain entry into its airline markets. These observers say that the EC needs to limit government subsidies to airlines and redistribute scarce slots for taking off and landing at highly congested EC airports. In addition, some EC countries believe that the development of uniform technical standards and regulations should be a priority for the Community. However, member countries do not agree on how and/or when these issues should be addressed.

Limiting Government Subsidies to EC Airlines Is Essential to Developing a More Competitive Market

Government financial support gives some airlines an unfair advantage by artificially lowering their financing costs. To offset their national airlines' losses in recent years, the French, Belgian, and Spanish governments have provided large subsidies. The French government budgeted $350 million for Air France in November 1991, and a French state-owned bank purchased 8.8 percent of the airline for $226 million in July 1992. The Belgian government authorized over $1 billion for Sabena in July 1991, and the Spanish government earmarked $1.25 billion for Iberia in July 1992.

The Directorates-General for Competition and Transportation within the EC Commission have joint responsibility for regulating government subsidies to airlines and are empowered under the Treaty of Rome to prohibit subsidies that distort competition in trade between member countries. However, the Treaty of Rome allows certain types of government financial support, such as aid to promote economic development in less developed areas.

The Commission approved the Belgian financing on the condition that the government provide no further aid or preferential treatment to Sabena. The Commission approved the French and Spanish subsidies without apparent conditions. The EC Commission has stated that it evaluates government funding of airlines by considering whether a private investor would do the same under comparable conditions. In addition, the Commission allows government financing to cover an airline's operating losses if the financial support is part of a program to restore the financial viability and competitiveness of the airline within a reasonable time.

The EC Commission reported in March 1992 that government subsidies to EC airlines were inhibiting the effectiveness of its measures to develop a more competitive air transport market. British Airways, the only wholly privatized major EC airline, has argued that liberalization is unlikely to succeed as long as a large number of EC airlines are supported or protected by governments and remain under state control. Officials from the airline argue that for free and fair competition to prevail, all EC airlines must be subject to the same market conditions.

Some EC Member Countries Want "Harmonization" Before Liberalization

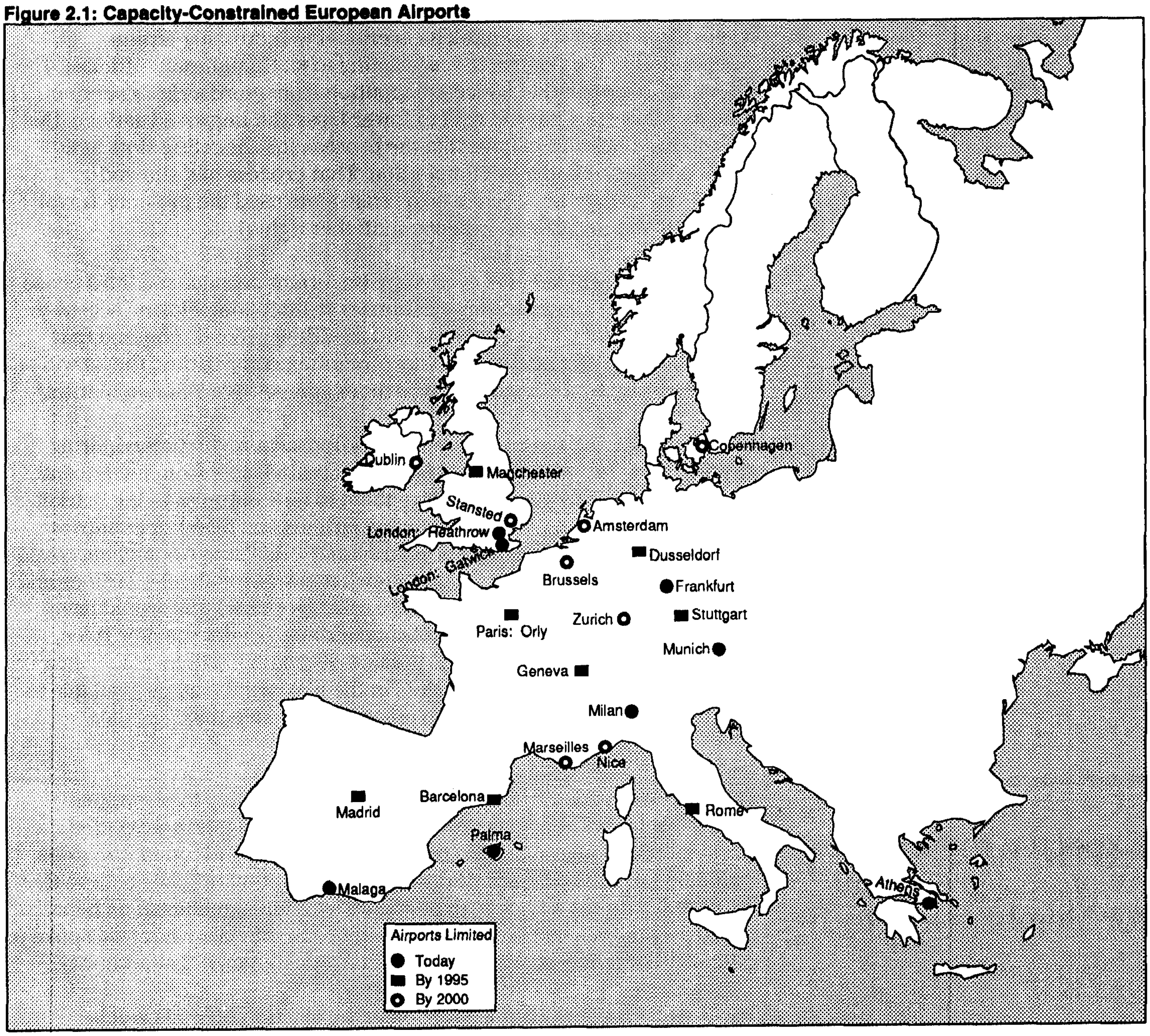
Some EC member states believe that the adoption of common technical standards, regulations, and taxes—called "harmonization"—should be completed before liberalization proceeds because different national standards and regulations impose unequal costs on airlines and affect their relative abilities to compete. For example, according to the Chairman of Air France, the national labor regulations under which his airline operates raise its labor costs relative to British Airways', putting Air France at a competitive disadvantage. Similarly, Alitalia officials said their airline pays 22 percent more than United Kingdom airlines in benefits to employees, such as social security payments and contributions to pension plans. The EC has already adopted common regulations establishing licensing standards for cockpit personnel and establishing noise standards, as well as a regulation for compensating passengers who are denied boarding on airlines.

Some specialists on European aviation view the argument that liberalization should await the establishment of common standards and regulations as a tactic by some EC countries to delay liberalization. EC countries supporting a "harmonization first" policy, such as Italy, have national airlines that suffer from high costs and that are not well positioned to compete in a liberalized market. Other EC governments and airlines, such as the United Kingdom and British Airways, are concerned that common air transport rules will mirror those of the most expensive airlines, raising all EC airlines' costs and increasing fares. Turning high-cost industry practices into standards for the EC would also undermine the competitive advantage of low-cost airlines, which most likely would be new entrants to the market.

Allocation of Slots Limits Access to Markets

Many EC airports are congested, and many aviation analysts cite the lack of takeoff and landing slots as the greatest barrier for new entrants to the European aviation market. Nearly all major European airports are subject to "slot controls" (see fig. 2.1). In contrast, only four U.S. airports—Washington National, Chicago's O'Hare, and New York's LaGuardia and Kennedy—have slot controls. A study by IATA found that 16 of 27 key European airports will be unable to accommodate the traffic expected by the year 2000 unless their facilities are improved. These airports include Frankfurt International, London's Heathrow and Gatwick, Madrid's Barajas, and Milan's Linate. Aviation specialists predict that building new airports or expanding existing ones in Europe will be difficult because of environmental considerations and the lack of available land. Only one new major airport has been constructed in Europe during the last 18 years—at Munich, Germany. As a result, how slots are allocated will be increasingly important in determining airlines' access to markets.

Figure 2.1: Capacity-Constrained European Airports



Source: AEA (1990).

Determining how to allocate slots at congested EC airports to allow for competitors to enter new markets is critical to increasing airline competition in the Community, according to EC Commission officials. The Commission hoped that added competition from more airlines serving routes within the EC would lead to lower fares and improved service. But Commission officials believe that the process for allocating slots at EC airports has inhibited new competition. That process has allowed incumbent airlines at EC airports to retain slots used the previous travel season (thus providing so-called grandfather rights).

Slot allocation will become even more important because the third phase of liberalization allows member countries to limit competitors' access to congested airports. Some analysts and EC airline officials contend that unless slots are reallocated in a way promoting competition, the EC will not achieve its goal of establishing a more competitive aviation market.[4]

In December 1990, the EC Commission proposed a regulation requiring airports to withdraw underused or newly created slots from incumbent airlines or create new slots and give them to new entrants to the market. However, strong opposition from many airlines and member countries prevented the proposal's adoption. In January 1993, the Council approved rules that will make getting slots somewhat easier for smaller airlines and new entrants, but which fell short of earlier proposals that would have withdrawn slots from larger established airlines. Under the new rules, slots that are not used at least 80 percent of the time will be placed in a slot "pool." Fifty percent of the slots in the pool will be made available to new entrants. The rules went into effect in February 1993.

EC Commission Expected to Negotiate Aviation Agreements for Members in 5 to 10 Years

The measures adopted and implemented thus far apply to EC airlines serving routes within the EC. After changing the EC's internal aviation market, the Commission plans to address relations with other countries, including the United States. Many European aviation officials believe that the EC will gain the authority to negotiate aviation agreements on behalf of member countries within the next 5 years. U.S. officials whom we spoke to estimate that it may be 5 to 10 years before the EC gains that authority.

The 5- to 10-year time frame anticipated by aviation officials will be necessary to develop a cohesive negotiating position that can be agreed to by all member states. Currently, the EC nations have widely different

[4]Congestion of the air traffic control system may also hamper liberalization. The development of European air traffic control services along national lines has resulted in a fragmented system with operational inefficiencies and, hence, travel delays across Europe.

aviation policies, ranging from the liberal free-trade philosophies of the Netherlands and Belgium to the more restrictive and protectionist trade policies of Greece and Italy. The Commission has overcome similar obstacles in other sectors and negotiates on behalf of its members on most issues involving trade in goods, and at the General Agreement on Tariffs and Trade meetings on other matters involving trade in services.

The Commission has taken steps toward gaining the authority to negotiate aviation agreements. In January 1990, it issued a proposal to establish the legal basis for negotiating with non-EC countries. Because of overwhelming opposition from the member states, the proposal was not adopted. In October 1992, the Commission issued another proposal that would give it the sole authority to negotiate new aviation agreements for the 12 member countries after 1998 (see ch. 4).

Both proposals sought the authority to negotiate under article 113 of the Treaty of Rome. The article does not require a mandate from member countries prior to any negotiations. Some EC countries have opposed the breadth of the proposed authority, and the EC Parliament amended the most recent proposal to change the legal basis to articles 84 and 228 of the treaty. Under article 84, the Council instructs the Commission on which specific issues can be negotiated and the range of actions the Commission may take during these negotiations.

If member countries grant the Commission a negotiating mandate that they control, the resulting agreements are likely to be more restrictive than those the Commission would otherwise have negotiated. The resolution of the Commission's current proposal could have important implications for U.S. airlines. U.S. aviation officials consider the Commission to be a pro-market, pro-competition force within Europe, and they believe that a stronger role for the Commission would be in the long-term interest of U.S. airlines by improving their access to the EC market.

