



COMPETITIVE ENTERPRISE INSTITUTE

**Open Aviation for a Global Industry:  
Removing the Last Barriers to Airline Competition**

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This year marks the 100<sup>th</sup> anniversary of the Wright brothers' historic flight that gave birth to the aviation industry. A century later, regulatory controls that restrict transatlantic competition are still in place in the United States. Bi-lateral "Open Skies" agreements between the U.S. and over 50 other countries have relaxed some of the restrictions but they still do not allow for the kind of freedoms existing in other worldwide industries. Fortunately, those restrictions could soon be lifted.

The European Union is working toward creating an "Open Aviation Area" with the U.S. that will create increased commercial opportunities for the global aviation industry. In addition, the U.S. is considering a revision of its rules that limit foreign ownership of U.S. airlines and allow for increased foreign ownership and capital investment.

**Opening Remarks:** **Robert L. Crandall**, former CEO, American Airlines

**Keynote Luncheon Address:** **Michael E. Levine**, Professor, Yale Law School

Panelists included:

**John Byerly**, Deputy Assistant Secretary, Bureau of Economic and Business Affairs, U.S. Department of State

**Brian Havel**, Associate Professor, DePaul University College of Law

**Paul Mifsud**, Vice President, Government and Legal Affairs, KLM

**Michael Reynolds**, Acting Assistant Secretary for Aviation & International Affairs, U.S. Department of Transportation

**Dorothy Robyn**, Senior Consultant, The Brattle Group

**Michael Whitaker**, Vice President, International and Regulatory Affairs, United Airlines

## This is an edited transcript

**Fred Smith, President, CEI:** Today's issue is going to be dealing with is, I think, a very important one and one that is very topical given the upcoming negotiations between the United States and the European Union (EU) on how to move forward the liberalization of this inherently global industry.

The two questions we'll be dealing with mostly today are: Does the policy of restricting foreign ownership of airlines serve the public well? What do we do to begin to think about bringing capital in a way that advances rather than threatens public policy? And secondly: What does Open Skies or open airways exactly mean? Our first speaker has commented on that already earlier this morning on CNBC's *Squawk Box*, and undoubtedly will have provocative things to say.

The challenge is how do we really move towards—not to be in any particular airline's favor—friendlier skies for all Americans. And I think we have started out from the base that we all understand. Almost all Americans realize that the partial liberalization of the air travel sector some 20 years ago did create massive benefits for the American people. Deregulation—even the partial deregulation we had—democratized air travel. Air travel was something that was once an elitist privilege, and deregulation brought it down. Who would have realized that the impact of deregulation was to move people off the bus and into agreed coach fares?

But as we all know, that partial frame is still partial. Airlines remain still heavily overseen by government, and much of the critical infrastructure of the airline industry still remains outside their control.

Like all network industries, we've tended to free up the flows—the airlines, in the case of airline deregulation—but we have left the grid—the airports and the air traffic control system—pretty much in rigid bureaucratic hands. Essentially, we deliver our passengers around the United States the way we deliver our mail, and post offices maybe aren't the most efficient way of integrating and achieving more friendly services. Of the three elements of the air travel system, the airlines, the airports, and the air traffic control system, really only the first was freed up; and, as we'll see today, even that only partially freed.

One of my prior jobs was in the railroad industry. Out of all the network industries, only the railroads fully deregulated. They deregulated both the grid and the trains themselves. As a result, they've been able to achieve integrated operations, far more efficient flow operations, and far more efficient traffic flows than the other network deregulations: airlines, telecommunications, and electricity.

There's still a lot to do today, and today's papers are going to discuss just how many of the problems remain and some of the avenues to actually move us forward. The challenge, of course, is to recognize that any step forward has risks as well as benefits. But the risks are also great in the present. How do we balance the risk of change with the risk of the status quo? To address that, we've got a distinguished group of speakers. And leading us off today is Robert Crandall.

