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International Aviation

Chapter Checklist • You Should Be Able To:

- Define *sovereignty of airspace,* and distinguish between the two principal theories held by early international jurists
- Discuss the major provisions of the Paris Convention
- Understand the purpose of international air law
- Explain the importance of the Warsaw Convention
- Discuss the major articles of the Chicago Conference, and describe the major purpose of ICAO
- Discuss the eight freedoms of the air
- Describe the *Chicago standard form*
- Discuss some of the major changes in international aviation over the past three-plus decades
- Explain current U.S. policy on international aviation
- Discuss some of the factors underlying the movement toward globalization in international aviation, including airline alliances and airport alliances

INTRODUCTION

Today, approximately 100 years after a frail craft made of metal, wood, and fabric struggled into the air and carried a single passenger 120 feet, the world is enveloped by a network of air routes. In 1945, 9 million passengers traveled by air, which represented less than one-half of 1 percent of the world's population at that time. Fifty years later, over 1.25 billion passengers were carried, equivalent to approximately 25 percent of the world's population. The air has literally become a highway for world commerce.

This development of the airplane into a major instrument of transportation has brought with it international problems—the coordination of operational techniques and laws and the dissemination of technical and economic information—far beyond the ability of individual governments to solve. The need for safe, reliable air transportation involves building airports, setting up navigation aids, and establishing weather reporting systems. The standardization of operational practices for international services is of fundamental importance so that no error is caused by misunderstanding or inexperience. The establishment of such standards or rules of the air, of air traffic control, of personnel licensing, and of the design of airplanes and airports, as well as other considerations of prime importance to the safety and economic viability of international aviation, all require more than national action.

THE QUESTION OF SOVEREIGNTY IN AIRSPACE

As the airplane developed during the first decade of the 20th century, the **sovereignty of airspace** above nations became an issue. Should airspace above a nation be considered within the sovereignty of each nation, or should airspace, like the high seas, be considered international? Should each nation have sovereignty over the airspace above it for a limited distance from the surface of the earth, and should the airspace above this limit be considered free airspace? Should there be complete freedom in airspace?

Two principal theories of national sovereignty of airspace were advocated by international jurists. One held that the air is free and therefore that individual states have no authority over it, either in time of peace or in time of war, except when necessary for self-preservation. The other held that the individual states indeed have a right of sovereignty over the airspace above their soil. They claimed that aircraft flying only a few miles over the land are in a position to observe, photograph, and otherwise obtain data that might be used to the disadvantage of the nation over which the aircraft are flown.

The advocates of the freedom of airspace contended that their approach would promote international air commerce and peace throughout the world. The opponents of the free-air theory argued that the concept of free airspace above nations was incompatible with national sovereignty and would threaten national interests and security.

At the close of World War I in November 1918, the problems of international air control became important subjects of negotiation at the peace conference. The secretary of the Inter-Allied Aviation Committee proposed that the committee be constituted as an organization for international air regulation. This action was approved by the representatives of the allied nations at the peace conference.

The Paris Convention of 1919

Representatives from the allied and associated nations met in Paris in 1919 and formed the International Commission for Air Navigation and enacted the International Air Navigation Code, usually referred to as the Paris Convention of 1919. The drafting of the convention was undertaken exclusively by the allied and associated powers. The war experiences and the unity of the allies tended to promote agreement among them and made possible the reconciliation of the divergent views regarding the question of sovereignty of airspace.

The International Commission for Air Navigation drew up a list of principles to govern the drafting of the convention that included the following:

1. The recognition of the principle of the full and absolute sovereignty of each state over the air above its territories and territorial waters, carrying with it the right of exclusion of foreign aircraft and the right of each state to impose its jurisdiction over the air above its territories and territorial waters

2. The recognition of the desirability of the greatest freedom of international air navigation subject to the principle of sovereignty, insofar as this freedom is consistent with the security of the state and with the enforcement of reasonable regulations relative to the admission of aircraft of the contracting state and with the domestic legislation of the state

3. The recognition that the admission and treatment of the aircraft of the contracting states was to be governed by the recognition of the principle of the absence of all discrimination on the ground of nationality

4. The recognition of the principle that every aircraft must possess the nationality of the contracting state only and that every aircraft must be entered upon the register of the contracting state whose nationality it possesses

The following provisions were recognized as desirable from an international point of view to ensure the safe conduct of air navigation:

1. The requirement of a compulsory certificate of airworthiness and licenses for wireless equipment, at least of aircraft used for commercial purposes; mutual recognition of these certificates and licenses by the contracting states

2. The requirement of compulsory licenses for pilots and other personnel in charge of aircraft; mutual recognition of these licenses by the contracting states

3. International rules of the air, including international rules for signals, lights, and the prevention of collisions; regulations for landing and for procedures on the ground

Among the principles adopted to guide the convention were the following:

1. Special treatment for military, naval, and state aircraft when they are in government service

2. The right of transit without landing for international traffic between two points outside the territory of a contracting state, subject to the right of the state transversed to reserve to itself its own internal commercial traffic and to compel landing of any aircraft flying over it by means of appropriate signals

3. The right of use, by the aircraft of all contracting states, of all public airports, on the principle that charges for landing facilities should be imposed without discrimination on the grounds of nationality

4. The principle of mutual indemnity between the contracting states to cover damage done to another state

5. The necessity of a permanent international aeronautical commission

6. The obligation of each contracting state to give effect to the provisions of the convention by its domestic legislation

7. The principle that the convention does not affect the rights and duties of belligerents or neutrals in time of war

These principles served as guides to three subcommissions—one on technical problems, another on legal problems, and a third on military affairs—that drafted the text of the convention and its annexes. On October 13, 1919, the convention, with its annexes, was finally agreed upon, adopted, and opened to signature by the representatives of the 32 allied and associated powers represented at the peace conference.

The rules and regulations incorporated in the International Convention for Air Navigation were adopted by the principal European nations. The 34 articles covered the reservation of the sovereignty of airspace by the contracting nations; each nation's registry of aircraft; the issuance of certificates of airworthiness and competence by each contracting nation; the flight of aircraft across foreign territory; international aircraft navigation rules; prohibition of the transportation of arms, explosives, and photographic equipment by aircraft; and the establishment and maintenance of a permanent commission for air navigation.

The supplementary annexes dealt with technical matters and other subjects apt to require more frequent changes, because of changing conditions in air navigation, than the articles of the convention. The annexes covered such issues as regulations for certificates of airworthiness, logbook regulations, light and signal rules, pilot and navigator license regulations, international aeronautical maps and ground markings, the collection and distribution of meteorological information, and national customs regulations.

The Havana Convention of 1928

At the Fifth Pan-American Conference, in 1923, an Inter-American Commercial Aviation Commission was appointed to draft a code of laws and regulations, the adoption of which was recommended to all the nations in the Americas. These rules dealt with commercial aviation, the determination of air routes, the establishment of special customs procedures for aviation, the determination of adequate landing policies, and recommendations with respect to the places at which landing facilities should be established.

The Commercial Aviation Commission met in May 1927, at the Pan American Union in Washington, and prepared a draft of the code, which was revised by the director-general of the union and submitted to the Sixth Pan-American Conference, which met in Havana in 1928. The Havana Convention included most of the basic tenets established by the Paris Convention. The draft was adopted, with some minor modifications, and signed by representatives of the 20 states of the Pan American Union.

INTERNATIONAL AIR LAW

With the expansion of commercial aviation after World War I, the need to draft an international code of regulations to govern commercial aviation became apparent. Commercial aviation, like all other means of transportation, involves many difficult legal problems, including the rights and duties of shippers and carriers and the questions of carrier liability. These questions were handled at the outset by applying the laws of the several nations, but the lack of uniformity among the commercial laws of different countries constituted a formidable obstacle to international commerce and transportation by air. In response to this need, several important international organizations sponsored movements seeking the international codification of commercial aviation law.

The first organized demand for the promotion of an international conference to draft a code of private international aviation law was made by the International Chamber of Commerce. In its conferences in 1923 and 1925, this organization adopted a resolution calling the attention of the public to the need for the establishment of a uniform code of international control over private commercial navigation.

The need for international private law was recognized by the French government as well. France issued a call to the nations of the world to meet for the purpose of considering a convention that would regulate the carriers and shippers in international air traffic and codify the private international law of the air, comparable to the Paris Convention of 1919 in the sphere of public international law. This proposal of the French government was accepted, and representatives of 43 nations met in Paris in 1925.