EC countries are currently at an impasse in determining the scope, timing, and legal basis for granting the Commission the authority to negotiate aviation agreement. The Council has not approved either the Commission's original proposal or the 1992 proposal. Having the Commission negotiate multilateral aviation agreements with non-EC countries is controversial among EC countries, which are not prepared to cede control of their international aviation policies as quickly or completely as the Commission proposes. As of February 1993, the Council had not addressed the issue in any detail.

Conclusions

The EC has made modest progress in giving EC airlines increased freedom to respond to market forces, but has not yet created a single air transport market or significantly enhanced real competition in the marketplace. Even under third-phase liberalization measures, national governments and the EC Commission still have the ability to intervene in the setting of airfares and awarding of routes, and governments can potentially use this authority to protect their national airlines from increased competition. Furthermore, liberalization measures will have limited effectiveness in enhancing airline competition until the EC addresses several issues, such as government financial support of national airlines and the establishment of common technical standards that could undermine the competitive advantage of low-cost airlines.

The establishment of the scope and legal basis for the EC's authority to negotiate aviation agreements with non-EC countries will determine the amount of control that the member countries' governments can exercise over the Commission's actions. If the Council tightly controls the Commission's negotiating mandate, the result may be more restrictive agreements than those the Commission would otherwise negotiate. With such agreements, member countries could attempt to continue protecting their airlines from competition by restricting non-EC airlines' access to their markets.

The EC Air Transport Market May Become Less Competitive

EC officials expect the liberalization measures to increase competition in the EC air transport market. The measures may, instead, lead to less competition in that market. Although the measures were expected to encourage new competition, improve services to passengers, and lower airfares, the results of the first two phases have been modest. Several airlines entered new markets within the EC, but the Community is not expected to experience the proliferation of airlines entering new markets and of low discount fares that initially occurred in the United States after deregulation. Because the third set of measures was not implemented until January 1993, it is too soon to fully assess their effect on competition, but because of strategies employed by EC airlines, along with the significant control EC governments retain over domestic markets, the effect is likely to be limited.

EC airlines are pursuing strategies to improve their competitive positions in the EC through mergers, acquisitions, and investment arrangements with other EC airlines and non-EC airlines. These activities preempt competition among airlines that are partners and may result in the EC market eventually being dominated by as few as three large airlines. Aviation analysts do not expect any EC governments to allow their national airlines to disappear, but some of these airlines might be reduced to serving only regional markets.

The expansion strategies of the dominant EC airlines are also aimed at improving their competitive positions, relative to U.S. airlines', in the transatlantic market by expanding their global route networks. In addition, some EC member governments are considering privatizing their state-owned airlines, which would increase these airlines' focus on profitability and could make them more competitive with U.S. airlines in the transatlantic market.

Liberalization Has Produced Few New Entrants Thus Far

The first two phases of EC liberalization have failed to produce many new entrant airlines. A senior EC official expressed to us his disappointment at the lack of aggressive new entrants to the market. Some analysts believe it is unlikely that third-phase measures will be any more successful in producing start-up airlines because financing is not available. In addition, airline observers believe that start-up and existing airlines are constrained in entering new markets within the EC by (1) incumbent national airlines that dominate the distribution and sale of tickets in their home markets; (2) congestion at airports, making obtaining desirable slots difficult; and

(3) the relatively few densely traveled routes in Europe that are able to support additional airlines.

Although entrants into new markets have not been common, some routes have opened up for additional airlines as a result of liberalization measures to increase access to markets, allow multiple airlines to be designated to operate on a route, and extend fifth freedom rights, according to EC airline officials. For example, British Midland Airlines now serves Amsterdam, Brussels, Dublin, Malaga, Nice, Palma, and Paris from London's Heathrow airport. The Irish national airline, Aer Lingus, which took advantage of fifth freedom rights, started serving Amsterdam, Copenhagen, Milan, Paris, and Zurich from its hub in Manchester, England. KLM Royal Dutch Airlines also began serving Lyon, France and Genoa, Turin, and Venice, Italy.

Many aviation analysts expected that a liberalized market would provide more access to markets and create more opportunities for independent charter airlines to compete on routes with scheduled flights. They also expected that a more liberal market would allow established airlines operating scheduled flights to compete with charter airlines for traditional holiday markets. Many new entrants, such as Air Europe, TEA, and Air Holland have been independent charter airlines switching to scheduled service, but they have not been successful. Their failure illustrates the difficulty new entrants face in competing against incumbent national airlines.

First Two Sets of Liberalization Measures Have Had Little Effect on Fare Levels

Aviation analysts and government officials whom we spoke to generally agreed that the first two sets of liberalization measures had little effect in reducing airfares in the EC. Indeed, EC airlines raised fares on intra-EC routes during 1991, anticipating that the Gulf War would cause the price of fuel to increase. Some industry analysts believe EC airlines have generally been opposed to lowering fares. In fact, in November 1991, the EC Commission cited five major EC airlines for overcharging for flights in 1990.

However, EC officials believe that the increased freedom to set fares, which is included in the third phase of liberalization, will eventually lead to lower fares. Indeed, Lufthansa lowered fares between Germany and other points in Europe from January through March 1993. Several EC airlines followed Lufthansa's lead, but one of these airlines, SAS, announced it would probably raise fares when Lufthansa's offer ended.

Lower fares have been introduced on several intra-EC routes, but the most dramatic price decreases have been on routes between countries with bilateral agreements that are more liberal than the EC's regulations. For example, after the United Kingdom and Ireland concluded a liberal bilateral agreement in 1986, fares on the Dublin-London route declined by about 15 percent. Also, after the United Kingdom and the Netherlands liberalized their bilateral agreement, competition on routes increased significantly, with lower fares and increased service, according to aviation analysts. However, on most routes, fares remain high because some governments—such as the French, Italian, and German governments—continue to protect their national airlines from competition.

Because there have been few low-cost new entrants, the EC will not likely experience the large reduction in fares that occurred in the United States following deregulation. Relatively high operating costs will prevent EC airlines from introducing significantly lower fares without competition from low-cost new entrants. Officials of at least two major EC airlines have even stated that they intend to continue to compete for business on the basis of the quality of their service rather than low fares. In addition, some aviation analysts believe that common aviation technical standards, labor rules, and taxes in the EC may, in fact, raise airlines' costs, causing fares to rise rather than fall.

Strategies by EC Airlines May Lead to Less Competition

In part because they expect the current and planned liberalization measures to eventually increase competition in the EC, airlines there are trying to improve their competitive positions by expanding their global route networks through mergers, acquisitions, cooperative marketing alliances, and ownership pacts with other EC and non-EC airlines. These strategies may impede increased competition in the EC, because airlines that are partners are not likely to compete directly with each other. Measures to ease restrictions on airlines' capacity, to increase the number of airlines that can offer service on intra-EC routes, and to enhance EC airlines' freedom to fly among EC countries have prompted some EC airlines to seek to expand from dominant national positions to dominant European ones. Some industry analysts believe that such expansion is necessary for an airline to survive as a major competitor in the liberalized market.

Mergers and Acquisitions Making the EC Air Transport Market Less Competitive at the National Level

To attain fleets and route networks of the size they believe necessary to compete in the liberalized aviation market, some EC airlines are trying to merge with or acquire other airlines. EC airlines are concerned with improving and maintaining their competitive positions not only in relation to those of other EC airlines, but also in relation to those of U.S. airlines and the low-cost Asian airlines—such as Singapore Airlines. A 1988 study speculated that following liberalization, a given EC airline would have a number of reasons to pursue mergers, including to

- increase its business by linking with an airline that operates from a more densely populated region or with an airline that can transfer passengers to the EC airline's international route network;
- improve the location of its hub through an alliance with an airline operating from a strategically stronger location;
- complement its existing route network;
- lessen the impact of congestion at an airport by allying with an airline with valuable slots or with an airline operating from a hub with room for expansion;
- improve its access to another continent; and/or
- prevent competitors from taking over its markets.[1]

The EC Commission may prohibit or alter mergers or acquisitions that threaten competition by placing an airline in a dominant position in a market within the EC or by increasing an airline's dominance within the EC (see ch. 1). To guard against anticompetitive effects, the Directorates-General for Competition and Transportation are jointly responsible for reviewing airlines' mergers and transfers of assets that meet certain financial criteria and criteria regarding the share of the market involved.[2]

Mergers have taken place only among airlines within the same nation: British Airways acquired British Caledonian in 1988, and Air France acquired two French airlines, Union de Transports Aeriens (UTA) and Air Inter, in 1990. Exercising its authority to review mergers, the EC Commission required both British Airways and Air France to give up routes to other airlines as a condition of its approval of each agreement.

[1]International Foundation of Airline Passengers Associations, European Airline Mergers: Implications for Passengers and Policy Options (1988).

[2]Mergers or acquisitions may be reviewed by the EC Commission if the aggregate revenue of the parties involved exceeds 5 billion European Currency Units (ECU) (about $6 billion) or if the aggregate revenue generated within the EC by at least two of the parties exceeds 250 million ECUs, unless each party generates more than two-thirds of its EC-wide revenue within one member state. The ECU equaled about $1.21 in January 1993.

Nevertheless, these mergers have decreased competition at the national level.

Many industry observers believe that the European market will eventually become dominated by as few as three major airlines, with a second tier of airlines serving niche or regional markets. The major airlines—British Airways, Air France, and Lufthansa—are likely to continue to consolidate their positions through mergers, takeovers, and cooperative arrangements that will make them more competitive with U.S. airlines on transatlantic routes.

Although some analysts expect that such consolidation will inevitably occur across the borders of EC countries, it is uncertain whether any EC country will allow its national airline to lose its identity through a merger with other EC airlines. Cross-border mergers are now possible because restrictions requiring national ownership have been replaced with rules permitting airlines to be owned and controlled by any EC citizen, and national licensing regulations are required to conform to common criteria across the EC. As a result, at least in theory, any EC airline is able to expand its operations into any member country and has the right to be treated equally with national airlines in that country. Furthermore, the EC Commission is less likely to oppose the consolidation of airlines across borders than the consolidation within a country. An official from the Directorate-General for Competition told us that the office looks more favorably on cross-border mergers than domestic mergers because domestic airlines are more likely to compete on the same routes.

Marketing and Cross-Ownership Alliances Are Alternatives to Mergers

EC airlines are also establishing marketing and investment alliances with both EC and non-EC airlines to protect and develop market shares.[3] These alliances may create airline systems in which the partners are not likely to compete directly with each other. The European Quality Alliance of Finnair, SAS, Swissair, and Austrian Airlines was established in 1989. Although Finnair left the alliance in 1991, the remaining members plan to strengthen their cooperation by coordinating schedules, providing one-stop check-ins for passengers, and sharing airport facilities. Together, the three remaining partners carried more passengers than any single AEA airline in 1991.

[3]Marketing alliances include agreements to coordinate flights, share routes and facilities, and jointly market services.

According to DOT, the largest cross-border investment within the EC has been Air France's purchase of a 37.5-percent stake in Sabena Belgian Airlines for $122 million. In October 1992, the EC Commission approved the purchase on the condition that both airlines give up some European and African routes, and placed a limit on the number of slots the airlines may use at Brussels Zaventem Airport. British Airways has been another active cross-border investor, purchasing 49 percent of two regional airlines: the French airline TAT and the German airline Delta Air, renamed Deutsche BA. Other EC airlines with significant cross-ownership include SAS, Iberia, and Lufthansa. (See app. I for more details on EC airlines' marketing and investment alliances). EC airlines are also investing in U.S. airlines, which is discussed in chapter 4.