There are some people you really don't need to introduce, and Bob Crandall is one of those people. I first got to know him when I was at a seminar at the American Enterprise Institute on computer reservation systems, the early version of the Internet for marketing airline services. And there was an academic there who was postulating about all the problems and all the monopoly issues, and how we had to be very careful and so on. And during the break, Bob goes over to this guy—he was a sort of academic, and you can see Bob's not exactly that—and he looked down at him and said: "Kid, I don't know what the hell you know about economics, but you don't know a damn thing about airlines!"

The kid looked up at him, and he said, "Yes, sir." And he said, "You know, I've been in business a long time, and I got my start selling bread in supermarkets. And you know how we got on the shelf?" "No, sir." He said, "We paid to get on the shelf." And that had the whole ability of whether the computer reservation system should be thought of as a supermarket shelf to the airline industry. He understood that. Most Ph.D.s in economics did not.

Bob has a lot to tell us. He's one of the most knowledgeable people about running airlines, but more importantly, about picking retirement time. I mean, can you imagine a time in the airline industry better to pick than the one he picked? And he's flown down here today. He's already been on CNBC's *Squawk Box* today to postulate on these issues, and he's now he's to kick off our conference today. Bob.

**Robert L. Crandall, former CEO, American Airlines:** Thank you very much, Fred. I guess with that introduction I ought to get back on my diet and lose a little weight. I don't know. You know, I've arrived at the point in life where I'm getting a little long in the tooth and beginning to approach the dates of 70, and 80, and 90.

Not long ago Bob Hope died, as you know. He had a whole series of very funny statements—what he'd do at 70, what he'd do at 80, what he'd do at 90. At 70, well, at 70 I still chase girls, but only downhill. Now I'm not quite yet 70; I still have energy enough to chase both up and down. And I still like to chase ideas around, and, as a consequence, I'm very glad to have this opportunity to share some thoughts with you about an important subject.

Now given the identity of the sponsor and the title of the conference, I'm going to be very surprised if we don't hear an enormous amount today about the many rewards that the U.S., other countries, airlines, aviation-related businesses, consumers, and the world's economies will realize from moving further and faster down the road towards what some would characterize as complete economic deregulation of the airline industry.

That's an important subject because there can be very little doubt that aviation greases the wheels of commerce. In the 21<sup>st</sup> Century, and particularly in the highly developed countries, knowledge is increasingly the raw material of success, and the successful use of knowledge depends, among other factors, on effective communication and transportation systems. And while we all know about many of the remarkably capable and increasingly complex electronic communication methodologies we use everyday, I think it is clear that an effective transportation system—which is going to enable people around the world to realize convenient and frequent face time with their customers, suppliers, and other contacts—is an essential ingredient of continued economic growth.

I think there is little doubt that if the United States is to retain its present position of world leadership, U.S. companies must be globally competitive. And I think that is particularly true in the airline business, which is increasingly regarded as a global, rather than a national, business, and which is integral to the success of the knowledge industries in which the United States excels.

So on the face of it, those thoughts would lead logically to an exuberant embrace of such concepts as removing current restrictions on airline ownership, approving cross border mergers, constructing an EU-U.S. open aviation area as a first step towards still more freedoms on a global basis, abandoning current limitations on cabotage [a foreign carrier's right to provide domestic service], and taking other similar steps. In fact, I think such steps are severely premature, and, if taken today, are very likely to lead to adverse consequences, particularly for U.S. airlines and for consumers.

Now it is not that those are bad ideas. In fact, I think some or most are likely to be adopted in the long term and should be adopted. But they are not the core issues impacting global aviation competition. And to shape aviation policy on the assumption that inadequate capital flows, or an inability to realize scale advantages, or the inability to utilize fifth freedom rights [the ability of airlines to carry passengers from one country and then fly them to another country—also called “beyond rights”] lie at the root of the airline industry's woes is, in my view, wrong to the point of naiveté.