The conference made several amendments to the draft convention prepared previously by the French government. It did not adopt the draft as amended, but left it for further study by the representatives of the respective governments and final discussion at a second international conference, to be convened later. At the same time, the conference established the International Committee of Technical Experts on Air Jurisprudence (Comité International Technique d'Experts Juridiques Aeriens), with headquarters in Paris, to oversee the conference proceedings, and especially the study of the possible codification of aerial law.

The committee, popularly called CITEJA, made a valuable contribution to the final codification of the private international air law as it was adopted in a convention by the conference in Warsaw, Poland, in 1929. The committee carefully drafted the projects of the convention that had been proposed by the experts representing many nations and studied and criticized by the various governments. The views of the various governments were exchanged, and the text of the convention was modified to meet the divergent views. During the next four years, the committee proceeded steadily toward the goal of codification. After four sessions held between 1926 and 1929, the final draft of the codified private international air law was adopted at the Second International Conference of Private Air Law, which met in Warsaw in 1929.

The Warsaw Convention of 1929

The convention for the unification of certain rules relating to international air transportation applies to any international transportation of persons, baggage, or merchandise by aircraft for compensations. It is commonly called the Warsaw Convention of 1929. The United States has been a party to it since 1934.

The convention defined international transportation as any transportation between two points in different contracting countries, irrespective of an interruption of the transportation or transshipments, and also as any transportation between two points in the territory of one state when a stop is made in another country or countries en route.

The Warsaw Convention provided that an air carrier was liable for damages in the event of (1) death or injury to passengers, (2) destruction or loss of or damage to baggage or goods, or (3) loss resulting from delay in the transportation of passengers, baggage, or merchandise. The limit of liability with respect to passengers on international flights was set at $8,300. The convention also set standards for passenger tickets, cargo waybills, and other air travel documentation.

Signed on October 12, 1929, the Warsaw Convention has become one of the most important documents in international commercial air transportation. The convention was amended on September 28, 1955, in The Hague, Netherlands, where a diplomatic conference was held primarily to discuss the limits of liability. The Hague Protocol to the Warsaw Convention, as it is called, doubled the monetary limit to $16,600 as a maximum recovery for death and extended to agents of the carrier the limit of liability provided to the carrier.

A diplomatic conference, held in Guatemala City in 1971, adopted a far-reaching revision of the provisions of the Warsaw Convention and the Hague Protocol. Among other things, the Guatemala City Protocol provided for absolute liability (no proof of negligence) on the part of the air carrier; an unbreakable limit to a carrier's liability of a maximum amount of $100,000 per person; a domestic system to supplement, subject to specified conditions, the compensation payable to claimants under the convention with respect to the death of or injury to passengers; a settlement inducement clause; conferences for the purpose of reviewing the passenger limit; and an additional jurisdiction for suits pertaining to passengers and baggage.

The Chicago Conference of 1944

World War II had a tremendous impact on the technical development of air transportation. A vast network of passenger and freight carriage was set up, but there were many problems, both political and technical, to which solutions had to be found to benefit and support a world at peace. There was the question of commercial rights—what arrangements would be made for airlines of one country to fly into and through the territories of another? Other concerns centered on the legal and economic conflicts that might arise with peacetime flying across national borders, such as how to maintain existing air navigation facilities, many of which were located in sparsely settled areas. Before World War II, the negotiation of international routes was left to the individual carriers.

The difficulty of negotiating for each new route was among the many reasons the United States and some other nations were anxious for a modification of the international law of civil aviation. In early 1944, the U.S. government issued invitations to the International Conference on Civil Aviation, often called the Chicago Conference. Representatives of 52

nations assembled in Chicago in November 1944. Although invited, the Soviet Union did not send representatives to the conference.

The preamble to this conference stated that its purpose was to foster development of international civil aviation "in a safe and orderly manner" and to establish international air transport service on the basis of equality of opportunity and sound and economical operation. The first of the 96 articles of the agreement made the usual grant to each state of complete and exclusive sovereignty over the airspace above its territory. The right of transit over the contracting sites and the right to land in a foreign state was made available to aircraft on nonscheduled flights, while scheduled services were required to secure prior authorization. Each state was granted the right to reserve to its own airlines' aviation traffic exclusively within its own borders.

The conference established the application of customs regulations and national traffic rules to aircraft in international flight, bound the states to take effective measures to prevent the spread of disease by air, and granted to each nation the right of reasonable search of arriving and departing aircraft. Among the measures provided to facilitate air navigation were rules for avoiding delays in "immigration, quarantine, customs, and clearance." Aircraft in transit and their normal supplies of fuel and oil were exempted from local duties or charges, and aircraft and supplies were made safe from seizures on patent claims. Each state undertook, "so far as it may find practicable," to adopt such standard procedures on airport control, radio services, navigational facilities, use of signals, publication of maps, and similar matters as it was contemplated would be recommended under the terms of the conference.

The conference specified that an aircraft engaged in international flight must carry certain documents, including certificates of registration and airworthiness, licenses for crew members, a logbook, and passenger or cargo manifests. The carriage of munitions was prohibited, and it was specified that a state might restrict the carriage of other articles if these regulations are applied uniformly to the aircraft of all other states.

The contracting states were required to undertake to secure the highest degree of uniformity in complying with international standards and practices, as might from time to time seem appropriate, with respect to the following:

1. Communications systems and air navigation aids, including ground marking
2. Characteristics of airports and landing areas
3. Rules of the air and air traffic control practices
4. Licensing of operating and mechanical personnel
5. Airworthiness of aircraft
6. Registration and identification of aircraft
7. Collection and exchange of meteorological information
8. Logbooks
9. Aeronautical maps and charts

10. Customs and immigration procedures

11. Aircraft in distress and investigation of accidents, and other matters concerning the safety, regularity, and efficiency of air navigation

Formation of ICAO. The Chicago Conference established the International Civil Aviation Organization (ICAO), composed of "an Assembly, a Council, and such other bodies as may be necessary" to foster the planning and development of international air transport in accordance with certain enumerated principles. Permanently headquartered in Montreal, ICAO is charged with the administration of the articles drawn up at the conference (see Chapter 3).

The ICAO assembly is composed of one representative from each contracting state. At its annual meetings, it may deal with any matter within the scope of the organization not specifically assigned to the council. It also elects the council and initiates amendments. There are close to 200 members today.

The council members, originally composed of 21 contracting states, are elected by the assembly for three-year terms. The council is charged with the establishment of an air transport committee and an air navigation commission, the collection and publication of information on international air services, the reporting of infractions, and the adoption of international standards and practices to be designated as annexes. The air navigation commission acts mainly in technical matters, considering modifications of the annexes and collecting useful information. The general expenses of ICAO are apportioned among the various states, and each state pays the expenses of its own delegation to the organization.

The Chicago Conference of 1944 specifically stated that it superceded the Havana and Paris conventions. It also stipulated that all existing aeronautical agreements and those subsequently contracted should be registered with the council of ICAO and that those that are inconsistent with the terms of the convention should be abrogated.

Disputes may be settled by reference to the Permanent Court of International Justice or a special arbitration tribunal. Enforcement is founded on the power to suspend an airline from international operation or to deprive a state of its voting power. However, states may not be deprived of their freedom of action in the event of war.

The Two Freedoms and Five Freedoms Agreements. The Chicago Conference produced two other significant documents: the International Air Services Transit Agreement, which became known as the **Two Freedoms Agreement,** and the International Air Transport Agreement, or the **Five Freedoms Agreement.**

The Two Freedoms Agreement provided that each contracting state grant to the other contracting states the following freedoms of the air with respect to scheduled international air services: (1) the privilege of flying across its territory without landing and (2) the privilege of landing for nontraffic purposes. The additional freedoms set forth in the International Air Transport Agreement were (3) the privilege of putting down passengers, mail, and cargo taken on in the territory of the state whose nationality the aircraft possesses, (4) the privilege of picking up passengers, mail, and cargo destined for the territory of the state whose nationality the aircraft possesses, (5) the privilege of picking up passengers, mail, and cargo destined for the territory of any other contracting state, and (6) the privilege of putting down passengers, mail, and cargo coming from any such territory.