EC Commission Needs to Balance Conflicting Goals to Enhance Airline Competition

Although the EC Commission has stated its intention to prevent the anticompetitive effects of mergers and acquisitions, the Commission faces difficulties in balancing its desire for a competitive industry with its goal of ensuring EC airlines' international competitiveness, as the following case illustrates. Before approving Air France's acquisition of UTA and Air Inter in October 1990, the Commission had expressed concern about the potential anticompetitive effects of the takeover. Consequently, the Commission reached an informal agreement with Air France, under which the airline gave up certain domestic and international routes to other airlines. In return, the Commission agreed not to pursue the case further.[4] The EC Directorate-General for Competition opposed the takeover, believing it would substantially reduce competition. The EC Directorate-General for Transportation, on the other hand, supported the takeover, believing that EC airlines need to consolidate to improve their global competitive positions in relation to non-EC airlines'.

Several Government-owned EC Airlines Are Considering Eventual Privatization

Several EC governments are considering privatizing or reducing their stake in their national airlines because of increasing competition attendant to the EC's liberalization, the poor financial performance of some airlines, and the large capital expenditures required. The German government intends to sell its 56.9-percent stake in Lufthansa. Greece and Portugal had plans in 1992 to sell up to 49 percent of state-owned Olympic Airways and TAP Air Portugal, respectively, retaining controlling interests in the airlines. In addition, the Italian government plans to privatize the state holding company that owns the government's shares in Alitalia. In contrast, the

[4]Air Littoral, a French regional airline, filed a complaint with the EC Commission in January 1992, alleging that Air France had not respected the agreement aimed at opening competitive opportunities to Air France's domestic rivals.

chairman of Air France has indicated that there are no plans to privatize that airline. How soon and the extent to which the governments pursuing privatization will reduce their ownership interests in their airlines is uncertain.

Governments are considering privatizing their airlines for a variety of reasons: to raise revenue; reduce their deficits; free airlines' management from political interference; and enhance the airlines' commercial viability, efficiency, and, ultimately, profitability. After being privatized in 1987, British Airways dramatically improved its efficiency and profitability.[5] By increasing airlines' focus on efficiency and profitability, privatization may make some EC airlines more competitive with U.S. airlines in the transatlantic market.

The trend toward privatization may encourage liberalization as privatized airlines push for greater operating and commercial freedom. For example, private airlines like British Airways and British Midland Airways have been vocal in calling for increased competition in the EC. Thus, privatization and liberalization may be mutually reinforcing. Ironically, the trend toward privatization may cause EC governments to increase subsidies and capital assistance to their airlines in the short term in an effort to put them on a sound financial footing, thereby making them more attractive to private investors.

Conclusions

The first two sets of liberalization measures had only modest success in encouraging airlines to enter new markets or in lowering airfares. Furthermore, the EC air transport market is changing as airlines anticipate a more competitive environment by pursuing strategies to improve their positions. These strategies may, in fact, impede airline competition. As a result, the European air transport market may become dominated by as few as three airlines that may be in a stronger position to challenge U.S. airlines in the transatlantic market.

[5]British Airways is the only major EC airline that is wholly privatized.

Some EC Countries Trying to Restrict U.S. Airlines' Access to EC Market

Although the first two sets of the EC's liberalization measures have had little direct effect on U.S. airlines, current and proposed measures could limit U.S. airlines' ability to compete in the EC. Non-EC airlines are prohibited from introducing low fares on routes between EC countries. While the EC Commission has the authority to prohibit certain airline mergers and route sales involving non-EC airlines if those sales will have an effect within the Community, it has not done so. The Commission investigated and cleared Delta's acquisition of Pan Am's European routes.

To improve their competitive positions in the European market before further liberalization measures were completed, the largest U.S. airlines expanded their European route networks as opportunities became available. In response to this increased competition and in an effort to improve their national airlines' competitive positions before 1993, some EC countries have tried, through renegotiating bilateral agreements, to restrict U.S. airlines' services to EC markets.

To improve and liberalize aviation relations with EC countries, the U.S. government has undertaken several initiatives that could enhance EC airlines' access to the United States. However, we do not believe the United States is likely to grant cabotage rights to EC countries in the near future. The EC Commission has stepped up efforts to negotiate aviation agreements on behalf of its members, which could lead to a multilateral agreement between the United States and the EC after 1998. EC member countries, however, have been reluctant to cede negotiating authority to the Commission, and until they do so, aviation relations between the United States and EC countries will continue to be governed by individual bilateral agreements.

Largest U.S. Airlines Are Expanding Their Presence in Europe

The largest U.S. airlines—American, Delta, and United—have been rapidly expanding their transatlantic service. These airlines, with well-developed domestic hub-and-spoke networks that can feed traffic to their international routes, bought European routes from financially ailing U.S. airlines, namely, Pan Am and TWA. Airlines that lack the financial resources to purchase routes, such as Continental and USAir, are expanding their access to the EC market through investments and marketing alliances with EC airlines. U.S. airlines want to ensure their access to any growth in the EC air travel market that results from liberalization and want to hedge against the uncertainty of the EC market's structure after liberalization measures are completed.

Major U.S. Airlines Have Purchased Routes From Financially Ailing Airlines

American, Delta, and United have been actively expanding their European operations. American and United, which had no transatlantic operations in 1980, acquired TWA's and Pan Am's routes to London's Heathrow airport in December 1990 and October 1990, respectively. In July 1991, Delta purchased Pan Am's New York and Frankfurt hubs, European routes, and remaining worldwide route authority. These purchases significantly increased American's, Delta's, and United's shares of the seating capacity available on all transatlantic flights (see table 4.1). (App. II shows the changes in European routes from 1990 to 1992 for the three airlines.)

Table 4.1: Top 10 Transatlantic Airlines' Shares of Seating Capacity, July 1990 and July 1992

	July 1990		July 1992[a]	
Airline	Percentage of seating capacity	Rank	Percentage of seating capacity	Rank
British Airways	11.4	3	13.3	1
Delta	4.6	6	13.1	2
TWA	15.7	1	10.4	3
American	5.6	5	9.1	4
United	0.7	10	7.1	5
Lufthansa	9.2	4	6.8	6
Continental	2.5	9	4.9	7
KLM	3.4	8	4.7	8
Air France	4.3	7	4.0	9
Pan Am	14.7	2	[b]	[b]

[a]Data for 1992 are projected.

[b]Pan Am ceased operations on December 4, 1991.

Source: Global Aviation Associates, Ltd.

U.S. Airlines Are Forming Alliances With EC Airlines

U.S. airlines are also trying to improve their access to the markets within the EC by forging marketing and investment alliances with European airlines (see table 4.2). This strategy has been adopted by airlines that lack the resources to finance expansion in Europe—airlines such as Continental and USAir. Similarly, EC airlines view alliances and investments in U.S. airlines as a way to gain more reliable access to the large domestic air travel market in the United States. Although few investments have been made, more EC airlines have invested in U.S.

airlines than vice versa, in part, because of the poor financial health of the U.S. airline industry in general.[1]

Table 4.2: Selected Alliances Between U.S. and European Airlines

U.S. airline	European partner	Type of alliance
American	Aer Lingus	Route-specific
Continental	SAS	SAS has an 18-percent voting interest in Continental.[a] Wide-ranging marketing alliance
Delta	Swissair	Delta and Swissair have reciprocal 5-percent equity stakes. Wide-ranging marketing alliance
Northwest	KLM	KLM owns 57 percent of Northwest's total equity. Wide-ranging marketing alliance
United	British Midland Airways	Wide-ranging marketing alliance
	Alitalia	Route-specific marketing alliance
USAir	British Airways	British Airways has agreed to purchase 21.8 percent of USAir's voting stock with options to invest up to $450 million more over the next 5 years.

[a]This investment will be wiped out under Continental's reorganization plan to emerge from bankruptcy.

Source: Airline Business, Aviation Daily, and DOT.

Although marketing alliances can be severed anytime, exchanges of equity provide a longer-term link between airlines, which could have significant implications for competition. For example, British Airways' investment in USAir would create the world's largest airline alliance in terms of the number of passengers carried and, under a code-sharing agreement, would allow British Airways to feed its international routes with traffic from USAir's large U.S. network.[2] In 1991, USAir carried 55 million passengers and had almost 10 percent of the U.S. market.[3] On January 21, 1993, the two airlines signed a comprehensive agreement under which British Airways will invest $300 million in USAir in exchange for 21.8 percent of its voting stock and 3 places on USAir's 16-member board of directors. The agreement also gives British Airways options, over the next 5 years, to

[1]See Airline Competition: Impact of Changing Foreign Investment and Control Limits on U.S. Airlines (GAO/RCED-93-7, Dec. 9, 1992).

[2]A code-sharing agreement between two airlines allows them to use the airline designation code of one airline on a flight operated by the other airline.

[3]The figure for USAir's market share is based on revenue passenger miles, or the miles traveled by paying customers. The number of passengers carried reflects enplanements.

invest up to $450 million more and obtain additional stock and other rights if U.S. law permits. In addition, the two airlines propose to integrate their operations to create a single global airline network.

KLM and Northwest applied to DOT in September 1992 for its approval of a marketing agreement under which the two airlines would integrate their operations to function in many respects as a single airline. DOT's approval of the agreement in January 1993 conferred limited antitrust immunity. The agreement allows the two airlines to coordinate the planning, scheduling, pricing, and marketing of their services. KLM already owned 10 percent of the voting stock and 57 percent of the total equity of Northwest (the equity in excess of 49 percent is held in a trust).

Largest U.S. Airlines Appear Well Positioned to Compete on Transatlantic Routes

American, Delta, and United are formidable competitors in the transatlantic market because they are more productive and have lower operating costs than most European airlines and have greater financial resources than the airlines they replaced—Pan Am and TWA. A recent study found that the productivity of European airlines' scheduled passenger services was only 72 percent of U.S. airlines' in 1989.[4] For example, the operating costs per seat mile of United, American, and Delta are lower than many major EC airlines'.[5] Because these U.S. airlines are more productive, they can offer lower fares and thereby gain market share on routes between the United States and Europe if pricing is deregulated. The EC's regulations prohibit U.S. airlines from charging lower fares than EC airlines on routes within the Community (see ch. 3).