Some examples: The United States is the world's largest capital market, and Western Europe is close behind. To my knowledge, no established carrier and few, if any, reasonably structured startups have been inhibited by a shortage of capital. There is no shortage of would-be airline moguls, each anxious to

be equipped with his or her own leather helmet and silk scarf. It is thus difficult for me to understand just how today's ownership rules adversely impact anything other than prospective mergers, which some may yearn for, but which, in historical terms, have been largely unrewarding in every industry, including aviation.

And there are few, if any, scale economies in the airline industry. In most past mergers, the economies involved have proven to be negative. In part, that is true because of the unique leverage that airline unions enjoy and because of the related safety costs of standardizing non-common fleets. In part, however, it is the inevitable consequence of greater complexity and a wider range of interests that must be accommodated.

Recent experience in both the EU and the U.S. underscores the reality that scale has little to offer. Jet Blue, Ryan Air, Southwest, AirTran, and others are examples of very small carriers that operate successfully in the shadow of much larger and much less successful airlines. Their success underscores the reality that in today's airline business, three factors are essential: cost, cost, and cost.

In my view, while the goal of worldwide, truly unfettered competition is admirable, and would likely have long-run benefits for virtually every airline's constituency, its near-term achievement is politically and practically unlikely.

Since we cannot, and indeed, since we do not seek to go where we say we are going, I think it is disingenuous and harmful to many constituencies to sustain the debate by persuading ourselves and others that by taking irrelevant measures we are truly advancing the cause of competition.

The problem is that the globalization debate is ignoring the elephants in the room, and those elephants are airport monopolies, the essentiality of connecting services, and labor inflexibility. The history of U.S. bilateralism is littered with corpses of false hopes, crushed by all three of these participants.

Take, as an example, the mid 1990's round of negotiations between Japan and the United States, in which U.S. airlines were granted various rights, and American, of which I was then chairman, was granted the right to serve Japan from a number of U.S. cities. Despite repeated and resonant assurances by the members of the Japanese delegation and related assurances from members of the U.S. negotiating team, American, to this day, has never been granted landing rights, which correspond to its treaty rights. For a long time, the rice farmers took the blame. It is now clear that Japanese protectionism is the villain.

Or, as another example, take Air France, which is now held out as an example of modern European airline resurgence. I wonder if the Air France circumstances would be the same as they are today if American had not been forced by the French government, with the active acquiescence of the U.S. government, to abandon its established operation at Orly, and move to unsatisfactory accommodations at De Gaulle, where it was forced to fly at non-competitive, non-commercial times. The answer, ladies and gentlemen, is clearly things would not be the same in France had that not occurred.

Let's turn to another subject. Airline alliances in revisionist history are often held to be the consequence of a desire on the part of U.S. airlines for more opportunities internationally and the desire of foreign flags for more opportunities in the United States. In fact, airline alliances were passionately opposed by every major U.S. carrier when they were first suggested. The early approvals came in direct response to the financial distress of Northwest, which was saved from bankruptcy by KLM Investment, which bought co-chairing rights in the U.S. And add Lufthansa, which was rescued from a financial crisis by an agreement with United directly negotiated by Chancellor Kohl and President Clinton, at which each was reported to have consumed 5,000 calories.

Absent those alliances, which had eliminated competition on many European routes, and, in my view, have been profoundly antithetical to consumer interest, U.S. airlines would have continued the thrust towards international leadership they launched in the 1980s. Supported by larger hubs, a larger and

faster growing economy and a much more entrepreneurial mindset, the U.S. carriers as a group would be much better off today, although there would probably be fewer of them, if code sharing alliances had never been blessed by the Department of Transportation (DOT).

Airport monopolies, of course, exacerbate the competitive problems created by alliances and will be made still more damaging by the mergers many now advocate. Take Frankfurt as an example. Since the Lufthansa-United alliance was launched, the percentage of trans-Atlantic traffic carried by the partners has steadily increased, while non-stop competition between Frankfurt and U.S. cities has steadily declined. In the years since the alliance was created, non-stop competition has vanished altogether between both Frankfurt and New York and Frankfurt and Miami, and has diminished on virtually every other Frankfurt-based trans-Atlantic sector.