These additional freedoms, in effect, would have eliminated the need for special negotiations in the conduct of international air transportation. Unfortunately, the Five Freedoms Agreement did not receive support from the representatives. The United States was among the original signers of the Five Freedoms document, but the State Department subsequently gave notice of U.S. withdrawal. The Two Freedoms Agreement, on the other hand, received fairly wide acceptance by various nations. Today, there are a total of nine freedoms (see Figure 16-1).

An important achievement of the Chicago Conference was the adoption of a standard form of air transport agreement that has influenced all subsequent bilateral negotiations conducted. Since the Chicago Conference, the United States has concluded arrangements with a number of countries for the operation of international American-flag services. Most of these are **bilateral agreements,** some based on the so-called Chicago standard form and others on the so-called Bermuda principles (to be discussed shortly).

On October 15, 1943, the Department of State and the CAB issued a joint statement relative to the development of American-flag air services in the international field. This stated that the CAB would certificate new American-flag air services to foreign countries, that corresponding air rights would be negotiated by the State Department in close collaboration with the CAB, and that the airlines would be certificated by the board.

Bilateral Agreements. The Chicago Conference resulted in various agreements and recommendations to facilitate the extension of world air routes through intergovernmental agreements. Among the documents was the Chicago standard form, which has been adopted by the United States and many other countries as a basis for arrangements. In addition, by virtue of the International Air Services Transit Agreement, U.S. airlines may exercise the rights of transit and nontraffic stops in certain other countries with which bilateral agreements have not been concluded.

The formal bilateral agreements negotiated by the United States achieve the primary purpose of obtaining satisfactory operating and traffic rights to be exercised by certificated U.S. airlines on their foreign routes. No two of these agreements are identical, but their basic similarities are summarized in the provisions of the Chicago or Bermuda types of agreements.

Agreements concluded on the Chicago standard form have the following provisions:

1. Intergovernmental exchange of air rights to be exercised by designated airlines of the respective countries

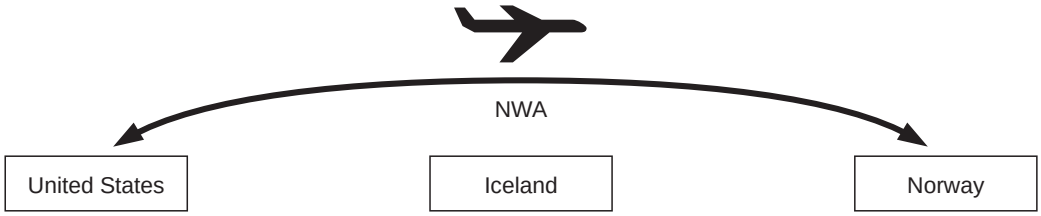
2. Equality of treatment and nondiscriminatory practices with respect to airport charges

3. The imposition of customs duties and inspection fees

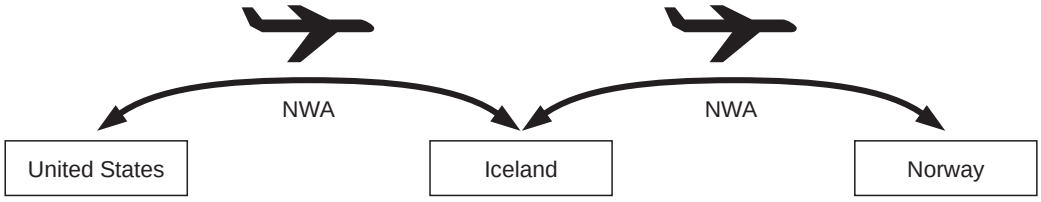
4. The exemption from such duties and charges in certain cases

5. Mutual recognition of airworthiness certificates and personnel

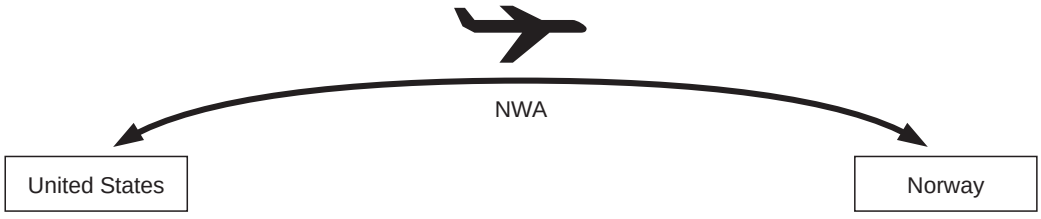
6. Compliance with laws and regulations pertaining to entry, clearance, immigration, passports, customs, and quarantine regulations



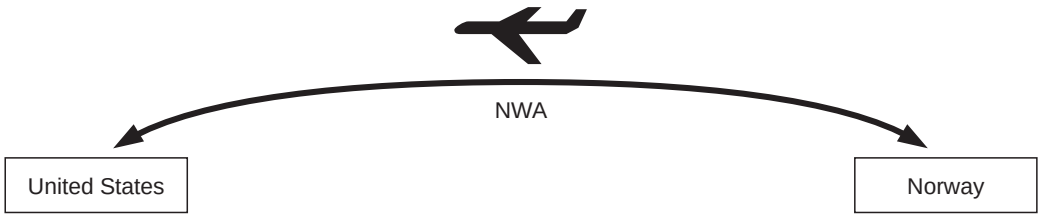
First freedom: A carrier may fly over the territory of another nation without landing. *Example:* Northwest (NWA) flies from the United States over Iceland to Norway.



Second freedom: A carrier may land in another nation for non-traffic-related purposes; i.e., only for a crew change or refueling. *Example:* NWA flies from the United States to Norway but lands in Iceland for fuel.

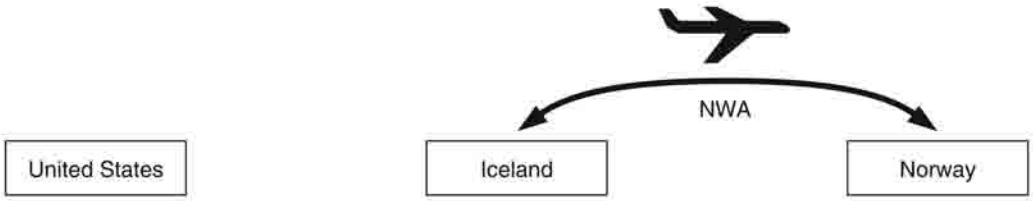


Third freedom: A carrier may drop off passengers from its own country in another nation. *Example:* NWA flies passengers from the United States to Norway.

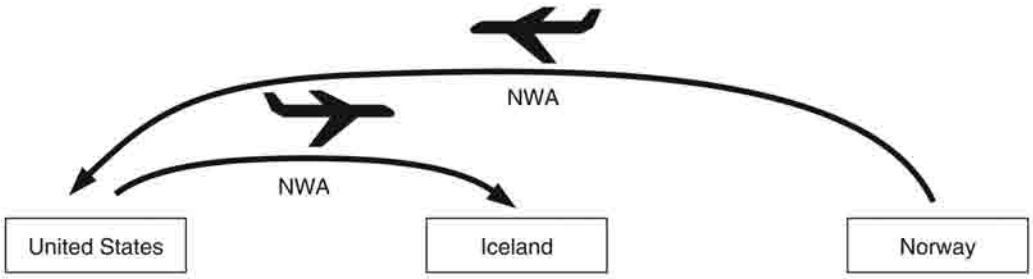


Fourth freedom: A carrier may pick up passengers in another nation and carry them back to its own country. *Example:* NWA flies passengers from Norway to the United States.

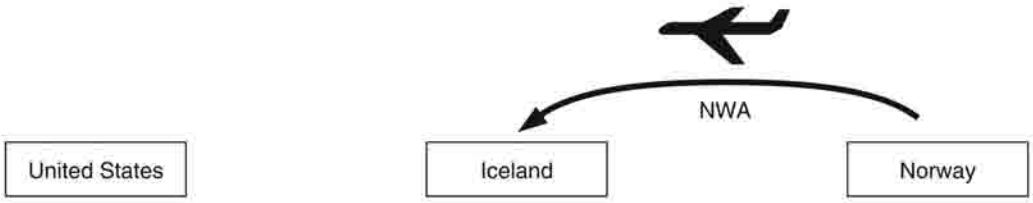
FIGURE 16-1 The nine freedoms of the air.