U.S. airlines' lower labor costs per seat mile relative to EC airlines' are also important competitive advantages (see fig. 4.1).[6] In addition, the social and economic policies of EC countries may constrain EC airlines from taking an action such as laying off employees to reduce labor costs and improve productivity, and, thus, EC airlines could be unable to lower costs sufficiently to reduce fares. When Air France, for example, announced plans to lay off several thousand workers in an effort to streamline the

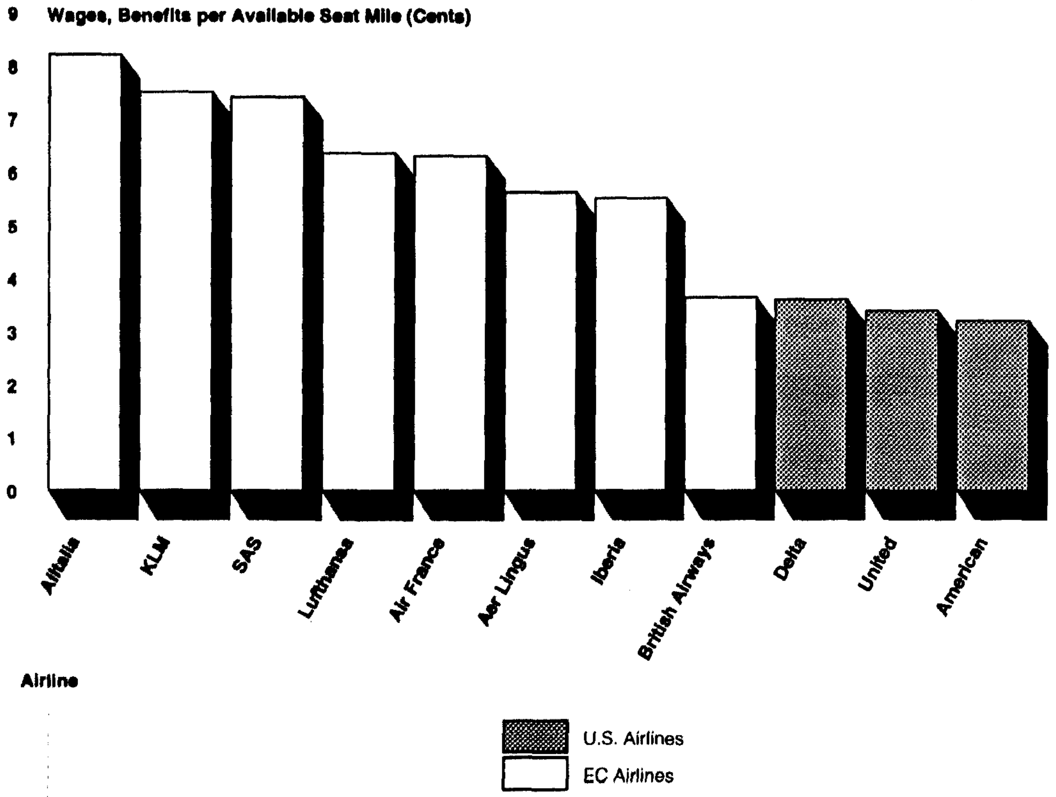
[4]McKinsey Global Institute, Service Sector Productivity (Washington, D.C.: Oct. 1992).

[5]In 1991, American's operating cost per seat mile was $0.0913, Delta's was $0.0927, and United's was $0.0984.

[6]Average compensation and labor productivity rates determine the labor cost per available seat mile. When comparing productivity among airlines it is necessary to consider several factors that can influence the results, such as the extent to which services are contracted out to other airlines and average length of routes.

airline's operation, the French government asked the airline's management to reconsider the cuts.

Figure 4.1: Comparison of Selected U.S. and EC Airlines' Labor Costs Per Seat Mile, 1990-91



Notes: Data for Air France, Alitalia, Iberia, Lufthansa, and SAS are for 1990. Data for Aer Lingus, American, British Airways, Delta, KLM, and United are for 1991.

Labor costs include wages and benefits.

Source: Simat, Helliesen & Eichner, Inc., and DOT.

Many Believe Bilateral Agreements Have Favored the United States

U.S. airlines are also in strong competitive positions in most markets within the EC because of rights the airlines were awarded many years ago in bilateral aviation agreements with European countries. Many officials from the EC Commission, member countries, and EC airlines believe that over the years, U.S. airlines have received more valuable rights in bilateral aviation agreements than EC airlines have. European officials believe U.S. airlines' fifth freedom rights are equivalent to cabotage rights, and these officials are concerned that EC airlines do not have similar rights in the United States. U.S. airlines have fifth freedom rights that allow them to carry passengers and cargo to Europe and then to provide similar service between countries within Europe (see table 4.3). Although European airlines provide service to many cities in the United States, they cannot carry passengers or cargo between U.S. cities. For example, Lufthansa can provide service from Frankfurt to New York but not from New York to Miami. Delta, however, can provide service from New York to Frankfurt and also from Frankfurt to Athens. On the other hand, some U.S. airlines believe certain bilateral agreements place them at a competitive disadvantage. For example, some airlines believe the agreement between the United States and the United Kingdom places too many restrictions on U.S. airlines' service to that country in terms of the number of routes served and the number of flights operated on a given route.

Table 4.3: U.S. Airlines' Operations Between EC Countries, 1991

Airline	Route[a]
American	Brussels-Dusseldorf
Delta	Amsterdam-Hamburg
	Amsterdam-Stuttgart
	Athens-Frankfurt
Pan Am	Amsterdam-Hamburg[b]
	Athens-Frankfurt[b]
	Frankfurt-London[c]
	Hamburg-London[c]
	London-Munich[c]
TWA	Athens-Rome
	Berlin-London
	Frankfurt-London
	Hamburg-London
	London-Munich
	Munich-Paris
	Paris-Rome
United	Berlin-London
	Frankfurt-London
	Hamburg-London
	London-Munich

Note: The table generally includes routes with 100 flights or more per year. However, on those routes operated by Delta, there were less than that number of flights, but Pan Am had conducted extensive operations on the routes. U.S. airlines have additional fifth freedom rights between EC countries that they are not exercising.

[a]Operations on routes occurred in both directions, and flights originated or terminated in the United States.

[b]Route was purchased from Pan Am by Delta in July 1991.

[c]Route was purchased from Pan Am by United in 1991.

Source: DOT.

Some Countries Trying to Restrict U.S. Airlines' Access to EC Market

U.S. airlines may not be able to fully exploit their advantages in having lower operating costs unless the EC Commission or individual member countries agree to liberalize their bilateral agreements with the United States. The French and German governments are trying to restrict U.S. airlines' access to their countries as they seek to renegotiate their bilateral aviation agreements with the United States. These countries are responding to the strong competitive position of the large U.S. airlines in the transatlantic market and their perception that an imbalance in their bilateral agreements with the United States gives U.S. airlines more valuable rights than EC airlines have. In addition, these countries were trying to improve the competitive position of their national airlines before further liberalization measures were implemented in January 1993. Although other countries, such as Spain, have granted additional rights to U.S. airlines in exchange for increased access to the U.S. market, these countries, too, are uneasy about increased competition from U.S. airlines.

On May 4, 1992, the French government renounced its bilateral aviation agreement with the United States. Problems began in late 1991 when the French government refused to approve summer schedules of U.S. airlines serving France that would take effect on April 1, 1992. A 42-percent increase in the service to France, which was proposed by U.S. airlines, exceeded the projected demand on those routes, the French argued. The French government wanted to reduce the increase in capacity to 15 percent. Recent increases in the service to Paris from Los Angeles and San Francisco have been proposed by United; from Houston, by Continental; and from Philadelphia, by USAir. The current bilateral agreement will continue until May 1993 while U.S. and French officials negotiate a new agreement. The EC Commission has offered to help the French government if it encounters problems during negotiations with the United States.

Furthermore, Germany has threatened to renounce its bilateral agreement with the United States. In ongoing meetings to discuss the U.S.-German agreement, the German government has called for restricting the capacity of U.S. airlines serving Germany, limiting the ability of the United States to designate multiple airlines to serve Germany, and requiring U.S. airlines to give up some flights from Germany to other points in Europe and beyond. U.S. negotiators, on the other hand, want Germany to ease restrictions on the prices airlines flying out of Germany may charge. A Lufthansa official who has participated with the German government in its talks with the United States said the airline would recommend terminating the bilateral agreement if progress is not made over the next year. In November 1992, the United States and Germany signed an interim agreement that freezes capacity. The U.S. government also committed to negotiating a new bilateral agreement. The interim agreement expires on October 31, 1993.

In contrast, Spain and Italy have granted the United States additional aviation rights in exchange for increased access to the United States during the past several years. Italy, however, is uneasy about the prospect of its national airline competing against the strongest U.S. airlines and has threatened to adopt a more restrictive stance in future negotiations.

Current and Proposed Measures Could Limit U.S. Airlines' Ability to Compete in the EC

U.S. airlines' ability to compete in the EC market could be curtailed by the EC's regulations on pricing. Furthermore, the EC's regulations controlling mergers give the EC Commission the authority under EC law to investigate and prohibit certain mergers or route sales between non-EC airlines. However, according to DOT, the United States has not recognized the EC's authority over mergers and acquisitions involving U.S. airlines. The Commission investigated Delta's acquisition of Pan Am's European routes and determined that it would not impede competition because of Delta's share of the market, which was less than 25 percent. Finally, though some U.S. airlines have modified their computer reservation systems (CRS) to conform to the EC's 1989 rules, there is no evidence that this has affected these airlines' business in Europe at this time.

Although air transport services between the United States and the EC are still governed by individual bilateral agreements, U.S. airlines' route rights in the EC might have to be renegotiated if the EC Commission gains the authority to negotiate aviation agreements on behalf of its members.

Regulations on Pricing Discriminate Against U.S. Airlines

Third-phase measures governing airlines' pricing prohibit U.S. and other non-EC airlines from introducing prices lower than existing ones on routes within the EC, limiting the ability of these airlines to compete for traffic on those routes. Officials at DOT, the State Department, the Air Transport Association (ATA)—the major U.S. airlines' trade association—and U.S. airlines serving Europe believe that the measures governing pricing discriminate against U.S. airlines. DOT officials believe that if U.S. airlines do not have the opportunity to introduce lower prices, fully effective competition on routes within the EC is more difficult to attain. However, DOT officials also pointed out that under existing bilateral agreements, only three EC governments—those of Belgium, Ireland, and the Netherlands—permit U.S. airlines to introduce lower prices than existing ones on routes within the EC that originate or terminate in their countries.

Rules on Allocating Slots Could Limit U.S. Airlines' Access to the EC Market

To promote competition and ensure new entrants access to the market, the EC Commission proposed rules in December 1990 to withdraw slots from incumbent airlines under certain circumstances. Any such regulation could possibly have been used to limit the access of U.S. airlines to the EC market by giving some slots they were using to new entrants or incumbent EC airlines. The officials of most of the major U.S. airlines with European operations whom we contacted opposed this proposal. DOT and the State Department were also concerned that the proposal would have allowed slots to be withdrawn from U.S. airlines, preventing them from exercising rights pursuant to existing bilateral agreements. The State Department was also concerned that only EC airlines entering new markets would be eligible to receive the slots. The State Department and DOT believe that nondiscriminatory access to slots at congested EC airports is an obligation that is covered by existing bilateral agreements and that cannot be undermined by the EC's legislation. In contrast to the possible results of the Commission's proposal, at O'Hare airport in Chicago, where slots are controlled, they are withdrawn from domestic airlines if needed by foreign airlines to fulfill terms of bilateral air services agreements.[7]

The 1990 proposal faced strong opposition from EC airlines and in January 1993 the Council adopted a rule that was not as far-reaching as the 1990 proposal. Under the new rule, slots that are not used 80 percent of the time will be returned to a slot "pool." Half of the slots in the pool will be available to new entrants. Although the new rule appears to be nondiscriminatory, according to DOT officials the rule does discriminate against non-EC airlines because it gives priority to providing slots for service within the EC. As a result, it may be difficult for U.S. airlines to obtain slots for transatlantic services, which could constrain the growth of their services to the EC.

Regulations Give EC Commission Authority to Block U.S. Mergers and Route Sales

The EC's regulation controlling mergers allows the EC Commission to investigate and prevent mergers or acquisitions that threaten competition by giving the airlines involved a dominant position within the EC market or by strengthening an already dominant position. The regulation applies to certain mergers and transactions between U.S. and EC airlines and to certain mergers between U.S. airlines that provide service in the EC.[8] Relying on this authority, in September 1991 the EC Commission examined the effects that Delta's acquisition of Pan Am's transatlantic and intra-European routes could have on markets within the EC. The Commission approved the acquisition, concluding that the transaction would not enable Delta to impede competition in the EC. The United

[7]O'Hare Airport, in Chicago, and LaGuardia and Kennedy airports, in New York City, are the only U.S. airports providing international service that have slot controls.

[8]Ch. 3 describes the conditions under which the regulations apply.

States, however, does not recognize the EC's authority over mergers and acquisitions involving U.S. airlines, according to DOT.