Moreover, nonstop competition for alliance flights has declined at Munich and the probability of new competition has been rendered moot by the fact that peak-hour slots are essentially unattainable in peak hours at all the major German airports—Frankfurt, Düsseldorf, and Munich.

The alliances have gained share in part because of their ability to obtain operating rights at desirable times. But that's not the only reason for their increased sector dominance. As virtually everyone here today understands very clearly, an airline's ability to operate long-haul international services depends heavily on its ability to put many kinds of passengers on the same airplane—passengers from behind its originating hub and from its originating hub city to both the destination hub city and to points beyond the destination hub.

In the U.S., a foreign carrier operating into a hub or gateway city often has multiple airlines with which to collaborate beyond the hub city; in the rest of the world, choice does not exist. Thus, alliances, and in tomorrow's world, merged carriers, will increasingly be able to foreclose competition to a major city by simply denying beyond passage at competitive prices to any passenger arriving on a long-haul competitor. That's the way it is done today, and if international mergers are approved before the problem is solved, it will be done even more successfully in the future.

Neither my time nor your patience is sufficient for a full recitation of the many limitations in place at the rest of the world's major, non-U.S. airports. It is sufficient to say that any airline seeking to fly to any major airport in Europe will find it essentially impossible to do so on an optimal schedule, while any European or Asian airline seeking to serve JFK, Chicago, Dallas, Atlanta, LAX, SFO, or anywhere else, will be accommodated whenever it wants to fly. Until this imbalance is addressed, any discussion of "open competition" is an oxymoron, and any movement in that direction by the U.S. government will further diminish the international opportunities available to U.S. carriers.

In addition to limiting arrivals and departures—the real product of any airline—foreign airports, with the visible or surreptitious support of their governments, subvert the meaning of competition by limiting ground handling options, club facilities, check-in desks, and other necessary facilities to whatever is offered by a limited group of chosen suppliers. At most U.S. airports, by contrast, an airline is free to choose ground handling firms and methods as it wishes, and can almost always find whatever space it wants.

Finally, to labor. The notion that labor substitution, in favor of lower rates and more rational work rules, is likely to occur as a consequence of globalization is dismissed by even the recent EU-U.S.-commissioned study of globalization's benefits. Labor substitution will not occur until airline labor feels the hot breath of successful competition, as has recently been dramatically illustrated in the U.S. Unless globalization creates more intense competition by removing the protections now offered by monopoly airports, globalization is unlikely to yield anything other than the continued intractability to be expected from unions able to leverage ever-larger organizations.

In addition to ignoring the reality elephants, advocates of near-term globalization make a number of points I find most peculiar. Some argue that one of the benefits of mergers is that combined carriers can

more effectively exploit still larger hubs, at a time when virtually every serious analyst in the U.S. and abroad agrees that the only real price competition in the industry is being generated by low-cost, point-to-point carriers. On what basis, I ask, can globalization be justified via by recommending greater use of a methodology that weakens competition?

Some studies conclude that, as airlines merge, they will be encouraged to maximize profits by reducing price. This interesting thesis, which is at odds with all my experience in the industry, holds that independent firms are intellectually unable to use existing industry protocols and pro-rate procedures to optimize their pricing decisions, but will do so when merged. Perhaps so, but I know of no unprofitable airline that has failed to take advantage of an opportunity to raise prices in the absence of effective competition. And I think even Fred Kahn now recognizes that what he characterized as the threat of entry is not an effective disciplinary mechanism.

So, what to do? I think we should keep our long-term objectives, including the abolition of ownership limitations, eliminating detailed rules about aircraft ownership and leasing, and freeing the industry from all other unnecessary limitations firmly in mind. However, before turning to such matters, which are essentially nuanced adjustments to the operation of an industry already structured for effective competition, we should take on the truly hard issues that are currently preventing the real competition we presumably seek.