Fifth freedom: A carrier may pick up passengers from a state other than its own and deliver them to a third state, also not its own. *Example:* NWA picks up passengers in Iceland and drops them off in Norway.



Sixth freedom: A carrier may carry passengers from one state through its home country to a third state. *Example:* NWA flies from Norway to the United States and then on to Iceland.



Seventh freedom: A carrier may carry passengers from one state to a third state without going through its home country. *Example:* NWA flies from Norway to Iceland without stopping in the United States.

Eighth freedom: A carrier may operate domestic services in a foreign country with continuing service to or from one's own country (also known as cabotage) *Example*: NWA flies between two cities in Norway or between two cities in Iceland.

Ninth freedom: A carrier may operate within a foreign country without continuing service to or from one's own country (sometimes known as stand alone cabotage. *Example*: NWA flies between two cities in Norway.

7. Regulations pertaining to ownership and control of each country's air services
8. Registration of pertinent agreements with ICAO
9. Termination of agreement on one year's notice
10. Procedures for amending the annexes to the agreement

Although the bilateral agreements vary, they all cover three fundamental issues: (1) the number of carriers that each government can designate to provide service between the countries, (2) the routes that each carrier can serve, and (3) the government's role in approving fares. Some agreements limit carrier capacity, but most do not explicitly restrict the number of flights or the type of equipment used by the designated airlines. The DOT has the primary responsibility for administering international regulations and assists the State Department in negotiating bilateral agreements. As of 2006, the United States has agreements with over 70 countries.

Today, most of the routes awarded by a bilateral agreement are the so-called third- and fourth-freedom rights that entail transportation of passengers and cargo between a city in one signator's country and a city in the other signator's country. Some agreements also provide fifth-freedom rights that enable a carrier to continue an international flight that originated in (or is destined for) the carrier's home country to another foreign country and to carry local passengers on the flight between the two foreign countries. An example would be a flight by a U.S. carrier from New York to London that continues to Paris and transports London–Paris passengers in addition to New York–London and New York–Paris passengers. The New York–London flights would be third and fourth freedoms, and the London–Paris flights would be a fifth freedom. A carrier must secure the necessary operating rights from its home country, as well as from both foreign governments, in order to operate fifth-freedom service.

Many of the bilateral agreements that governed U.S. international aviation through the 1970s were products of the post-World War II environment. The agreements gave the United States broad authority to designate carriers to serve major cities in foreign countries from any point in the United States; several of the agreements also awarded the United States extensive fifth-freedom rights. In contrast, foreign governments generally could designate carriers to serve only a few specified U.S. cities on the coasts, and any beyond service was very limited. Under these agreements, carriers needed approval of both governments to offer a fare, and fares were generally established in cartels sponsored by the International Air Transport Association (IATA). The U.S. carriers participated in these fare-setting conferences under a grant of antitrust immunity.

THE FORMATION OF IATA

In the spring of 1945, representatives from 31 scheduled carriers, many of whom had attended the Chicago Conference, assembled in Havana to organize the International Air Transport Association (IATA). Its broad aims were "to provide a means for collaboration among air transport enterprises engaged directly or indirectly in international air transport service; to promote safe, regular, and economical air transport for the benefit of the people of the world; to foster air commerce and to study the problems connected therewith; and

to cooperate with ICAO and other international organizations." Its principal purpose was to address one of the problems that Chicago had failed to deal with—that of fares and route structures (see Chapter 3).

IATA has a director general and an executive committee made up of airline executives and a president who presides at the annual meetings. There are two classes of air transportation enterprises in the association: the voting members, who are active in international flying, and the nonvoting members, who are not. When nonvoting members become active in overseas routes, they acquire a vote.

There are four permanent committees of IATA: (1) the Traffic Advisory Committee, which has jurisdiction over the fixing of tariffs, rates, schedules, and other related issues; (2) the Technical Committee, which is responsible for operations, safety and efficiency of flight, standardization of equipment, and related issues; (3) the Financial Committee, which serves as a clearinghouse for insurance, international monetary documents, and other similar functions; and (4) the Legal Committee, which has the responsibility for international conventions on public and private air law, arbitration, and the like.

Both IATA and ICAO have their headquarters in Montreal, but the former association is divided into three traffic conferences: (1) the Western Hemisphere, Greenland, and the Hawaiian Islands; (2) Europe, Africa, and the Middle East, including Iran; and (3) Asia, Australia, and the islands of the Pacific. IATA works closely with ICAO and is permitted to have a representative at the meetings of the latter organization and its committees.

THE BERMUDA AGREEMENT OF 1946

Although a number of countries were willing to conclude bilateral arrangements with the United States based on the Chicago standard form, there were fundamental differences of opinion among some of the countries represented at the Chicago Conference as to how international air transportation should be developed. The United States and certain other countries favored a relatively liberal approach to the problem, without any arbitrary restrictions or predetermined formulas on capacity of aircraft, flight frequencies, carriage of so-called fifth-freedom traffic, and fixing of rates. Another group of countries, led by the United Kingdom, was not prepared to go this far and wanted these matters regulated to such an extent that, in the opinion of the United States and other countries, the full development of air transportation would be hampered.

However, as the airlines of the United States, Britain, and other countries became better prepared to offer services to one another's territories, it became obvious that these fundamental differences in air policy should be reconciled. Accordingly, in 1946, representatives of the United States and Britain met in Bermuda and negotiated a bilateral understanding that is generally known as the Bermuda Agreement.

In addition to incorporating the Chicago standard clauses, the Bermuda Agreement provided that disputes that could not be settled through bilateral consultation were to be referred to ICAO for an advisory opinion. It also stipulated that the agreement should be revised to conform with any subsequent multilateral air pact that might be subscribed to by both countries.

In contrast to the agreements concluded by the United States before Bermuda, this agreement not only described the extensive routes and traffic points involved but also set up a comprehensive procedure for determination of rates to be charged by airlines operating between points in the two countries and their territories. Procedures for rate

making and for the establishment of traffic rules were assigned to IATA. These rates were subject to review by the respective governments having jurisdiction. Provisions were also made for the manner in which route changes would be made. And one section dealt with *change of gauge*—that is, with the carrying onward of traffic by aircraft of a different size from that employed on the earlier stage of the same route and connecting services.

In addition, the Bermuda Agreement included a number of collateral understandings on the operation and development of air transportation services between the two countries. No arbitrary restrictions were placed on capacity, flight frequencies, or fifth-freedom traffic, but it was stipulated that the airlines of one country would not treat the airlines of the other unfairly. The Bermuda Agreement was generally regarded as a satisfactory reconciliation of the differences that existed on international air policy between the United States and the United Kingdom after the Chicago Conference. At the time of its conclusion, there was no specific understanding that either government would insist on this type of arrangement in its subsequent negotiations with other countries. However, in a joint statement, both governments agreed that experience had demonstrated that the Bermuda principles were sound and provided a reliable basis for the orderly development and expansion of international air transportation. It was further agreed that the Bermuda type of agreement presented the best form of approach to the problem of bilateral arrangements until a multilateral agreement could be adopted. As a means of furthering acceptance of the Bermuda principles, the joint statement also mentioned that each government was prepared, upon the request of any other government with which it had already concluded a bilateral pact that was not deemed to be in accordance with those principles, to make such adjustments as might be found necessary. The agreements concluded by the United States with other countries since Bermuda include all the important Chicago and Bermuda provisions. These agreements total over 70 today.

THREE DECADES LATER: FROM BERMUDA TO DEREGULATION

Had one looked back at the Bermuda Agreement in, say, 1963, one would have had to be pleased with its results—not in every detail, but in overall effect. European (and other) airlines had been able to catch up with U.S. airlines, but not really at the latter's expense. The lack of capacity controls had enabled the optimism of the U.S. carriers and government to prevail over the skepticism of the Europeans. Bigger and better aircraft were continually joining fleets, and there was a general downward pressure on fares (compared to other prices) as the purchasers of the new planes sought, for the most part successfully, to fill them.