EC's Rules for CRSs Ensure That Some Services by U.S. Airlines No Longer Have Preferred Location on Display Screens

The EC's code of conduct for CRSs, which went into effect in 1989, prescribes criteria for ranking scheduled flights in all CRS displays in EC countries. The code is intended to ensure a fair and competitive environment by not discriminating among airlines in CRS displays. Specifically, the EC's code ensures that all services involving changing from one plane to another are listed according to the elapsed time of the journey, from the shortest to the longest. Some U.S.-owned CRSs give preference to change-of-plane service that involves only one airline, which some U.S. airline representatives believe is more convenient for many passengers. According to ATA officials, to comply with the new requirements, U.S. airlines that own CRSs have altered their displays for systems installed in the EC.[9]

Officials from one U.S. airline believe that their flights involving changing from one plane to another are inadequately displayed under the EC's code. However, these officials found no evidence that complying with the code so far has affected their traffic from Europe, nor did they believe that the code will prevent the EC's traveling public from learning about or requesting their flights to the United States.

DOT's Initiatives Could Improve Foreign Airlines' Access to U.S. Market

DOT has undertaken several initiatives to try to liberalize and improve aviation relations with European countries by proposing "open skies" agreements and, under its Underserved Cities Program, by expanding European airlines' rights to operate routes between Europe and the United States. Prompted by the September 1992 open skies agreement between the Netherlands and the United States, the EC Commission has been stepping up efforts to gain the authority to negotiate aviation agreements on behalf of its members.

In March 1992, the Secretary of Transportation offered all European countries the opportunity to explore open skies agreements with the United States in exchange for permitting U.S. airlines similar access to

[9]American Airlines owns Sabre CRS; United and USAir are members of the Covia Partnership, which owns Apollo CRS; Continental Airlines' parent company, Continental Holdings, Inc., owns System One; and Northwest, TWA, and Delta own Worldspan CRS. For more information on these U.S. systems, see Computer Reservation Systems: Action Needed to Better Monitor the CRS Industry and Eliminate CRS Biases (GAO/RCED-92-130, Mar. 20, 1992); Competition in the Airline Computerized Reservation System Industry (GAO/T-RCED-88-62, Sept. 14, 1988); and Airline Competition: Impact of Computerized Reservation Systems (GAO/RCED-86-74, May 9, 1986).

their markets. As defined by DOT, an open skies agreement allows access to all routes between the United States and the European country; provides for the greatest possible degree of freedom in pricing; prohibits restrictions on the capacity and frequency of flights on these routes; and allows unrestricted route and traffic rights, such as an airline's ability to serve intermediate destinations and points beyond the countries that are parties to the agreement, to change the size of aircraft used, to serve "coterminal" airports, and to exercise fifth freedom rights.[10] As of February 1993, only the Netherlands had accepted DOT's offer.

The EC Council is considering the Commission's proposal that would permit member governments to adopt bilateral aviation agreements with non-EC countries only until 1998, and then only after the governments consult other EC nations. Under the proposal, no EC country would be able to negotiate an open skies or similar agreement with the United States unless the majority of EC countries approved. The proposal would also give the EC Commission the authority to negotiate new aviation agreements for the 12 member countries after 1998. However, as discussed in chapter 2, member countries have been reluctant to cede negotiating authority to the Commission.

Under the Underserved Cities Program, initiated by DOT in 1989, KLM and Swissair provide service to Baltimore, Detroit, Minneapolis, and Philadelphia (see table 4.4). The program allows foreign airlines to provide specific international air service to U.S. communities that do not receive that service from U.S. airlines. To participate in the program, an airline must be from a country having a liberal bilateral agreement with the United States, and certain other conditions need to be met. In addition, no U.S. airline can be providing equal or superior levels of service on the route in question. The program was expanded in November 1991 to allow foreign airlines to fly passengers from a designated U.S. city to more than one city in the airline's homeland. For example, under the original program Swissair could fly passengers or cargo from Philadelphia to Zurich; under the expanded program, Swissair is allowed to fly a route from Philadelphia to Zurich and Geneva.

[10]An airline may serve two or more so-called "coterminal" airports on the same flight, as long as these airports are part of the same route and third and fourth freedom service is not provided between the airports. For example, KLM could discharge passengers in both New York and Boston on an Amsterdam-New York-Boston route, but the airline would not be allowed to enplane passengers in Boston and discharge them in New York.

Table 4.4: European Service Provided Under DOT's Underserved Cities Program

Airline	Route served
KLM	Amsterdam-Baltimore
KLM	Amsterdam-Minneapolis-St. Paul
KLM	Amsterdam-Detroit
Swissair	Zurich-Philadelphia

Source: DOT.

Cabotage Unlikely in the Near Future

The United States is not likely to grant cabotage rights to EC countries in the near future. Cabotage, which would allow foreign airlines to provide domestic air service, is prohibited in the United States and will not be possible unless the law is changed.[11] Almost every country similarly bars the airlines of other countries from providing service on its domestic routes. Attempts to legalize cabotage would face strong opposition from U.S. labor unions because they fear that increased foreign competition will lead to fewer jobs and reduced work benefits. Furthermore, even if cabotage were legalized, both the EC and U.S. markets present constraints to significantly expanding service.

Safety Regulations Needed for Cabotage Service

In addition to requiring legal changes, cabotage would require administrative procedures to ensure the safe operation of foreign aircraft operating within the United States. Currently, FAA has no regulations for foreign airlines that might operate routes within the United States.[12] FAA officials told us that they could handle cabotage in one of two ways. They could issue certificates and regulate foreign airlines operating routes within the United States, treating these airlines in the same manner as they treat U.S. airlines. The foreign airlines would undergo a review to ensure compliance with safety standards and, after being issued an operating certificate, would remain subject to FAA's surveillance. Alternatively, safety could be regulated through an international organization, such as the International Civil Aviation Organization, or regulation could be defined by bilateral agreements. According to FAA, if another regulatory body issued the operating certificate, that organization would also be responsible for setting safety standards and for oversight.

[11]49 U.S.C. app. section 1508.

[12]For more information on FAA's responsibility for overseeing foreign airlines serving the United States, see Aviation Safety: Increased Oversight of Foreign Carriers Needed (GAO/RCED-93-42, Nov. 20, 1992).

Attempts to Legalize Cabotage Would Face Strong Opposition

Airline labor unions in the United States oppose cabotage because they believe it would not enhance airline competition in this country and would further weaken the airline industry by diverting domestic traffic and revenue away from U.S. airlines. These groups also argue that cabotage would be detrimental to U.S. workers in the airline industry. According to officials from the Air Line Pilots Association, increased competition from foreign airlines would lead airlines' managers to demand concessions from their employees to make their airlines more competitive, resulting in falling wages, reduced benefits, and less favorable work rules. Furthermore, some U.S. labor groups believe that many EC airlines would have an unfair advantage in competing in the United States because they are owned or subsidized by their governments.

Congestion Could Constrain Expanding U.S. Airlines' Access to the EC

Most U.S. airline officials we spoke with are not opposed to granting cabotage rights to the EC as long as U.S. and EC airlines receive rights having commensurate value. However, according to some U.S. airline officials and aviation analysts, an equitable exchange of cabotage rights with the EC is probably impossible in the near future because of problems with the EC's air traffic control system and because of the Community's inadequate airport infrastructure. As a result, U.S. airlines would probably be unable to obtain aviation rights of equal value to the rights EC airlines could obtain in the United States. Many European airports are at capacity, leaving little room for U.S. airlines to expand service. Congestion will make it very difficult for new entrants to obtain access to airports in order to compete on routes within and between EC countries. This congestion exists both on the ground, because of insufficient runways, gates, and terminals, and in the air, because of the air traffic control system's inability to handle more planes.

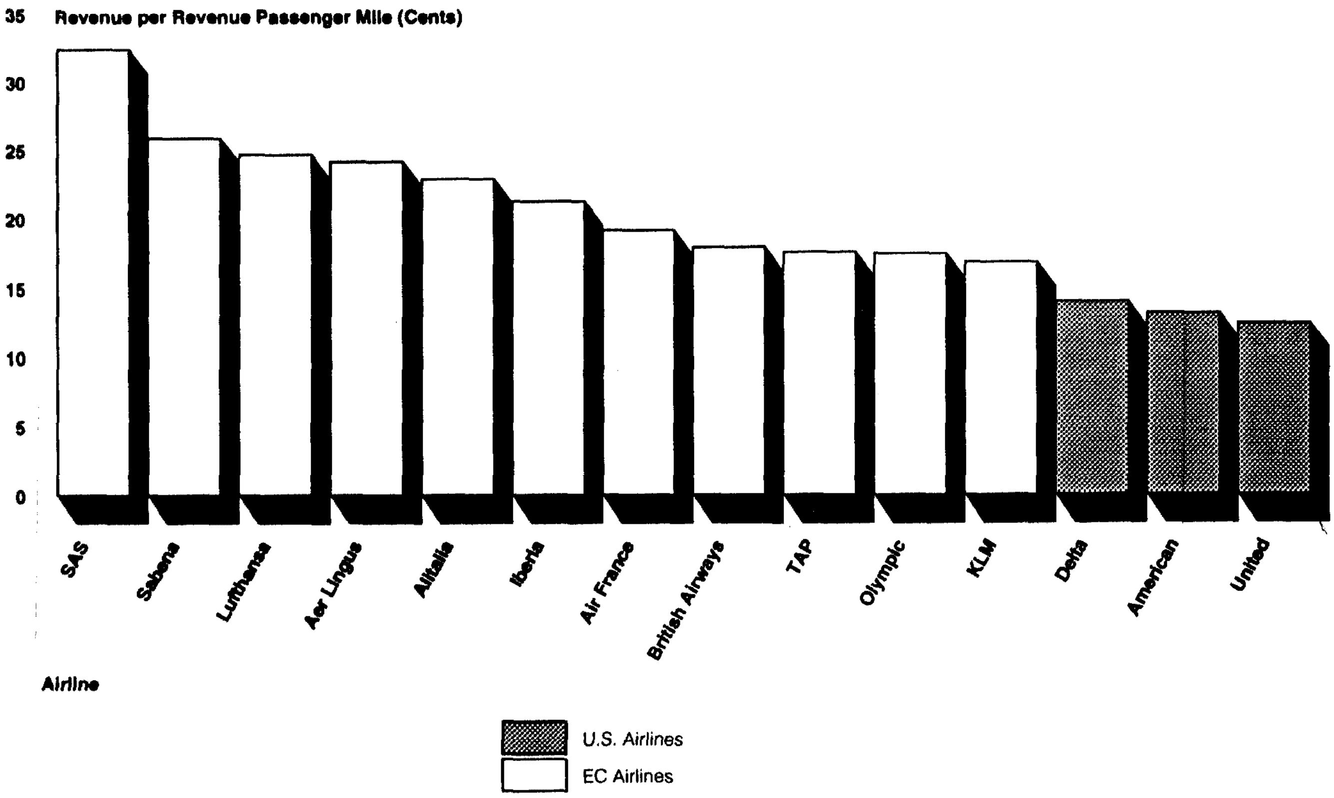
High Costs and Infrequency of Flights Could Constrain Implementing Cabotage in the United States

EC airlines would face the same problems that domestic airlines encounter in entering new markets in the United States. Airlines' marketing practices and difficulties in gaining access to airports present barriers for airlines attempting to enter new domestic markets.[13] In addition, EC airlines that desired to engage in "full" cabotage would be constrained by the large investment necessary, and those that tried to provide "fill-up" cabotage would find that the low frequency of flights would make the endeavor uneconomical in many cases. Full cabotage would require foreign airlines to dedicate aircraft to serve the U.S. market and probably establish hubs

[13] We discuss these issues in detail in Airline Competition: Industry Operating and Marketing Practices Limit Market Entry (GAO/RCED-90-147, Aug. 29, 1990).

similar to U.S. airlines' operations. This activity would require a substantial investment, and the service would probably not have as high a return on investment as service within the EC. EC airlines have relatively high costs compared to U.S. airlines' and are used to serving markets with high yields.[14] In 1991, the average yield for European services conducted by airlines belonging to the Association of European Airlines (AEA) was about 37 cents, compared to 13.2 cents for U.S. airlines conducting domestic services. AEA airlines' yields would be substantially reduced if the airlines operated locally in the United States (see fig. 4.2).