To make international aviation truly competitive, we must kill the elephants. We must de-monopolize airports so that every slot is available to every potential competitor and every job is done by the lowest-cost bidder. We must take steps to require that any carrier which has a preponderance of service at a hub or gateway is required to provide effective "beyond hub" services to all actual and prospective long-haul competitors. And we must overhaul labor laws to deny unions the power to control costs and deprive both airlines and the public of market-priced services.

When we get those things done, it will be time to turn to the relatively easy issues with which we are currently preoccupied. Unless we solve the core problems, however, the current furor won't accomplish much. It may produce something different than what exists today, but the new structure will be neither global nor competitive. Thanks for your attention. I look forward to the rest of the day.

### **Question and Answer period**

**Sandy Rederer, *Aviation Post*:** Given your pessimism about the realistic possibility of labor law reform in the near term, what would you recommend for the U.S.-EU negotiations in general terms?

**Crandall:** I think the United States ought to say to the European Union that we really would like to have a very liberal kind of agreement. Before that happens, you're going to have to accommodate our airlines in your airports in the same way that we accommodate yours in ours. That's a conditioned precedent to the negotiations.

**Carol Hallett, Carmen Group:** [On] the labor issue, Bob, and the first, essentially two questions. The first one is: With all of the givebacks that have resulted this year because of the economic condition of the industry, how long do you think it will take before we're right back where we were before the givebacks actually occurred? And the second part of it: Is binding arbitration, which we see in many levels of government, an alternative that could turn this around?

**Crandall:** Well, binding arbitration has been around, as you know, Carol, for a long time. And in my view, adopting mandatory binding arbitration for the airline industry would be a great step forward. Again, it would force both parties to behave a lot more responsibly than has been the case in the past.

As to what might happen in the near term, I don't know what's going to happen. I don't think you're going to see a lot of creep up. In my own opinion, the major carriers have not gotten their costs low enough, and they have not gotten their work rules sufficient enough. Their labor costs continue to be too

high. And I think they will continue to lose market shares in the low-cost carriers over the next four or five years. They either transform themselves or go back to the bankruptcy cycle again.

**Smith:** We'll now be taking our first panel. The first panel is Mike Whitaker, Paul Mifsud, and Dorothy Robyn. What we will do is go with Mike first. Mike is the Vice President of International and Regulatory Affairs for United Airlines, and he's based in Chicago, so he gets to fly in and out of O'Hare even more than most of us do. He's been there since 1998. He's responsible for solving some of the problems Bob suggested are impractical. So he mentioned your challenges placed in front of you. He came to United initially in 1994 and was the senior counsel there at that time. And beforehand, Mike, as others in this room, worked at the ABA. He's been a litigation attorney before that at sites in (indiscernible), which includes Kentucky. And he holds a Juris Doctorate of Law from Georgetown University Law School and graduated with high honors (indiscernible). He lives in Chicago, and he'll start off our panel discussion. Mike.

**Michael Whitaker, Vice President, International and Regulatory Affairs, United Airlines:** Thank you, Fred. Some of you may not realize, but in the United Airlines charter, we are required to never agree with American Airlines on anything. I was a little worried about them coming in, but actually Mr. Crandall made that easy for me.

I've got a very different view on some issues, and I want to talk today really about the U.S.-EU agreement. U.S. carriers have been accused over the last couple of years of being at best apathetic about the U.S.-EU process. I think that's partly true. We've got a lot going on, and our focus has been on cost, cost, cost, and fundamental restructuring, and trying to survive through the next quarter. But United has been a bit more vocal than others. We've been very supportive of the process, and I think we're a little more optimistic.

Fred started this morning by referring back to deregulation 25 years ago. I think that the U.S.-EU agreement, if done properly, has the potential to be as important an event in changing our regulatory structure as deregulation was 25 years ago. And in fact, the EU agreement... through deregulation of our industry, can allow us [to become] a global industry. We are not a global industry now. We are very much a domestic industry, and some of us have airlines, aircraft that are flying internationally, but we are not a global industry.