Challenges to the Established Order: The Early 1970s

By 1975, in the context of economic stress, the Bermuda compromise looked very different. The first assumption to be tested was that the scheduled carriers in IATA could control fares indefinitely. In the spring of 1963, there was a showdown of sorts between IATA and the U.S. government when IATA, backed by the European governments, increased fares (or rather, reduced the round-trip discount) at a time when the CAB thought fares should remain stable. IATA stood firm and won that fight, but at a heavy cost. The CAB's response, though never explicitly stated, was to give a big boost to a new class of

airlines that had not been considered in the original agreements—the nonscheduled or supplemental carriers. First, the CAB, with the support of Congress, granted permanent certificates to many supplementals, enabling them to receive financing for the purchase of jet aircraft. Second, it permitted so-called split charters, whereby groups as small as 40 were allowed to charter part of an airplane. Third, from 1966 on, the CAB permitted so-called inclusive tour charters, whereby tour operators could market vacation travel to the public at bargain prices, without requiring that the passengers belong to any club or preexisting group. Supplemental transportation attracted millions of travelers to Europe from the United States, especially from the west coast. The CAB, using the same approach that it developed in domestic regulation, tried various distinctions between scheduled and charter services, such as requirements for affinity groups, requirements for ground services and multiple stops in package tours, and advance booking and down-payment conditions, all designed to encourage creation of new markets and to discourage diversion from the scheduled carriers.

After a while, the CAB realized that the public did not particularly care for any of the distinctions: all kinds of arrangements were made to circumvent the requirements. But as long as the overall market continued its straight-line growth, only sporadic enforcement was undertaken, accompanied by frequent tinkering with the rules. By the time the growth began to level off, just as the wide-bodied jets arrived, the market had changed, probably irreversibly. A side effect was that, although the share of international traffic carried by scheduled U.S. carriers kept declining, the overall share of traffic carried by U.S. carriers began to rise again, because the supplementals were predominantly American.

Among the European countries, several considered limiting or controlling charters, which were not provided for in the postwar agreements, but as long as all the European countries were not united, only those countries that could count on a separate and distinct market, such as Israel, were able to avoid the charter problem. Another basic assumption of the international air transport system had been shattered: much of the tourist market, it turned out, was not a point-to-point market at all, but rather a region-to-region market. If one wanted to tour Europe in a rented car, for instance, or with a Eurail pass or by hitchhiking, it did not matter very much whether one flew to Paris or Brussels or Amsterdam. And within limits, it did not matter very much whether one flew on Friday the 31st or Thursday the 30th, or returned from the first gateway or from another one.

The response of the major airlines was interesting. After arguing unsuccessfully to the CAB that air travel was all one big market and therefore that expanded charter authority would be largely diversionary, the scheduled international carriers took the opposite approach in their own pricing policy. From a basic two-class fare structure, they developed in the late 1960s and early 1970s a schedule of fares so complicated that hardly anyone—carriers, travel agents, or government regulators—could keep up with it. Excursion fares, peak and directional fares, "group-inclusive tours" (which were neither inclusive nor tours), and various fares calling for advance booking or payment proliferated, again with cheating almost universal and not perceived as wrong and with virtually no relation between the fare paid and the cost of providing the service. The objective was to treat different demand elasticities differently, on the theory that business travelers, who had to travel on short notice, would be prepared to pay more than vacationers with a fixed holiday schedule, who, in turn, might make down payments or otherwise commit themselves several months in advance. The result often was a reduction in yield per passenger not made up for by a corresponding increase in the number of passengers carried.

In a sense, one might say that price competition had come to international aviation, and specific countries and airlines became increasingly sensitive to the prospects of attraction or "diversion" of potential tourists as the result of any given new fare proposal. But under IATA rules, it was not possible for any single carrier or group of carriers to experiment with promotional fares to see whether they created new traffic or simply diluted the yield from the same passenger who would have traveled anyway. IATA rules provided that if one carrier could offer a special fare, all could, and unless all would do it, none could. By the early 1970s, the basic economy fare on which the system in theory rested was paid by less than 20 percent of travelers across the Atlantic, not even counting the widespread rebates to travel agents that became ever more widespread as the ratio of fixed to variable costs of air services kept rising. Ironically, just as IATA finally decided to invite the supplemental carriers to join, Pan American became the largest international charter carrier; TWA was close behind, and many of the major European airlines either took up chartering themselves or developed subsidiaries to do so.

As load factors fell on scheduled services, profits declined and then disappeared altogether. The advent of the wide-bodies increased capacity, while traffic failed to increase at anything like the rates that had been predicted and assumed within the industry at the time the decision was made to move to the new generation of larger aircraft.

All these trends were most acute in the critical North Atlantic routes, which account for over one-third of international air traffic but which provide, for almost all the major airlines of the world, the make-or-break margins of profit and success.

In the face of the trends that were evident from 1970 on, one might have supposed that the airlines would move to curtail their services drastically and comprehensively. But no major airline was prepared to do this on its own, lest its competitors capture a greater share of the traffic. From time to time in the early 1970s, carriers tried to fashion joint capacity–restraint agreements. But these agreements—for example, New York–London, New York–Rome, or United States–Switzerland—were ad hoc, short-term arrangements without any consistent formula. The CAB gave its approval, but with a bad conscience and in the expressed hope that overcapacity was a temporary phenomenon that would soon pass. The prevailing doctrine in Washington still held to the Bermuda Agreement—no predetermination and no interference by governments in matters of capacity.

Thus, even before October 1973, the basic Bermuda structure was under severe stress, and international aviation was a sick industry. The rise in oil prices in late 1973 simply dramatized and made far more acute the underlying situation. Pan Am, long the pioneer and pacesetter in routes and equipment, lost over $80 million in 1974, its sixth straight year of massive financial setbacks.

Meanwhile, fares, which had gone down overall between 1960 and 1970, rose in the early 1970s almost as fast as the Consumer Price Index—in 1974 alone up 30 percent on some routes. U.S. travelers saw, to their surprise, that Pan Am had withdrawn from Paris and much of the Mediterranean, and TWA from Frankfurt and the Pacific. Foreign airlines were making similar retreats, giving up, for example, hard-won routes to the U.S. west coast. As not only the United States but also most of the non-Communist world experienced for the first time the combination of inflation and recession, as well as fuel shortages, price increases, and unemployment, an industry geared largely to the discretionary consumer seemed to be facing a situation quite different from that which its founders in the 1940s had in mind.

The key elements of the Bermuda Agreement, as we have seen, were that fares would be controlled but capacity would be essentially unrestrained. Three decades later, it appeared that the reverse solution might be appropriate.

New U.S. Policy in International Aviation: The Late 1970s

As early as 1975, President Ford called for regulatory reform in international aviation. While his steering committee was reviewing the necessary changes in U.S. aviation policy, the British announced their intention to terminate the Bermuda Agreement with the United States, effective in June 1977. The primary problem that the British had was the excessive capacity offered by U.S. carriers on the North Atlantic route. A compromise agreement was signed by the two countries on July 23, 1977, which provided for (1) some new carriers to enter the market with the understanding that their schedules would be prescreened by their governments and (2) government approval of proposed fares and routes after review by IATA. It was this agreement that permitted Laker Airways to enter the market, which gave the impetus for the intense competition for the next several years over the North Atlantic.

In 1978, President Carter's administration began to review the Bermuda II Agreement, as it was commonly referred to, as being excessively protectionist and providing an unfair advantage for the British carriers. Encouraged by the CAB's deregulation of the domestic airline industry and the initial success of Laker's Skytrain service in the London–New York market, the Carter administration pushed for a U.S. policy based on free-market competition in the international arena. In a terse statement, the administration threw out the concept of regulated competition in international markets by pledging to "work to achieve a system of international air transportation that places its principal reliance on actual and potential competition to determine the variety, quality and price of air service. An essential means for carrying out our international air transportation policy will be to allow greater competitive opportunities for U.S. and foreign airlines and to promote new low-cost transportation options for travelers and shippers."[1]

In implementing its new policy, the Carter administration issued a new policy statement regarding the conduct of the United States in international aviation. Seven specific goals would be sought in all future negotiations of international agreements:

1. A more innovative and competitive approach to pricing that would meet the needs of different travelers and shippers

2. Elimination or greater liberalization of restrictions on charter operations and rules

3. Elimination of restrictions on capacity, route, and operating rights for scheduled carriers

4. Elimination of discrimination and unfair competitive practices experienced by U.S. carriers in international markets

[1]United States Policy for the Conduct of International Air Transportation Negotiations, 1978, p. 1.