Figure 4.2: Comparison of Selected U.S. and EC Airlines' Yields, 1991



Source: AEA and DOT.

[14]Yield is the fare per passenger mile.

If they do not establish route systems in the United States, EC airlines would probably "tag on" flights within the United States as segments of their international routes. Such fill-up cabotage may not be economically valuable to EC airlines. Not only would they would be competing with established U.S. airlines offering many more flights, they may only be able to attract 10 to 15 additional passengers to "fill up" the domestic segment of a flight, according to a U.S. airline representative.

U.S. airlines' flights in certain transcontinental markets in the United States, such as Philadelphia-Los Angeles and Boston-Los Angeles, are not so frequent, so these markets may be more likely candidates for cabotage service by foreign airlines, according to one U.S. airline representative. In these markets, a flight originating in Paris or London may stand a good chance of obtaining a competitive market share on the domestic segments, according to the airline official. At least one U.S. airline also believes that the high quality of service provided by EC airlines could make them competitive.

EC Airlines Want Increased Access to U.S. Markets

Marketing alliances with U.S. airlines may not provide sufficient access to the U.S. market for some EC airlines. Furthermore, these alliances can be dissolved at any time. It is impossible, therefore, to ensure that a link, once established, stays in place. Some EC airlines—such as British Airways, KLM, and SAS—would like to ensure that access by exchanging cabotage rights with the United States or by ownership investments in U.S. airlines.

Ownership and control of a U.S. airline is more important to some EC airlines than cabotage, according to aviation analysts. Foreign airlines want to control the flow of traffic to and from the United States so that they can transport people in North America just as easily as in the rest of their route systems. Although these airlines want access to U.S. traffic, they do not want to have to operate a domestic system in the United States to gain such access. Although some British airline officials have stated their desire for exchanging cabotage rights with the United States, according to DOT officials British airlines prefer ownership stakes in U.S. airlines. This approach would allow the foreign airlines access to the U.S. market without tying up airplanes and would avoid the high cost of developing a market. The proposed linkup with USAir would give British Airways just such access. Under current law, foreign investors may own up to 25 percent of the voting stock of a U.S. airline, but control of the airline must remain with U.S. citizens.[15]

Conclusions

The EC's liberalization measures have focused thus far on EC airlines operating within the Community and have had little direct effect on U.S. airlines. However, U.S. airlines' operations in the EC could be limited by current and proposed measures that restrict fares on routes between EC countries and give the EC Commission a basis for asserting authority to prohibit mergers and route sales that affect the EC air travel market. Thus far, the EC Commission has taken no action to directly restrict service by U.S. airlines.

The largest U.S. airlines are responding to changes in the EC aviation market by enhancing their already strong competitive positions, by either acquiring new routes or entering into marketing or investment alliances with EC airlines. Several EC countries, in turn, are trying to restrict U.S. airlines' access to their markets through renegotiating bilateral agreements.

Several unresolved issues could have important implications for U.S. airlines' international competitiveness. First, U.S. airlines could be significantly affected by events in the EC after 1993, when the EC countries plan to address their aviation relations with non-EC countries and determine what role the Commission will play. Until that time, aviation relations between the United States and Europe will be governed by the existing bilateral agreements. Second, British Airways' investment in USAir would create not only the world's largest airline alliance in terms of the number of passengers carried, but also one of the first truly global airlines. Such foreign investments could signal a change in the future structure of the airline industry.

[15]See Airline Competition: Impact of Changing Foreign Investment and Control Limits on U.S. Airlines (GAO/RCED-93-7, Dec. 9, 1992).

Selected Marketing and Investment Agreements by Airlines in the European Economic Community

Airline	Partner	Carrier's equity in partner (percent)	Agreement
Aer Lingus	American	[a]	Route- or market-specific alliance
	Lufthansa	[a]	Route- or market-specific alliance concerning cargo
Air France	Air Inter	71.9	Wide-ranging marketing alliance
	Air Madagascar	3.48	[a]
	Air Mauritius	12.77	Route- or market-specific alliance
	Austrian	1.5	[a]
	CSA	19.1	Wide-ranging marketing alliance
	Canadian	[a]	Route- or market-specific alliance
	Lufthansa	[a]	Joint venture
	Royal Air Maroc	[a]	Wide-ranging marketing alliance
	Sabena	37.58	Wide-ranging marketing alliance
	Thai International	[a]	Route- or market-specific alliance concerning cargo
	USAir	[a]	Route- or market-specific alliance
	UTA	84.5	[a]
Alitalia	ATI	100	[a]
	Canadian	[a]	Route- or market-specific alliance
	Iberia	[a]	Wide-ranging marketing alliance
	Malev	30	Wide-ranging marketing alliance
	United	[a]	Route- or market-specific alliance
	USAir	[a]	Wide-ranging marketing alliance
British Airways	Air Mauritius	12.77	[a]
	Air New Zealand	[a]	Route- or market-specific alliance
	Caledonian	100	[a]
	Dan-Air	100	[a]

(continued)

Airline	Partner	Carrier's equity in partner (percent)	Agreement
	Deutsche BA	49	[a]
	GB Airways	49	[a]
	Maersk	[a]	Joint venture
	Qantas	25	Wide-ranging marketing alliance
	TAT	49.9	Wide-ranging marketing alliance
	USAir	21.8	Wide-ranging marketing alliance
British Midland[b]	Air Canada	[a]	Route- or market-specific alliance
	United	[a]	Wide-ranging marketing alliance
Iberia	Alitalia	[a]	Wide-ranging marketing alliance
	Aerolineas Argentinas	30	Wide-ranging marketing alliance
	Aviaco	67	[a]
	JAL	[a]	Route- or market-specific alliance
	Ladeco	35	Wide-ranging marketing alliance
	Royal Air Maroc	[a]	Wide-ranging marketing alliance
	Viasa	45	Wide-ranging marketing alliance
	Viva	100	[a]
KLM	Air UK	14.9	Wide-ranging marketing alliance
	ALM	[a]	Wide-ranging marketing alliance
	Garuda	[a]	Route- or market-specific alliance
	Martinair	29.8	[a]
	Nippon Cargo	[a]	Route- or market-specific alliance concerning cargo
	NLM	100	Wide-ranging marketing alliance
	Northwest	57[c]	Wide-ranging marketing alliance
	SIA	[a]	Route- or market-specific alliance concerning cargo

(continued)

Airline	Partner	Carrier's equity in partner (percent)	Agreement
	Transavia	80	[a]
	Viasa	[a]	Route- or market-specific alliance
Lufthansa	Aer Lingus	[a]	Agreement concerning cargo
	Air France	[a]	Joint venture
	Air Mauritius	[a]	Route- or market-specific alliance
	Canadian	[a]	Route- or market-specific alliance
	Cargolux	24.5	[a]
	Cathay Pacific	[a]	Route- or market-specific alliance concerning cargo
	CityLine	52	Wide-ranging marketing alliance
	Condor	100	[a]
	Finnair	[a]	Wide-ranging marketing alliance
	Garuda	[a]	Route- or market-specific alliance
	German Cargo	100	[a]
	Hapag Lloyd	10	[a]
	Thai International	[a]	Route- or market-specific alliance, and route- or market-specific agreement concerning cargo
Sabena	Air France	[a]	Wide-ranging marketing alliance
SAS	All Nippon	[a]	Wide-ranging marketing alliance
	Austrian	[a]	Wide-ranging marketing alliance
	British Midland[b]	40	[a]
	Canadian	[a]	Route- or market-specific alliance
	Continental	18[d]	Wide-ranging marketing alliance
	LAN-Chile	30	[a]
	Linjeflyg	100	[a]
	Scanair	100	[a]
	Spanair	49	[a]

(continued)

Airline	Partner	Carrier's equity in partner (percent)	Agreement
	Swissair	7.5[e]	Wide-ranging marketing alliance
	Thai International	[a]	Wide-ranging marketing alliance
	Varig	[a]	Route- or market-specific alliance

[a]Not applicable.

[b]British Midland is a subsidiary of the Airlines of Britain Group, which also owns Longanair, London City Airways, and Manx Airways.

[c]KLM owns 10 percent of the voting stock of Northwest.

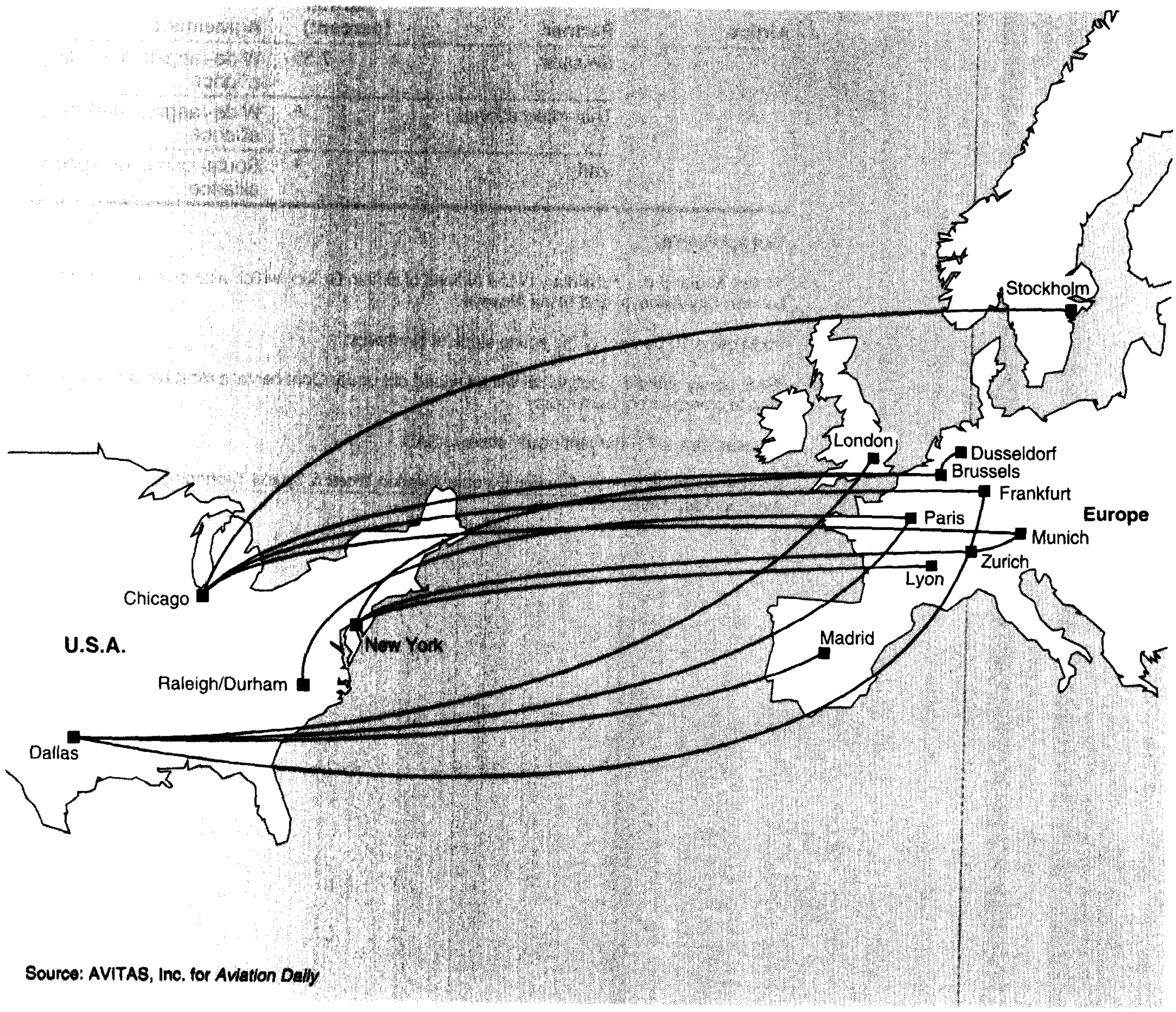
[d]SAS' equity stake in Continental will be wiped out under Continental's most recent reorganization plan to emerge from bankruptcy.

