

---

## **TOWARD AN INTERNATIONAL OPEN SKIES REGIME: ADVANCES, IMPEDIMENTS, AND IMPACTS**

**Rex S. Toh**  
**Seattle University, Seattle, WA**

---

### **ABSTRACT**

The International Air Transportation Competition Act of 1979 heralded the era of Open Skies in international aviation. This paper traces the post-war regulation and then deregulation of fares, rates, routes, and capacity all the way from Bermuda I through the partial dismantling of the International Air Transport Association (IATA) price fixing apparatus; and discusses the impediments to Open Skies and examines the impact on the IATA.

### **THE POST WORLD WAR II ERA OF REGULATION**

Following the 1944 collapse of the Chicago Conference, the United States and Britain signed the precedent-setting Bermuda I Agreement in 1946. Bermuda I granted each party the five freedoms of the air<sup>1</sup> on named routes and for approved multiple carriers without capacity or flight frequency restrictions (but which could be imposed ex-post facto). The Agreement clearly favored the United States which then accounted for about 60 percent of the world's passenger airline traffic and which had the largest and most efficient international airlines. As a concession to the British who feared American domination, the Americans agreed to allow the International Air Transport Association (IATA) to set international fares and cargo rates and severely limit fifth freedom rights. Bermuda I served as the model for future bilateral aviation agreements between countries, making IATA a virtual fare-setting cartel. But in subsequent bilateral agreements not involving the United States, capacity and flight frequency was determined ex-ante with an attempt to evenly split the traffic between the carriers of the two countries, often involving pooling agreements to evenly share the revenues.<sup>2</sup>

Thirty years later, in 1976, the British gave notice of termination of Bermuda I, claiming that under the terms of the treaty the American carriers had a disproportionate share of the traffic. Fearing a complete breakdown of commercial air activity with Britain, the United States was forced to sign Bermuda II in 1977, capitulating to British demands to virtually eliminate multiple carrier designations, limit the capacity offered, and relinquish some of the American fifth free-

dom rights to carry traffic between Britain and other countries. Bermuda II was a devastating policy setback for the United States which had always advocated a freely competitive market structure.

On the other hand, in the same year in 1977, Freddy Laker launched Laker Airways, a charter service that lowered fares on the North Atlantic blue ribbon route. In the meantime, non-IATA air carriers from developing countries, particularly in Southeast Asia, were heavily discounting fares by as much as 50 percent,<sup>3</sup> causing illegal discounting of IATA fares through extra commissions to travel agents by the association's own members.

### **The Push for Open Skies**

In 1978, the United States orchestrated three events to show the international aviation community that her concessions in Bermuda II did not signal a policy change and that she was firmly committed to a pro-competitive negotiation policy.

First, in early 1978, the United State issued a statement entitled, "Policy for the Conduct of International Air Transportation", which proclaimed that America will endeavor to "trade competitive opportunities, rather than restrictions...and pursue our interests in expanded air transportation and reduced prices."<sup>4</sup> At the same time, U.S. Department of Transportation officials made clear that the new policy directives signaled the denunciation of Bermuda II.

Second, in the same year, the Civil Aeronautics Board (CAB) issued an order directing the IATA to show cause as to why the CAB should not rule that its international tariff agreements are no longer in the public interest and therefore should be disapproved.<sup>5</sup>

Third, towards the end of 1978, Congress passed the Airline Deregulation Act which deregulated domestic airline transportation and provided for the eventual demise of the CAB at the end of 1984. This clearly set the stage for an Open Skies policy to be pursued internationally.

Soon after, the International Air Transportation Competition Act (IATCA) of 1979 was passed promulgating, among other things, three categories of goals.

- **Category I:** Multiple carrier designations or traffic rights for American air carriers with permissive route authority and without operational restrictions with respect to capacity and flight frequency to allow them to swiftly respond to shifts in market demand.
- **Category II:** Freedom of air carriers to offer fares which correspond with, and are responsive to, consumer demand.
- **Category III:** Elimination of discrimination and unfair competitive practices against American air carriers.

The guiding principles of American negotiating strategies were to trade competitive opportunities rather than oppressive restrictions and to ensure that mutual concessions were to be of a liberalizing nature. It was expected that

increased open competition will result in greater consumer benefits through increased travel options and reduced fares and rates, improved airline efficiencies through more extensive and rational routes structures, and general increase in economic welfare.