5. Designation of additional U.S. airlines in international markets that could support such service

6. Authorization of more gateway cities and improved integration of domestic and international service

7. Greater development of competitive air cargo services

These policy goals were established to provide U.S. negotiators with guidelines in formulating their negotiating objectives. Clearly, the intent of U.S. international aviation policy was to give consumers the most competitive service available.[2]

THE PURSUIT OF OPEN SKIES

Predictably, a fight against the policy's implementation ensued. But the policy, unlike its predecessors, was issued independent of any immediate crisis in international markets or financial performance of U.S. carriers. The introduction of change while the industry was financially strong actually facilitated the process. Implementation proceeded at a rapid pace for at least a couple of years as so-called liberal bilateral agreements were negotiated with Korea, Thailand, Singapore, Taiwan, Israel, The Netherlands, Belgium, and, to a lesser degree, Germany.

The International Air Transportation Competition Act of 1979

The International Air Transportation Competition Act of 1979, which was enacted by Congress on February 15, 1980, amends the Federal Aviation Act of 1958 to provide competition in the international market. Basically, the act is the international counterpart to the Airline Deregulation Act of 1978 and implements U.S. policy in international aviation. The act's primary objectives are:

1. To strengthen the competitive position of U.S. carriers to at least ensure equality with foreign air carriers, including the attainment of opportunities for U.S. carriers to maintain and increase their profitability in foreign air transportation

2. To give air carriers (U.S. and foreign) the freedom to offer consumer-oriented fares and rates

3. To place the fewest possible restrictions on charter air transportation

4. To provide the maximum degree of multiple and permissive international authority for U.S. carriers so that they could respond quickly to shifts in market demand

5. To eliminate operational and marketing restrictions to the greatest extent possible

[2]For an excellent discussion of the pros and cons of current U.S. international aviation policy, see Nawal K. Taneja, *U.S. International Aviation Policy* (Lexington, Mass.: Lexington Books/Heath, 1980), Chap. 3.

6. To integrate domestic and international air transportation

7. To increase the number of nonstop U.S. gateway cities

8. To provide opportunities for foreign carriers to increase their access to U.S. points if exchanged for benefits of similar magnitude for the U.S. carriers or passengers and shippers

9. To eliminate discrimination and unfair competitive practices faced by the U.S. carriers in foreign air transportation, including excessive landing and user fees, unreasonable ground handling requirements, undue restrictions on operations, and prohibitions against change of gauge

10. To promote, encourage, and develop civil aeronautics and a viable, privately owned U.S. air transport industry

The 1980s

By early 1981 the new president's policy staff was being barraged with criticism of the previous administration's policies from incumbent operators, who were less than enamored of the relentless pursuit of pure competition. At the same time, the economy moved into a recession, oil prices again spiraled upward, the air traffic controllers' strike drastically disrupted the domestic market, and the airline industry slipped into a period of financial loss. These losses, and the first demise of a U.S. trunk carrier in 1982 (Braniff Airlines), lent credence to the cries of havoc in the international aviation policy arena. Implementation of the procompetitive policy came to a halt in the early 1980s.

However, many factors gradually converged to support the conviction that free trade in international aviation should progress over time. Carrier management, much of which was also changing, appeared to like being unfettered, although it may not always have welcomed or thrived on unbridled competition. There was some political support from a presidential administration that viewed free trade and deregulation of industry as basic tenets of its economic policies. At the same time, the domestic market was showing a tendency toward lackadaisical growth, while international travel was burgeoning. As U.S. carriers again introduced new and more efficient aircraft, they looked to international markets for expansion. Finally, the economic boom of the mid- to late 1980s resulted in higher profits and ambitions to expand.

From the regulator's perspective, evidence began to emerge that markets that had been liberalized were growing faster than those that remained closed. Liberalized markets were those markets open to U.S. carrier competition, while restrictive markets were those in which U.S. carrier designation and/or capacity was limited, either by negotiated agreements or by practice. In the case of the United Kingdom, which could be classified as "other," entry and capacity were restricted, but negotiations and provisions in the agreement allowed some increases in capacity. Also, the pricing provision in the agreement was interpreted liberally by both the United States and the United Kingdom, permitting a substantial amount of price competition.

In every instance, between 1978 and 1983, the liberal markets demonstrated a stronger traffic growth rate than the restrictive markets. By 1988, this disparity was even greater,

with the only exceptions being France and Japan. The growth in United States–France traffic reflected the fact that the Bermuda Agreement with the United States, which permitted multiple designation and unlimited frequencies, had been honored by France as U.S. carriers moved to introduce new services. This expansion by U.S. carriers was stopped when France served notice in 1992 that it would terminate its agreement with the United States. In the case of Japan, new services by incumbent carriers were permitted to some extent in order to accommodate the boom in traffic that was largely driven by the Japanese economy.

Thus, although most of the liberal markets were not large, the decision to trade open access in the foreign country for expanded access in the United States appeared to be a good one for the traveling public.

Nevertheless, the continuing efforts to liberalize aviation agreements were hampered for a number of reasons. First, the countries that were the most likely candidates for such agreements had already been approached by the U.S. government. In these instances, the foreign-flag carriers were anxious to expand into the United States and willing to make a generous offer to the U.S. government to do so. Where the foreign-flag carriers had no, or very limited, expansionary ambition, there was no interest in liberalizing the relationship with the United States. Thus, there was no clear path as to how to handle the remaining countries.

Second, disruption within the U.S. domestic industry was continuing apace, with bankruptcies and mergers becoming commonplace. These changes lent political credence to the arguments being made in some quarters that deregulation of the domestic industry had been too abrupt and that the U.S. government should again become more concerned about the health of its industry.

Third, U.S. carriers, often competing against one another and seeing international markets as the ticket to expansion, fought harder than ever to strengthen their market presence, and the infighting around negotiations became increasingly brutal. The U.S. government was unwilling and unable to take risks by negotiating arrangements that could not be well justified to Congress in terms of their constructive effect on U.S. air carriers.

As the economy strengthened in the mid-1980s and fuel prices stabilized, the United States tried to find opportunities for liberalization of international aviation agreements. Accordingly, the most effective way to create a more competitive environment was to negotiate a new bilateral agreement. To get other governments to grant carriers the greater pricing and operating flexibility it sought, the United States often had to give foreign carriers the right to operate more international routes to the United States. Smaller nations generally found such offers to be more appealing than did larger ones. The United States entered into agreements with countries like The Netherlands and Belgium, although it recognized that U.S. carriers would gain little from the greater operating flexibility. In part, the United States viewed less regulation as an end, in and of itself, but it also saw the agreements with smaller countries as a means of putting pressure on larger nations. For example, KLM's expanded service to the United States placed competitive pressure on Lufthansa, the carrier of The Netherlands' larger neighbor, Germany.

None of these early agreements represented what has become known as an **open-sky agreement.** Under an open-sky agreement, carriers of both countries can fly any route they wish between the countries and can continue those flights into third countries, although **cabotage** is still not permitted. Cabotage is a foreign operator carrying passengers between two domestic points of another country.

Although the United States was the most vehement proponent of increased international competition, its carriers' share of international traffic declined in the early 1980s. Although U.S. carriers' international traffic grew, their share fell from 50.7 percent in 1979 to 47.4 percent in 1986. In addition, both U.S. and non-U.S. carriers were registering losses on many international routes despite the growth in traffic. As a result, the United States relaxed its pursuit of the deregulation of international markets.

The picture began to change in the mid-1980s. Carriers with large domestic systems expanded international service from their hubs and acquired outstanding route authority from other carriers. For example, United, a very large domestic carrier with no international service in 1982, acquired Pan Am's Pacific division in 1983. By 1994, United's share of U.S. international traffic was larger than its share of domestic traffic. Most international routes operated by U.S. carriers have become an integral part of a domestic route system, and carriers with large domestic route systems now control a large share of international traffic.

In late 1992, concerned with the horrendous financial losses in the industry, Congress created the Commission to Ensure a Strong, Competitive Airline Industry. Once again, given the circumstances of the time, the commission was faced with the choice of competition versus protectionism. Throughout the commission's discussion of international policy, its ambivalence was evident. On the competitive side, there were statements to the effect that "air service agreements should be competitive" and recognition that bilateral agreements are "resulting in agreements or de facto relationships either markedly more rigid or protectionist than before, or seriously out of balance." The remedy, as far as the commission was concerned, was to be the negotiation of liberal multinational agreements. However, at the behest of a small number of U.S. carriers, the commission perpetuated old-style concepts of comparability and equivalency of market size and opportunities: "Because of our country's geographical size and population, bilateral agreements can result in the U.S. granting foreign carriers greater access to the immense and diverse U.S. air travel market without corresponding competitive opportunities for U.S. carriers." The commission either did not recognize or did not want to acknowledge that these concepts, based on views of "our" traffic versus "their" traffic, are inescapably protectionist and are increasingly outdated and irrelevant as markets become global.