[e]Swissair has a 7.5-percent equity stake in SAS.

Source: Airline Business; Aviation Europe; Aviation Week & Space Technology; and Global Aviation Associates, Ltd.

U.S. Airlines' Routes to Europe

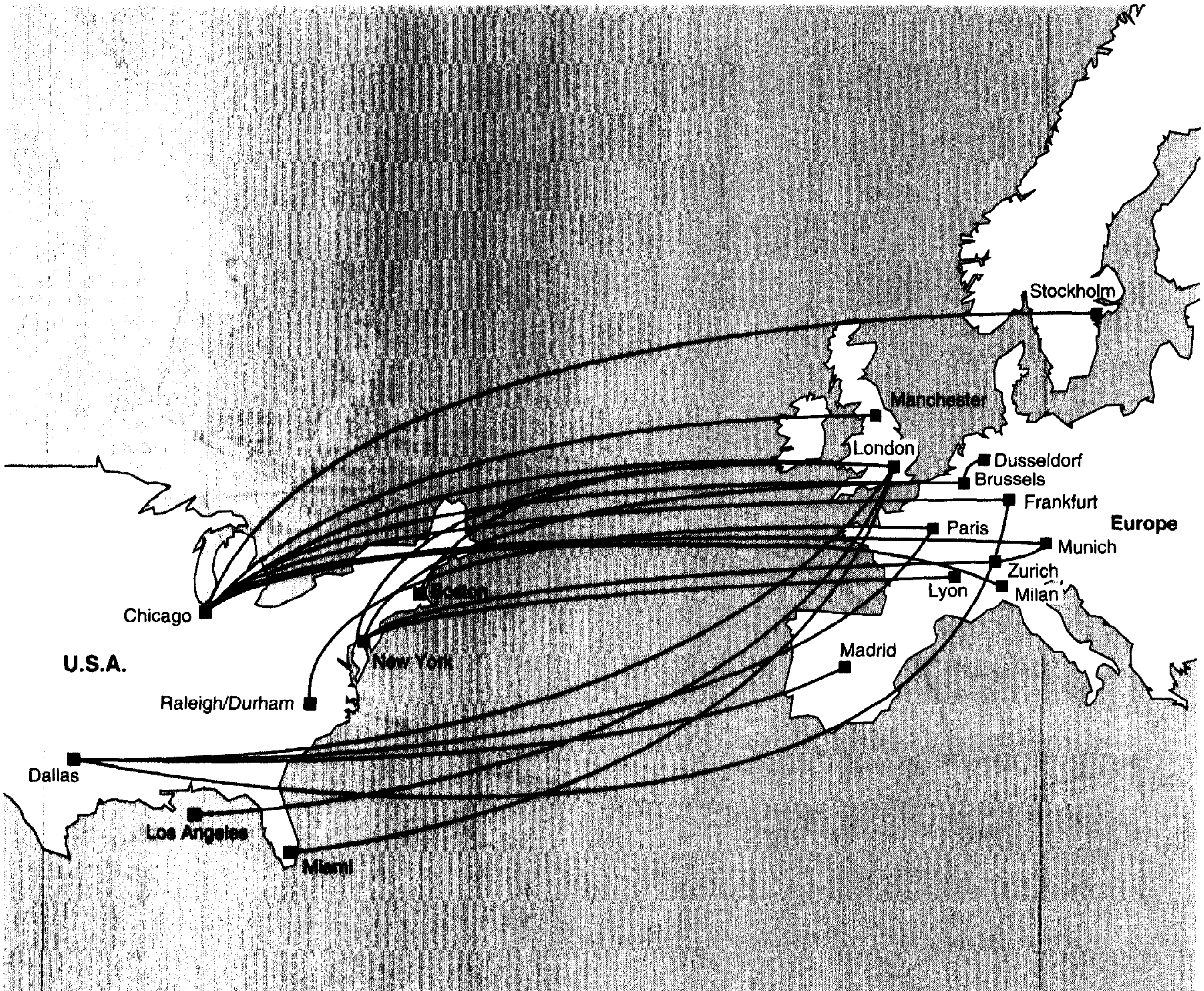
Figure II.1: American Airlines' Route Structure, United States to Europe, Summer 1990



Source: AVITAS, Inc. for *Aviation Daily*

Note: Dallas-Frankfurt route does not include Zurich-Frankfurt segment.

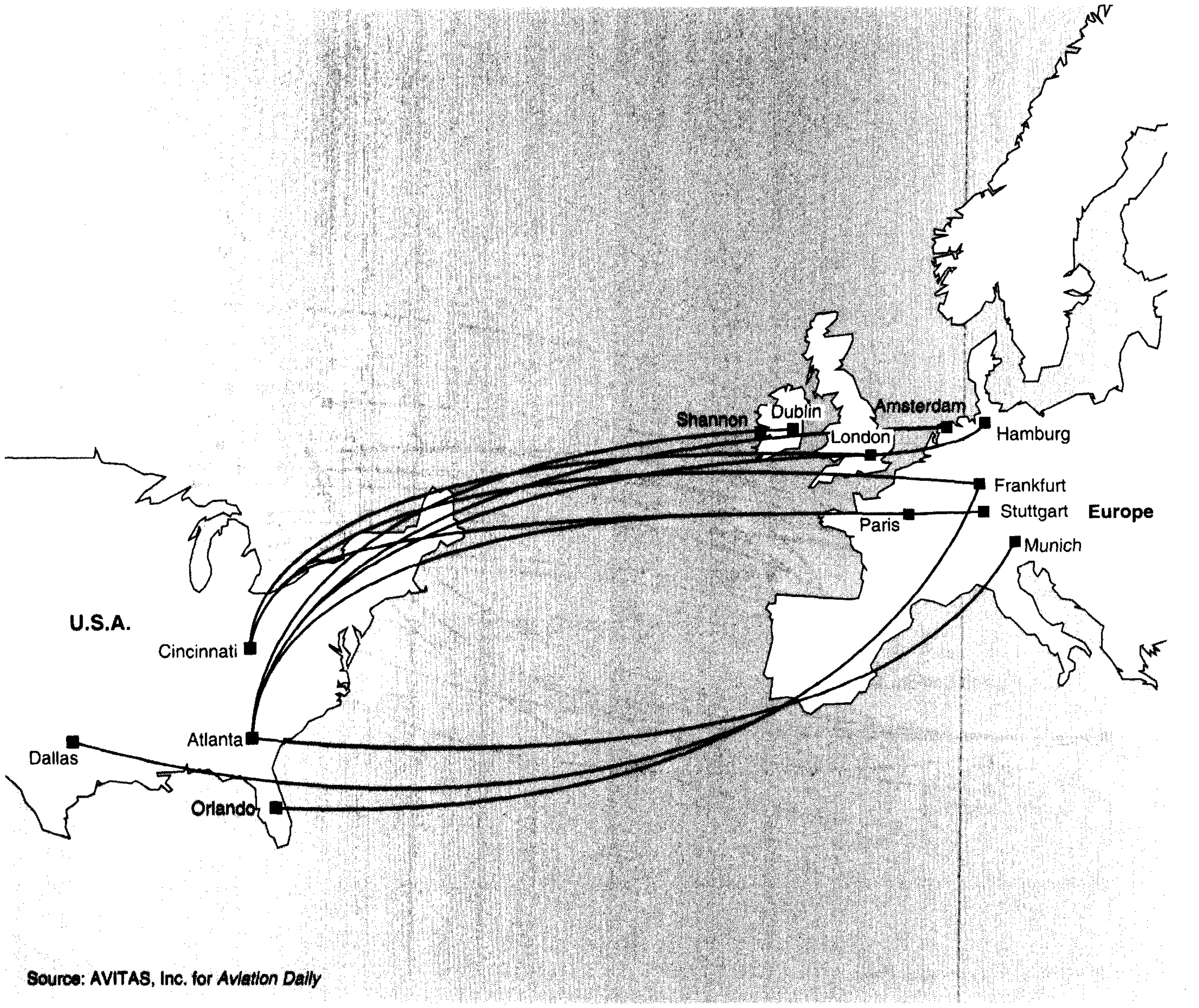
Figure II.2: American Airlines' Route Structure, United States to Europe, Summer 1992



Source: AVITAS, Inc. for *Aviation Daily*

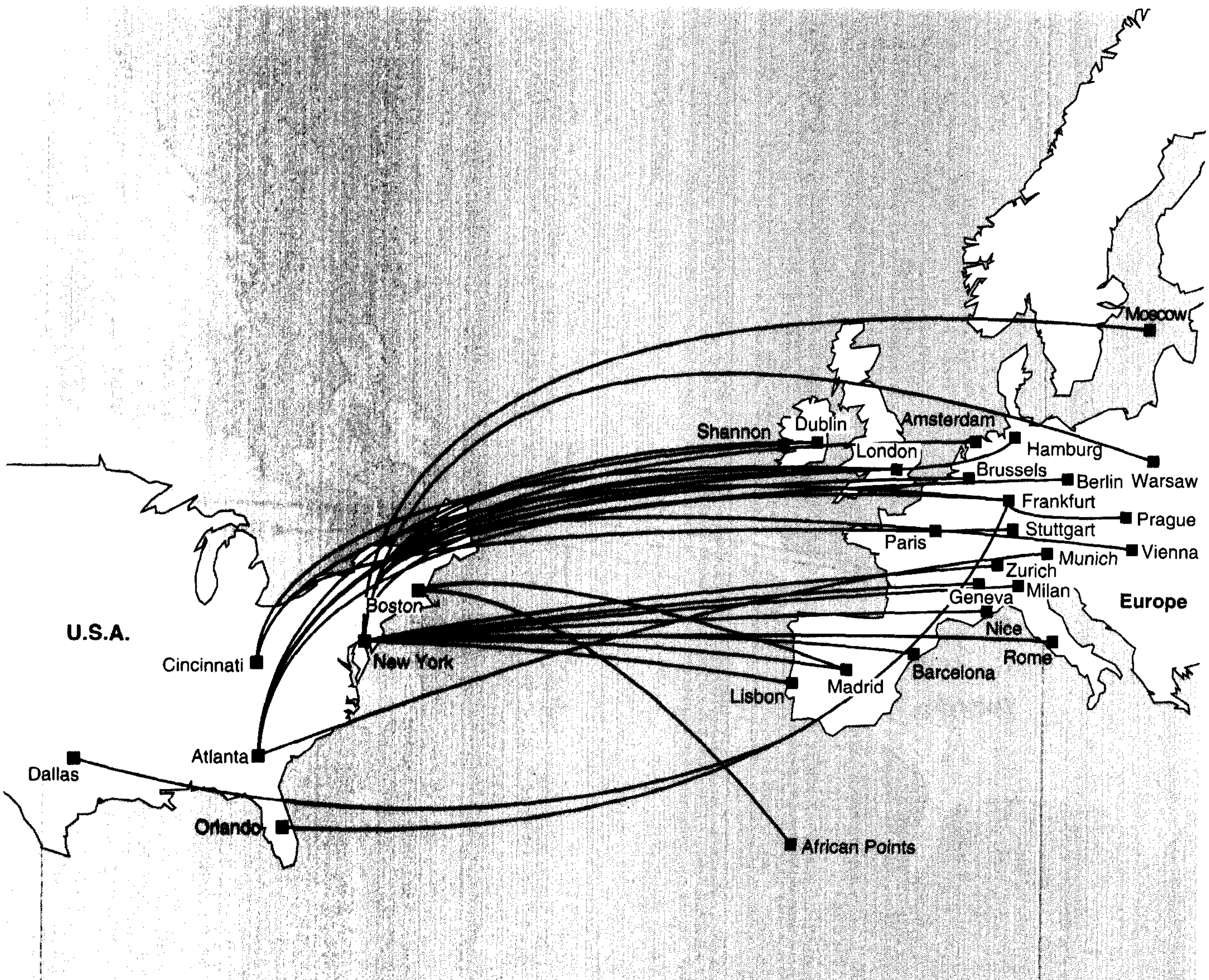
Note: Dallas-Frankfurt and New York-Munich routes do not include Zurich segments.