### **Advances Toward Open Skies**

Soon after the passage of IATCA 1979, the United States achieved some success in getting multiple carrier designations and unlimited route authority without operational restrictions from South Korea, Singapore, Thailand, Finland, Belgium, and New Zealand. The smaller countries, particularly those in the Far East, by themselves did not generate much third and fourth freedom traffic with the United States. Therefore they were willing to make liberal concessions to the United States in the way of multiple carrier rights to all their major airports plus unlimited fifth freedom beyond rights. In return, they would have the benefits of the lucrative fifth freedom traffic going to and from the United States. On the other hand, larger countries such as Japan, the United Kingdom, France, and Italy by themselves generate a tremendous amount of third and fourth freedom traffic with the United States. Therefore they were less willing to concede fifth freedom rights without substantial reciprocity. Also, fearing domination by the larger and more numerous American carriers, the larger countries resisted American attempts to obtain multiple carrier traffic rights and unlimited capacity and flight capacity. The United States also had difficulty negotiating with Brazil and other Latin American countries because the South Americans have always had a tradition of tight economic control over civil aviation.

The United States had much greater success in seeking increased freedom of pricing to counter the success of Freddy Laker Airways which had diverted a large portion of the tourist market from the scheduled airlines by providing low cost service across the North Atlantic. In the first post-Bermuda II Agreement signed with Israel in early 1978, the United States insisted on and got a mutual disapproval provision which ensured that fares can only be disapproved if **both** governments disallowed them. Shortly after, in an agreement with The Netherlands, the country-of-origin rule of pricing principle was adopted. This rule stipulated that each contracting party had the exclusive right to approve or disapprove prices for one-way or round-trip carriage commencing in its own territory. These two liberal concepts were widely adopted in subsequent bilateral agreements. (The country-of-origin rule was widely used to liberalize charter operations worldwide.) Government intervention in pricing was generally limited to the prevention of predatory or discrimination pricing, protection of consumers from unduly high monopoly fares, and protection of airlines from the prices of others that are artificially low because of government subsidy.

Perhaps the greatest advances in freedom of pricing were achieved in Europe where tight economic regulation of fares prevailed. Under the shadow of the 1978 CAB show-cause order, the United States managed to convince the European Civil Aviation Conference to agree, on several occasions, to liberalize air

fares within broad zones of reasonableness. These agreements represent, for the first time, a successful regional approach to free competitive pricing.

A multilateral aviation agreement with the European Civil Aviation Conference was signed in October 1984. The price-fixing machinery is complicated, but the basic features are as follows. Reference fares for round-trip trans-Atlantic scheduled passenger services between city pairs in the United States and Europe are established once a year, based on cost and capacity data supplied. Different reference fares are set for basic, shoulder, and peak periods differentiated by country and directionally defined by the origin of the flight. Then, different zones of reasonableness are established for each city pair and for each class of service. For instance, in the first year of operation in 1984, the reference round-trip fares for New York-Frankfurt (U.S. originating) were as follows:

Basic season (September 15 to May 14):	\$1,221
Peak season (May 15 to September 14):	\$1,321
Shoulder season (None)	

The initial zones of reasonableness for each class of travel were as follows:

<i>Deep Discount</i>	<i>Discount</i>	<i>Economy</i>	<i>Business</i>	<i>First</i>
54-70	70-80	80-120	100-130	130+

This means that any American or participating European airline could set a round-trip economy fare of not less than 80 percent below or more than 120 percent above the peak season reference fare of \$1,321 for a passenger traveling economy class from New York to Frankfurt and back if the flight begins between May 15 and September 14. As long as the fare is within the prescribed zone of reasonableness, all participating governments must approve or "refrain from notifying dissatisfaction" with the fare filed by the carrier.

Additionally, there have been great advances in liberalizing bilaterals among European countries. The United Kingdom, in particular, has led with liberal bilaterals with The Netherlands, West Germany, Ireland, and Luxembourg.

### **Impediments To Open Skies**

There are many obstacles to open competition associated with Open Skies. One of them is the issue of public subsidies. It was well known that the money-losing Anglo-French Concorde was viable only because of heavy subsidies by the British and French governments. Alitalia fell so far into the red one year that the Italian government simply converted its existing debt into equity, thus relieving the inefficient airline of its huge interest burden. But no airline was more favored by subsidies than the SAS because it is supported, not by one, but by the three governments of Denmark, Norway, and Sweden. Also, many airlines are encouraged by their governments to operate below cost to establish an identity in new markets. Ireland's Aer Lingus, for example, operated the North Atlantic routes at a loss, as its main function was to bring tourists to Ireland. And

some carriers even receive free government goods and services.<sup>6</sup>

But the more serious impediment to free enterprise in international aviation is the prevalence of discriminatory practices. Listed below are some examples.