Late 1990s Policy

Given the conservative nature of the commission's report, it is surprising that a year later, in November 1994, the Clinton administration issued a policy statement that was both perceptive and adventuresome. Reminiscent of the CAB when it realized that the domestic industry had essentially grown beyond the bounds of the regulators' ability to keep up, the DOT focused on the fundamental and dramatic structural changes in the industry:

> As a direct result of the Chicago Convention, an air transport system has developed that consists primarily of national carriers offering point-to-point services, with international connections principally provided through interline arrangements between those airlines. Although such operations continue to be important components of international air transport, major changes have occurred during the past few years that are challenging traditional notions of these services. Airlines are becoming increasingly global. Route networks are now being linked in alliances consisting of carriers from different nations, with international hub-and-spoke networks that offer passengers on-line services to cities around the world.

The document also contained a precise "Plan of Action." The first step in this plan was to "extend invitations to enter into open aviation agreements with a group of countries that share our vision of liberalization and offer important flow traffic potential for our carriers *even though they may have limited Third and Fourth Freedom traffic potential*" (emphasis added). This was the first time that the U.S. government implicitly acknowledged that its previous attempts to implement its free-trade policies had, in fact, been discriminatory and inconsistent. With the exception of the United States–Netherlands service, the United States had focused since the early 1980s on trading access for U.S. and foreign air carriers only if the foreign market was relatively large.

This acknowledgment marked a giant step forward in government thinking because it fundamentally rejected the notion that international aviation markets between countries must be "comparable" or "equivalent" in size before they should be opened. As basic as this concept is to most other areas of trade, it has eluded the international aviation industry since bilateralism and freedoms of traffic was invented. The DOT also acknowledged political reality when it stated that "we will offer liberal agreements to a country or group of countries if it can be justified economically or strategically." Subsequently, despite the opposition of some U.S. carriers and some members of Congress, the government began negotiations with a group of countries and reached agreements with nine small aviation partners in Europe.

At the same time, the U.S. government expressed a willingness to construct a phased-in open agreement with Canada. This agreement, which was a major breakthrough in a market that had grown extraordinarily slowly under a highly restricted regime, is certain to demonstrate the benefits to the public and to the two countries' carriers as the market is expanded through increased services and greater flexibility in setting prices.

Today, carrier networks seem to be at least as important to success in international markets as they are domestically. International services generally involve substantially longer distances than domestic services, and most can be served efficiently only with wide-bodied aircraft. There are only a handful of international routes, therefore, that have sufficient local traffic to make point-to-point service economically viable. Regulation created a segmented industry in which carriers had to supplement their local traffic on international routes with interline connecting traffic from other airlines. The growth of international service from carrier hubs has changed that and has made it increasingly necessary for carriers to generate on-line connecting traffic from their own networks.

GLOBALIZATION

Globalization of the world economy, which is being so profoundly evidenced in myriad manufacturing and service industries, as well as the airline business, will most certainly press the United States and other governments away from protectionist posturing and toward open markets. Yet under existing laws and agreements, it is difficult for U.S. carriers to establish hubs outside the United States, and foreign carriers cannot establish hubs in the United States. First, governments throughout the world both prohibit cabotage and limit nonresident ownership of domestic carriers. In addition, fifth-freedom rights tend to limit a carrier's flight frequency and therefore its ability to compete for local traffic. Although fifth-freedom rights often have only limited value in establishing an international hub, there are exceptions. For example, U.S. carriers have had some success in fifth-freedom markets and have, in effect, established hubs in Japan. Both United and

Northwest continue their Tokyo flights to beyond destinations such as Manila, Singapore, and Malaysia. These routes are relatively long hauls, and their frequency limitations are not as much of a problem as they are on shorter-haul routes. Probably of greater significance, however, are the slot restrictions at Tokyo's Narita Airport, which limit the ability of third- and fourth-freedom carriers to increase their services in these markets.

While still actively seeking expanded third- and fourth-freedom service, the United States and other governments are increasingly addressing carrier desires to create global route networks. There are two approaches. Under one option, countries can negotiate a new international regulatory regime multilaterally. Such an agreement conceivably could provide a forum to address not only fifth-freedom rights but also cabotage and foreign ownership issues. Independent commissions in both the United States and Europe have advocated such multilateral negotiations, yet the negotiation of such agreement is likely to be a very difficult process.

An alternative approach is to continue to negotiate bilateral agreements and to permit carriers to expand their route networks through the use of code-sharing agreements with other carriers. Such code sharings are most commonly used for connecting service and permit carriers to market interline transportation as though it were on-line. Although multilateral agreements may ultimately be negotiated, the United States is pursuing the development of global networks bilaterally. A carrier can offer a code-sharing service only in markets where it has the underlying authority, and so the United States is attempting to negotiate open-sky agreements that give both U.S. and non-U.S. carriers broad operating authority. The United States, however, still prohibits cabotage and limits foreign ownership of U.S. carriers; both restrictions are legislated and can only be changed by an act of Congress.

With an open-sky agreement and a code-sharing partner, a non-U.S. carrier can form an alliance with one or more domestic carriers and gain access to virtually the entire United States. Most foreign countries are much smaller than the United States, and therefore, a single bilateral agreement, in and of itself, does not provide U.S. carriers with similar opportunities. An open-sky agreement does permit a U.S. carrier to incorporate cities in other countries into its network through code sharing, but each such service requires the acquiescence of a third country. These countries can provide that acquiescence by also signing an open-sky agreement, so the United States has sought a critical mass of countries to accept such agreements. For example, the United States signed seven open-sky agreements with nine European countries in the spring of 1995, although the United States' three largest European aviation trading partners—France, Germany, and the United Kingdom—did not participate. In their own right, these agreements offer the possibility of increased competition and better service for consumers. In addition, following the precedent of more than 15 years earlier, these agreements may put pressure on larger countries that have been more reluctant to relax their regulations. Future open-sky initiatives may depend on how U.S. and non-U.S. carriers divide the traffic generated by these agreements.

Under some code-sharing arrangements, the partners make a concerted effort to coordinate both flight schedules and ground operations to mimic on-line service. In some cases, one carrier, and perhaps both, in the cooperative venture invests in the other. Such investments can demonstrate a good-faith commitment by the carriers and reduce the risk of opportunistic behavior. Governments, however, restrict the share of an airline that can be owned by a foreign citizen. In the United States, foreign ownership of domestic airlines is limited to 49 percent with a maximum of 25 percent of the voting rights.

Some code-sharing agreements, however, provide little in the way of service enhancements and are simply the carrier's same interline services marketed under a different name. In these cases, an important part of the marketing advantage stems from computerized reservations system practices. Frequently, both of the carriers participating in code sharing will market the service as their own, and thus, a given service is displayed three times in a CRS: under each carrier's code and on an interline service. Governments may come under increasing pressure to determine whether these CRS practices distort the information provided by travel agents and, if necessary, to design a regulatory solution.

A more fundamental question, however, concerns the impact that these code-sharing agreements have on competition. An agreement that leads to less capacity than would otherwise be provided will likely yield reduced service and increased airfares, which is not in the public interest. For example, instead of servicing a particular route, a carrier might rely on its code-sharing partner, and other carriers may be reluctant to enter. On the other hand, by expanding the size of its network and generating increased traffic, code sharing can prompt a carrier to institute new services. For example, by increasing feed, code sharing may make service on a route economically viable. Code sharing can also stimulate traffic by providing more frequent service and better connections, and by increasing traffic, it can reduce costs and fares.

A code-sharing agreement gives carriers the authority to serve markets jointly; it does not give them the right to set fares jointly. Before carriers serving the United States can set fares jointly, they must receive antitrust immunity from the DOT. In some cases, a code-sharing agreement with antitrust immunity may produce lower prices than an agreement without antitrust immunity.