Figure II.3: Delta Airlines' Route Structure, United States to Europe, Summer 1990



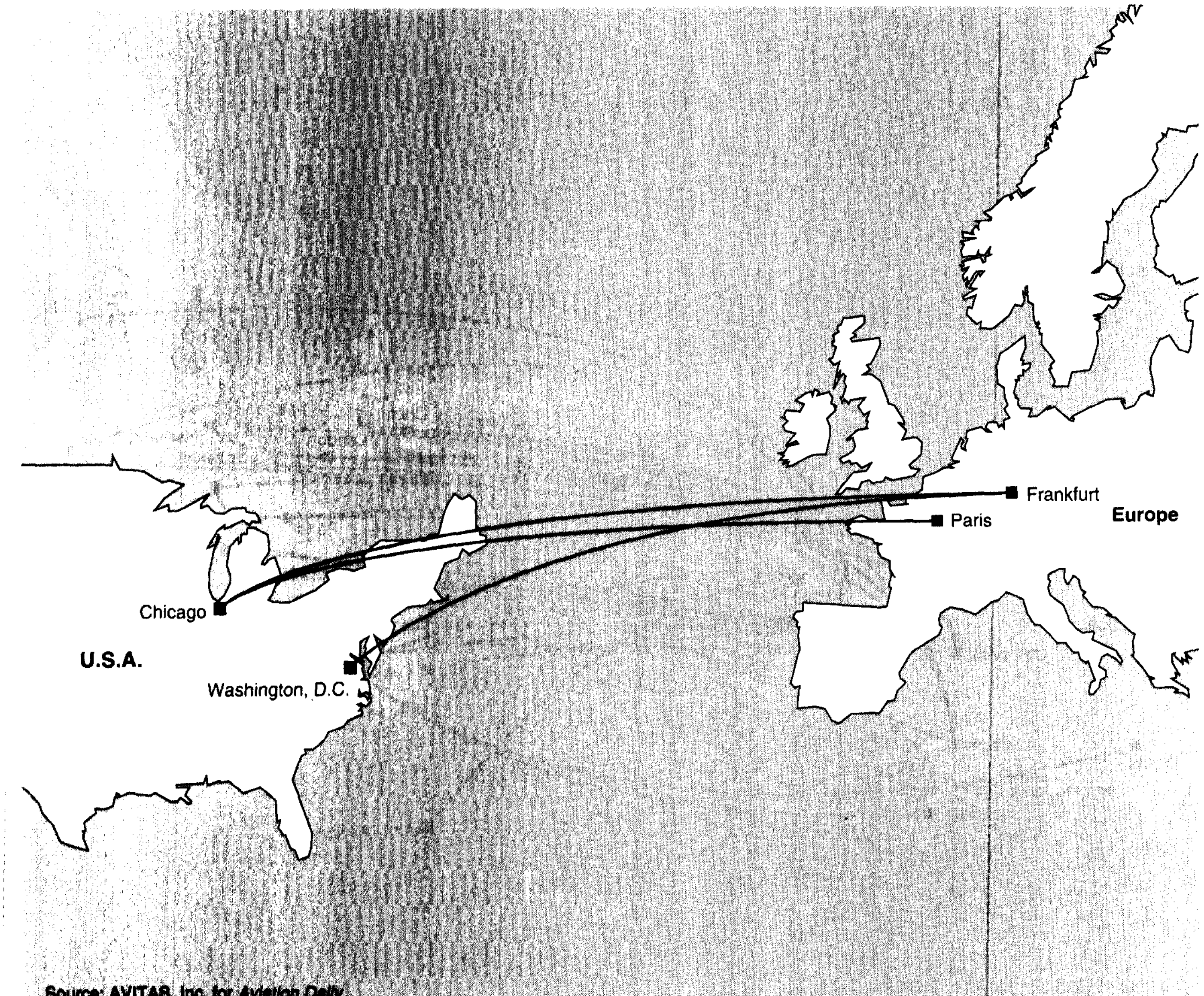
Source: AVITAS, Inc. for *Aviation Daily*

Figure II.4: Delta Airlines' Route Structure, United States to Europe, Summer 1992



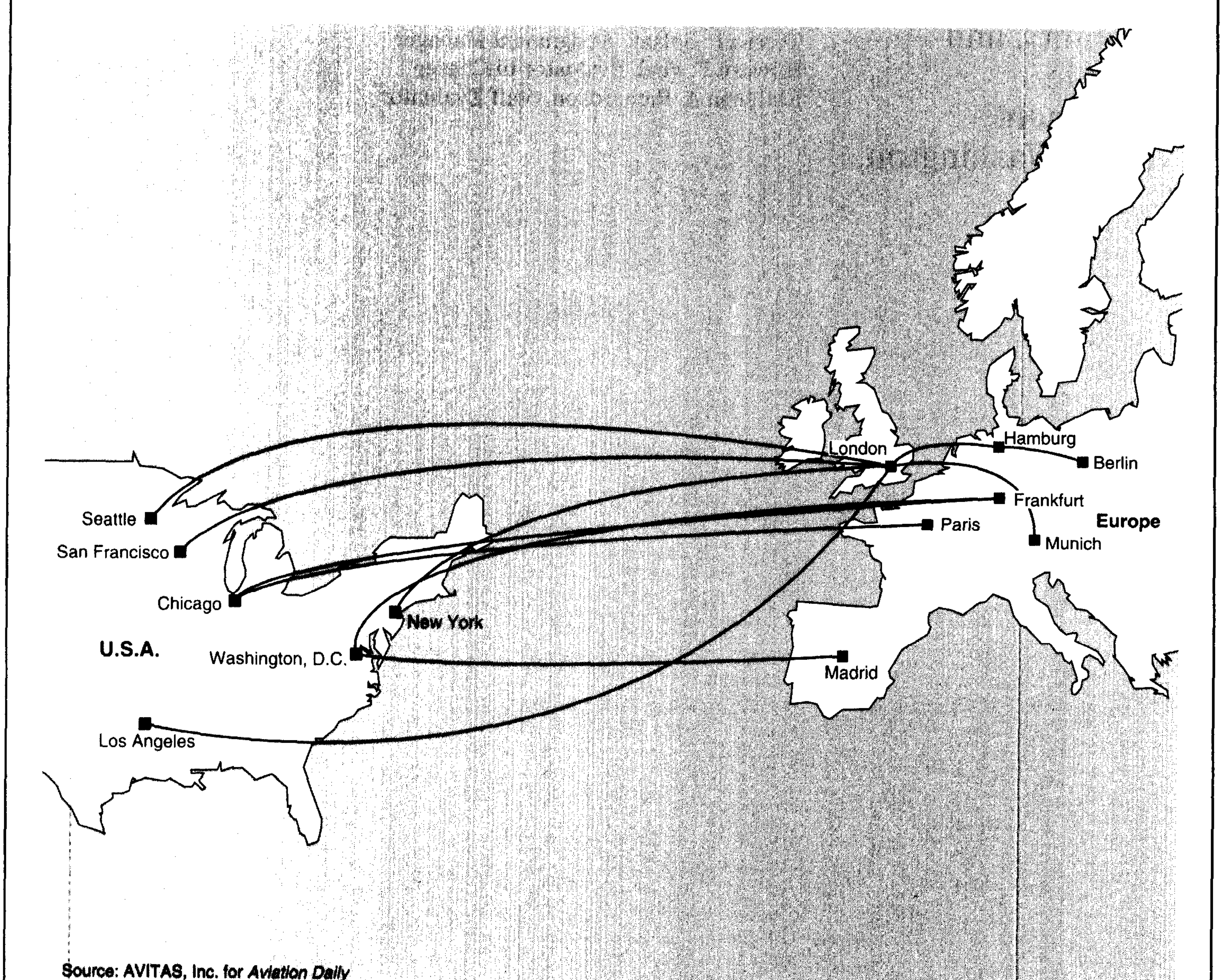
Source: AVITAS, Inc. for *Aviation Daily*

Figure II.5: United Airlines' Route Structure, United States to Europe, Summer 1990



Source: AVITAS, Inc. for *Aviation Daily*

Figure II.6: United Airlines' Route Structure, United States to Europe, Summer 1992



Source: AVITAS, Inc. for *Aviation Daily*

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Glossary

Bilateral Air Transport Services Agreement	Agreement that regulates air services between two countries.
Cabotage	The right of an airline of one nation to carry traffic moving exclusively between two points in another country.
Capacity	The number of flights multiplied by the number of seats or the amount of cargo space on the aircraft used.
Charter Air Services	Air services that do not operate according to a published schedule.
Code-Sharing Agreement	An agreement between two airlines to use the airline designation code of one airline on a flight operated by the other airline.
Country-of-Origin Pricing	Pricing system under which a government may unilaterally disallow fares for traffic originating in its own territory.
Double Disapproval Pricing	Pricing system under which both governments concerned must disapprove a fare before it can be rejected.
Freedoms of the Air, First Freedom	The right of the airline of one country to fly over the territory of another country.
Freedoms of the Air, Second Freedom	The right of the airline of one country to make a stop in another country for technical reasons, such as refueling.
Freedoms of the Air, Third Freedom	The right of an airline to carry traffic from its home country to another country.
Freedoms of the Air, Fourth Freedom	The right of an airline to carry traffic from another country to its home country.
Freedoms of the Air, Fifth Freedom	The right of an airline to carry traffic between two foreign countries on a route beginning or ending in its home country.

Freedoms of the Air, Sixth Freedom	The right of an airline to carry traffic between two foreign countries via its home country.
Freedoms of the Air, Seventh Freedom	The right of an airline to carry traffic between two foreign countries without stopping in its home country.
Multiple Designation	The right to designate more than one airline to fly a given international route.
Revenue Passenger Mile	One paying passenger transported one mile.
Scheduled Air Services	Services that are available to the public and operated according to a published timetable.
Slot	Takeoff or landing reservation at an airport.
Traffic	Passengers, cargo, or mail.
Yield	Fare per passenger mile.

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