The analogy of U.S. deregulation, I think, is very instructive. If you go back to the 1970s, you will find that it really was among the academics and the economists that there was support for deregulation, whom some famous airline leader at the time who will go unnamed, referred to as eggheads. It was the "eggheads" who supported deregulation. And the carriers, with very few exceptions, really adamantly opposed deregulation. And they opposed it because they saw that it was going to be a dramatic change to our industry's structure. They saw that it was going to take away the safety net of government, and they saw that there were carriers that were going to fail. If you look back on this time period, it was perfectly logical for TWA and Pan Am to oppose deregulation with every fiber of their being, because, in fact, they did not survive the process.

The U.S.-EU agreement has the potential to yield that same change in the competitive landscape, and, if it's done correctly, it has the same potential to remove government from our economic decisions, because government is still very much part of our economic decisions. Some carriers won't survive, particularly on the European side. So, I think, from our perspective, the reason that this agreement could be so important is it allows us to attack one of the real structural flaws of our issue, which is the multiple barriers in the foundation.

So from my perspective rather than this being about cost, cost, cost; it's really about overcapacity, overcapacity, overcapacity—and we really need to do something about this overcapacity problem or we're going to be back here in 10 years making other comments about why the airline industry is in such a mess. So I want to first talk about overcapacity and where we see overcapacity, and then talk about how the U.S.-EU agreement can have a positive effect when running into that problem.

Over capacity is a problem at every level. It's a problem in the U.S. The U.S. government has decided that six network carriers should seek to be a minimum that is acceptable to the U.S. market, notwithstanding the rapid growth of low-cost carriers and the ever-shrinking market network carriers. The past actions by the government have made it clear that that number of network carriers should be six, which is not a legal barrier; it's a bureaucratic mindset, if you will. I always argue the number should be more like three, but there you are. So far they're winning that battle.

Overcapacity is a global problem. If you look at how to measure over capacity internationally—I think one of the interesting references is what number of carriers are members of IATA, International Air Transport Association—currently there are 252 international airlines that are members of IATA; 252 network carriers; and 252 flight carriers. If you compare that to any other industry, that's an absurd number.

But the bad thing about that number is it's getting bigger every year. If you go back to the last five, six years, you see that number increasing every year. There are more airlines. I'm not talking about low-cost carriers; IATA doesn't include Southwest and the low-cost carriers that emerged in Europe. These are international flight carriers. That number is going up. In 1996, the number was only 215. So we've added 37 carriers, and yet they wonder where these carriers come from. It's not because they're a good investment. It's more a political phenomenon that more flight carriers are entering the market. We actually took a look at this, and to really give an example of how this happened, looked at the Soviet Union. The Soviet Union had one airline, Aeroflot. When the Soviet Union dissolved into 15 states, it spawned two dozen airlines. Not to pick on Latvia, but Latvia has fewer people than the Washington metropolitan area, certainly is not as affluent, and they have two international carriers! So this kind of policy is driving a very severe overcapacity problem.

Well, what does this have to do with Europe? Europe's got the same problem. There are six network carriers in the U.S. All six of those carriers serve Europe. But if you look on the European side of the ledger, we don't have six carriers from Europe serving the U.S.; we have 25 carriers from Europe serving the U.S. So you get virtually none of the consolidation in Europe. And they range from Finnair, to Olympic, to Aer Lingus, to Virgin. They're all over the board, and they all serve the U.S. This is not a natural economic state. This is a politically imposed structure that needs to be changed.

On top of that, on top of the six U.S. carriers and the 25 European carriers, you also have eight, what I refer to as, dogs and cats. These are the Air Indias, the Air New Zealands, the Air Tahitis—carriers that are basically flying around the world and end up in that market as well. So you have 39 carriers just in the U.S.-EU market alone.