- Many foreign governments ensure that their flag carriers have the inside track. For example, the Portuguese government makes a list of Portuguese emigrants available to her national carrier, TAP. For a long time, Canada insisted that all immigrants travel to Canada on Canadian airlines. Brazilian laws provide incentives for shippers to use native air carriers.
- Many foreign countries insist that foreign airlines must use their exclusive ground handling services which provide expensive and inefficient services in Italy, Argentina, Ecuador, Japan, Kenya, and Peru. At Tokyo's Narita Airport, for example, in the past only Japan Airlines had a dedicated and fully computerized cargo terminal. It has also been recorded that warehousing and customs requirements were, at least at one time, discriminatory in Belgium, Canada, France, West Germany, Italy, Mexico, Taiwan, Japan, South Korea, and the United Kingdom.
- In the area of reservation control, the airlines of countries such as France, Italy, and Germany deliberately place American carriers at a disadvantage by denying them full access to their computerized reservations systems. Worse still, in Japan, Belgium, Portugal, Italy, and Scandinavia, the national airlines not only own some of the travel agents (illegal in the United States), but they also control what the agents can see on their screens.
- Many governments charge excessive user fees at their international gateways to cross-subsidize their smaller airports which are usually used only by their domestic airlines. Japan imposed a noise charge most heavily on transoceanic B747 aircraft although these wide-bodied jumbo jets are quieter than the noisy narrow-bodied jets used on Japan's domestic network. In U.S. Congressional hearings, it was reported that American planes were charged \$1.53 a gallon for jet fuel in Israel while the national carrier was only charged \$1.00. And India once charged a fuel tax only on international charters because essentially she did not operate them.
- Finally, even if under discriminatory conditions, foreign carriers make a profit in some countries, they face currency conversion problems in Ghana, India, Kenya, Nigeria, Pakistan, and Taiwan. Sometimes there is a total blockage of remittances altogether, which caused Pan American to completely withdraw from Zaire.

Continued dissatisfactions with the disproportionate amount of fifth freedom traffic carried by American air carriers has also acted as a brake towards the Open Skies concept. In this regard, Germany and the United States reached an agreement in 1993 in which the United States agreed to a two-year freeze on the

number of flights to Germany to allow Lufthansa time to restructure and privatize. Several countries, including Japan and France, have also indicated their intentions to renegotiate their bilaterals with the United States, citing similar complaints of imbalance in the carriage of fifth freedom traffic.

### **The Encirclement Strategy**

In 1979, the Director of the Bureau of Pricing and Domestic Aviation at the now defunct Civil Aeronautics Board (CAB) outlined the Encirclement Strategy.<sup>7</sup> He noted that pressure could be placed on Italy and France through whatever increased competition could be negotiated with Greece, Spain, Portugal, and Yugoslavia. Britain, on the other hand, could be pressured to concede to American demands by concluding liberal agreements with neighboring countries such as Belgium, The Netherlands, and Finland. All of these would serve to divert Italian, French, and British-bound traffic to other European gateways served by cheaper scheduled services and inexpensive charters which were then governed by the liberalizing country-of-origin rules. The same Encirclement Strategy was used against Japan, using the liberal bilateral agreements concluded with South Korea, Singapore, and Thailand as leverage.

Subsequent and recent developments have shown that the Encirclement Strategy worked. Britain was forced into renegotiating Bermuda II and accepting more liberalizing terms.<sup>8</sup> France was forced into coming around. Germany was induced to sign a more liberal bilateral because of concerns that KLM might make inroads into its U.S.–Germany traffic. Japan eventually had to accede to American demands for multiple carrier designations.

### **Recent Developments**

These increased route and carrier liberalization led to strategic global alliances. The major ones are the following:

- British Airways, Qantas, Air Russia, and USAir
- KLM and Northwest Airlines
- American Airlines and Canadian Airlines
- Air Canada and Continental Airlines
- Air France and Sabena
- SAS and British Midland
- Delta, Swissair, and Singapore Airlines
- United, Lufthansa, and Thai International
- American Airlines and Japan Airlines
- Japan Airlines and Lufthansa

The advantages of strategic alliances are in coordinated promotions and frequent-flier programs, code sharing to gain priority in computer reservation

systems, coordinated flight schedules for improved networking, sharing of airport terminal space, and overall economies of scale. Global alliances are the result of liberalization in international aviation but they also promote Open Skies in that international corporate linkages and interests break down national barriers.