With an efficient code-sharing arrangement, a carrier faces essentially the same cost of providing the service as it would if it provided the same service on-line. In most code-sharing agreements, however, one carrier charges the other for traffic it carries in its aircraft, and that charge is likely to be the cost of transporting the passengers plus some markup. Because of this markup, each carrier faces a higher cost for transporting passengers under the code sharing than it would for a similar service it provided on-line.

With antitrust immunity, carriers are free to establish some mechanism by which fares can be based on incremental costs, and then the profits generated by the sale can be divided. In that case, the carriers will perceive the cost of transporting an additional passenger to be lower than the cost each carrier would face from a typical joint-fare agreement. If two carriers have a large share of the relevant markets, however, the reduction in competition could dominate any efficiency gain. A decision about antitrust immunity should be based on an analysis of both the affected markets and the impact of the joint-fare agreement. As the web of global alliances and code sharing increases, the United States will clearly be mindful of the competitive effects and the possible impact of antitrust immunity. There are incentives for the United States to be relatively liberal in awarding grants of immunity, because the prospect of antitrust immunity is a valuable bargaining chip in negotiating liberal agreements with foreign governments.

The airline and airport industries are facing continuous change on a global scale and recent trends show that as both industries continue to expand, globalization will increase in importance.

Globalization of Airlines

Global alliances will continue to expand among airlines because passengers demand travel to destinations beyond a single airline's network. Alliances are necessary to drive down the costs of airline operations.

There are three main factors influencing the development of airline alliances: marketing advantages, nationality and ownership rules, and competition. The marketing advantages of airline alliances were identified in the United States during the 1980s in a deregulated environment. Major U.S. airlines were able to survive in a competitive market through mergers and acquisitions, thus increasing the size of networks.

Nationality and ownership rules limit the power of airlines to purchase a foreign carrier, thus restricting competitive advantage over other carriers. Bilateral regulations state that airlines must be substantially owned and controlled by nationals of the state in which they are registered. The only way to get around these rules is to enter airline alliances that may incorporate code sharing, franchising, joint frequent-flier programs, combined sales outlets, and so on.

Finally, competition plays a large role in the development of alliances because mutual agreements among airlines eliminate the need to compete with each other. For example, routes that were previously flown by two competing companies may result in reduced fares because there is no need to compete against each other once an alliance has been formed.

Formation of airline partnerships expands existing route networks through code-sharing agreements, provides new products for consumers, creates a high brand of service for business travelers, and creates global recognition for priority passengers. Concentration of airline activity will take place at hub airports and priority will go to airports providing a flexible structure. However, a large number of secondary airports will increase in terms of importance as LCCs and point-to-point carriers make a stronger presence without the need for connectivity. As a result of transfer traffic, minimum connecting times will be important, but this will be a challenge as airports become more congested as hub-and-spoke network carriers constrain themselves with somewhat limited time schedules. Specific targets will be made to decrease aircraft and luggage delays. For an airport to be successful, it must understand the needs of the airlines and be able to meet those demands.

Airport Alliances

Airports, like any other business, try to reduce costs wherever possible and maximize their profits. One way of doing this is to join an airport alliance. This is a relatively new concept, but it is becoming more important as airport operators realize the benefits. Airport alliance members can reduce costs through the joint purchasing of equipment, joint marketing, joint training, and the centralization of corporate office functions. This type of alliance is especially beneficial for small airport operators, because they can take advantage of the large airport's management and expect to increase profit at the same time.

Airports located close to one another may choose to join an airport alliance in order to control runway and terminal capacity or to control future development. This may lead to the joint marketing of the member airports, resulting in less competition. In other words, such alliances decrease the friction of transition.

Frankfurt International Airport would like to promote the concept of airport alliances in Germany, but as yet, it has not been able to convince other German airports that this move would be beneficial for all concerned. An airport alliance would bring operational benefits

for aviation and nonaviation business, increase the catchment area, promote intermodal transport, simplify operational procedures, coordinate communication systems, and provide a good quality product to all.

FUTURE CHALLENGES

The challenges are hardly over for the United States in the international arena. It must continue to retain the courage of its convictions and pursue liberalization of international aviation markets. To do so, it must apply its convictions consistently and ignore the arguments of those who would have the United States revert to traditional concepts about balancing benefits and seeking equivalencies. These mercantilist concepts belie the fact that aviation trade, like all other trades, should be based not on the ability of one country to produce as much as the other or the fact that one country's market for a product is as large as its partner's market, but on the willingness of countries to open their markets to free trade.

The United States will also have to continue to undertake additional major policy changes. Just as it had to break down entrenched ideas about the need to regulate competition in international markets, so, too, it must re-examine the rationale for many of the tenets on which the scheme for regulating competition in international aviation markets was originally based. Clearly, times have changed dramatically since the infancy of the industry, and what seemed natural and right at the time of the Chicago Convention may be irrelevant at best, and harmful at worse, to the interests of both the traveling public and U.S. carriers and their employees.

Specifically, requirements for national ownership, reservation of domestic traffic for domestic carriers (cabotage, Fly America, government-reserved traffic), and various means of propping up the financial state of domestic carriers (state aids and subsidies, Chapter 11 bankruptcy laws) should be questioned on a worldwide basis. The United States should take the lead in this debate, but it cannot do so if it is uncertain about its own commitment to unregulated markets.

At this stage in its development, it is unclear why the U.S. international aviation industry should be treated differently than any other industry. Right now, the industry is a strong international competitor, and it should be among the beneficiaries of a reduction in trade barriers. The United States must continue to use the muscle of its large domestic and international market to beat down trade barriers. But it must also be dedicated to genuinely open markets in the purest terms. This will require taking some risks, but only by leading the way, as it has recently done in its negotiations with Canada and the smaller European countries, will the United States reap the benefits of an unrestricted market in international aviation services.

KEY TERMS

sovereignty of airspace
Two Freedoms Agreement
Five Freedoms Agreement
rights of freedom
bilateral agreement
open-sky agreement
cabotage

REVIEW QUESTIONS

1 What were the two principal theories regarding the national sovereignty of airspace? Which theory prevailed?

2. Discuss several of the principles governing the drafting of the Paris Convention. What provisions were designed to ensure the safety of air navigation? Discuss several of the principles that were adopted by the convention. What was the primary purpose of the Havana Convention?

3. Why is there a need for international air law? What were the major agreements resulting from the Warsaw Convention? How did the Hague Protocol and the Guatemala City Protocol affect the provisions of the Warsaw Convention?

4. Discuss some of the reasons for the Chicago Conference of 1944. What was the purpose of this convention? Describe some of the important articles under this convention. What were some of the areas in which the contracting states agreed to develop "the highest degree of uniformity"?

5. What is the purpose of ICAO?

6. How many rights of freedom are there? What was the Two Freedoms Agreement? The Five Freedoms Agreement? What is meant by *bilateral agreement?* Discuss some of the provisions under the Chicago standard form.

7. What is the broad aim of IATA? What is the function of the four permanent committees of IATA?

8. What were some of the factors leading up to the Bermuda Agreement? What was the position of the United States? Discuss some of the principles established under the Bermuda Agreement.

9. Discuss some of the major changes that took place in international aviation during the three decades following the Bermuda Agreement. How would you describe the CAB's position toward IATA during the 1970s? What was the problem that the British had regarding the Bermuda Agreement in the late 1970s?

10. What major event prompted the new U.S. policy on international aviation in the late 1970s? Describe some of the goals enumerated under the U.S. policy statement. Discuss some of the objectives of the International Air Transportation Competition Act of 1979. How was traffic affected during the early 1980s? Why were continuing efforts to liberalize aviation agreements hampered?

11. What is an *open-sky agreement? Cabotage?* What was the purpose of the Commission to Ensure a Strong, Competitive Airline Industry? In 1995, the commission outlined a "Plan of Action" regarding future open-aviation agreements. Explain.

12. Describe globalization as it applies to the airline industry. Why is it so difficult for U.S. carriers to establish hubs outside the United States? Why are bilateral agreements between the United States and many foreign countries to the disadvantage of U.S. carriers? How would an open-sky agreement improve this situation? Describe how code-sharing agreements operate. What is the impact on competition? How does the airline industry differ from other industries with regard to globalization?

WEB SITES

http://www.icao.org

http://www.iata.org

http://www.atwonline.com

http://www.balpa.org

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