Another recent development is the complete or partial privatization of national flag carriers such as British Airways, Air Canada, Alitalia, SAS, Lufthansa, KLM, SABENA, and Qantas. Pakistan, Brazil, and South Africa are making efforts to privatize their flag carriers. Privatization of airlines does much to remove much of the incentive for governments to protect them, thus paving the way for open competition.

With privatization and deregulation comes consolidation. For example, Australia deregulated its domestic airline industry in 1990. By 1992 Qantas and Australian merged. Domestic mergers are often desirable to position the strengthened carrier to play a larger role in global alliances<sup>9</sup> or to compete with other mega carriers. Partly for this reason, Air France was allowed to acquire UTA and Air Inter, and British Airways was allowed to merge with British Caledonian. But consolidation reduces competition in domestic markets which makes liberalized bilaterals more attractive.

### **Exporting Deregulation and Open Skies**

The overall success of airline deregulation in the United States since 1978 served as a model to other countries. In 1987, Canada deregulated airline operations in the southern half of the country and called for more liberal bilateral agreements. Australia soon followed in 1990. Restrictions in bilateral agreements between European Community (EC) countries are being eliminated as part of the overall unification effort. The goal is full liberalization of international aviation within the European Community and complete Open Skies in 1997. Member states of the European Free Trade Area (EFTA) have expressed interest in joining the EC Open Skies. The concept of a Single European Market as advocated by the EC Council of Ministers and the broader based ECAC offers the prospect of replacing bilateralism with regionalism. This would permit the unrestricted carriage of sixth freedom traffic. For example, Lufthansa would be able to pick up traffic in London and carry it to Rome via Frankfurt. As barriers to free trade are rapidly removed, the Europeans will move one step further and negotiate with other countries on a multilateral basis.<sup>10</sup>

The recent United States-Canada bilateral aviation agreement signed in 1995 permits American and Canadian airlines to serve all points in either country. There is a three-year phase-in period, which expires in 1998, for additional service by United States carriers to Toronto, Montreal, and Vancouver. These fares are subject to the double-disapproval standard (to be disallowed only if both countries agree to do so to prevent predatory or monopolistic pricing).<sup>11</sup> A trans-border Open Skies regime already exists between the United States and Mexico.

The Japanese government has recently proposed the creation of a transborder Open Skies market for Japan, Korea, and China. In fact, Japan, Taiwan, Korea, and Hong Kong already have fairly liberal access to each others' markets. Also, the Association of South-East Asian Nations (ASEAN) has been discussing the possibility of creating a liberalized air transport bloc in the region. It appears that with the exception of China, which has traditionally pursued restrictive policies in bilateral negotiations, the Far East will follow the lead of the United States and Europe in the pursuit of Open Skies.

Today, the only parts of the world that have resisted Open Skies are South America (with the exception of Chile, Ecuador, and Panama), Africa, and the Middle East.

### **Impact on IATA**

When the Civil Aeronautics Board issued the show cause order in 1978, the International Air Transport Association (IATA) reacted strongly by accusing the United States of forcing American anti-trust laws on to the rest of the world. Nevertheless, after an internal study and several meetings, IATA agreed to restructure itself in 1979.

Soon after its inception in Havana in 1945, IATA assumed its role as a regulator of international air fares occasioned by Bermuda-type bilateral agreements. Three regional traffic conferences were created and generally met once every two years to establish international fares and rates. All fares had to be *unanimously* approved by both the participating member airlines as well as their respective governments before they could be enforced, again generally for two years. Agreements were published in the Manual of Traffic Conference Resolutions. Airlines that charged more or less than what was agreed upon were heavily fined.

The restructuring in 1979 resulted in IATA activities being grouped into trade association activities covering legal, technical, baggage, clearinghouse, and ticketing functions and tariff coordinating activities for setting fares and rates. With respect to tariff coordinating functions, IATA does not generally regulate international fares in the North American and European markets, which are now governed mostly by multilateral agreements with broad zones of reasonableness and carrier-specific fares.<sup>12</sup> In Asia, three large non-IATA airlines (Singapore, Thai International, and Cathay Pacific) forced IATA member airlines such as Japan Airlines to respond in their territory with non-IATA sanctioned or open-rated fares to meet the competition. In the rest of the world, rate-making traffic conferences have been replaced by smaller sub-group meetings. Fare agreements are for shorter periods, usually for six months, and often, unanimous consent is no longer required.<sup>13</sup> Where competition from non-IATA airlines or charters is fierce, zones of reasonableness or even open-rated fares have been adopted to allow member airlines to set competitive prices and to accommodate changing market conditions. Thus, for all intents and purposes, IATA is no



longer the fare-setting cartel it once was. Most of its functions today involve trade association activities.

### Conclusion

Despite impediments, setbacks, and recalcitrant states, the United States has led the world inexorably towards an international regime of Open Skies with multiple carrier designations and unrestricted access to gateway cities without capacity constraints or discriminatory practices, and with the right to set competitive fares and rates to meet market demand for all six freedoms of the air traffic. Domestic deregulation; the creation of regional aviation blocs and multilateral negotiations; privatization and consolidation of airlines; and global alliances all contributed towards the deregulation of international aviation. But the ultimate goal of international Open Skies is the mutual granting of the rights of cabotage, allowing foreign airlines to operate flights serving domestic city pairs.

Although the American-Canadian Bilateral Agreement of 1995 did not go far enough in removing the traditional prohibition on cabotage, fearing foreign domination of domestic aviation, there have already been steps taken in this direction. When Australia and New Zealand signed the Closer Economic Relationship Agreement, Air New Zealand was allowed to operate on Australian domestic routes beginning in 1993, essentially granting the right of cabotage. Also, in 1997 when the European Community completely embraces Open Skies, all European airlines will enjoy the rights of cabotage within the EC. Only then will international skies be truly open.

### ENDNOTES

1. Five Freedoms of the Air:

1. An airline of one country has the right of innocent passage to overfly another country en route to a third country with pro forma approval.
2. An airline of one country has the right to land in another country for technical reasons without offering any commercial service to or from that point.
3. An airline has the right to discharge commercial traffic originating from its own country of registry, into another country.
4. An airline has the right to pick up traffic from another country to be discharged into its own country of registry.
5. An airline has the right to carry traffic between two countries outside its own country of registry as long as the flight originates or terminates in its country of registry.

2. For a long time, Singapore had a pooling agreement with Indonesia whereby the revenues generated from traffic between Singapore and Jakarta were shared, even though Singapore Airlines carried much more passengers than Garuda. In pooling arrangements, the carrying airline is compensated for variable costs, and sometimes there is a limitation clause to limit the extent of pooling.

3. See Gowan, Roy (1979), Proceedings, Papers and Dialogue from the IATA 14th International Air Transport Public Relations Conference, Dublin, October 4-5, pp. 18-21.

4. Hearings before the Subcommittee on Aviation of the Committee on Commerce, Science and Transportation, United States Senate (95th Congress Second Session 1978 on S.3363) pp. 19–20.
5. Report of the Subcommittee on Investigations and Oversight of the Committee on Public Work and Transportation, U.S. House of Representatives, on the Improvement Needed in the Implementation of the United States International Aviation Policy (98th Congress First Session 1983), p. 3.
6. See Civil Aeronautics Board (1975), *Government Ownership, Subsidy, and Economic Assistance in International Commercial Aviation*, Washington, D.C.
7. "Civil Aeronautics Memo by Michael E. Levine," *Aviation Daily* (March 8, 1979), pp. 1–7.
8. A number of liberal amendments to Bermuda II were signed between 1978 and 1982.
9. See Oum, T., Taylor, A.J., & Zhang, A. (1993). Strategic Airline Policy in the Globalizing Airline Networks. *Transportation Journal* (Spring), pp. 14–30.
10. Such negotiations were approved for non EC countries such as Norway and Sweden.
11. A similar closer Economic Relationship Agreement was signed between Australia and New Zealand creating a Single Aviation Market.
12. See Dresner, M.E., & Windle, R. (1989). The Effects of Liberalization on European Air Transport. Paper presented at the Transportation Research Forum, Williamsburg, VA, Oct. 11, 1989.
13. For a discussion of voting procedures at IATA tariff conferences, see Haanappel, P.C. (1984), *Pricing and Capacity Determination in International Air Transport*, Deventer, The Netherlands: Kluwer.

*Toh*

71