So the real promise of the U.S.-EU agreement is to allow some much needed consolidation among the 25 European carriers. And the good news is that probably doesn't involve the U.S. carriers, Mike, so we don't have to go through the painful merger process that Mr. Crandall referred to. But if you eliminate the nationality clauses that are in all of our bilateral agreements now—just as an example, if Paul's company were to buy Air France, Air France would no longer be considered a French airline, and it would lose its rights to fly over the U.S. If you replace that with a European nationality clause so that any European carrier can fly from any European point to any U.S. point, then you allow the kind of consolidation that has been flirted with for many years, and you allow that number of carriers actually to be reduced. Now it doesn't solve all of our problems, but it creates a template for solving these problems. It creates an example of how perhaps you can get away from this nationality-driven economic system. And it's a step in the right direction.

Having said that, I'll close with a couple of observations about the U.S.-EU process. One is most people predict it's going to be a very long kind of process. I actually think it's going to be harder than most people predict, but I think what we're seeing now is some of the EU carriers, who had been enthusiastic about this process when it was largely an academic debate, are starting to realize that maybe they're going to be the Pan Ams or the TWAs in this process. So you're starting to see some waning



enthusiasm. There was a wonderful story in the *Aviation Daily* earlier this week that said it better than I could ever say it. The headline said, "Italian Minister Wants Alitalia to Stay Away From Air France." And the story goes on to say, Italy state-controlled carrier, Alitalia, should find Italian partners—good luck with that—rather than seek an alliance with Air France, [says] the Italian transport minister, Pietro Lunardi. This is not going to be an easy process, and it's going to take a long time.

The second observation, though, is that I think it's inevitable that we solve the overcapacity problem because the current situation is simply not sustainable as an economic model. You really only have three choices in the situation. One, you have a rational consolidation process that proceeds under a U.S.-EU agreement. Two, you have failure; you go out of business. As we've seen, it's very hard to do that—Swiss Air tried it and wasn't able to pull it off—and we know historically it's very hard for an airline to simply disappear.

And the third choice, which is also unattractive, (indiscernible). But this is not a sustainable model with as much capacity in our global system. The only way you keep that capacity there is by subsidizing it. And I think nobody thinks that's a good solution. So consolidation through agreement, I think, is a much better, more promising, and almost inevitable approach.

And my final observation is that in the deregulation era, we had people like Alfred Kahn, and people like Michael Bishop—if I were in a different forum I would even say people like Ted Kennedy, but I won't say that here—people who drove the process, the eggheads, if you will, who drove the process and made it happen over the objections of carriers. And we need that again because I think that if the U.S. carriers are apathetic, you're likely to find the European carriers hosting this process ultimately. We need the economists, and we need the academics to drive this forward. You're going to hear from Dorothy Robyn. She and her group have done some terrific economic work on this, which is going to be very helpful in moving this forward.

This afternoon you're going to hear from Professor Havel, who's also done a lot of work on open skies and how to move beyond that. These are key components in moving this forward because otherwise you risk really getting a stalled process. So I'll stop there.

**Smith:** Paul Mifsud is the Vice President, Government and Legal Affairs in USA for KLM Royal Dutch Airlines. One of his achievements was mentioned earlier, somewhat less than four years (indiscernible) by Bob Crandall. He helped to conclude the Open Skies aviation agreement between the United States and the Netherlands. He has a background in, well, aviation law. He teaches (indiscernible).

He is going to give us a perspective and also bring a bit of the European side of the coin. Does it look as slummy on that side of the ocean as it does on this side (indiscernible)? Paul.

**Paul Mifsud, Vice President, Government and Legal Affairs, KLM:** Thank you very much. It's a pleasure to be here this morning, and I enjoyed very much a very great speech. And it's always refreshing for me to hear people remind everybody that open skies was a Dutch idea—and the best deal that the Dutch did since they bought Manhattan for \$24.

There are many other people who feel that the advantages of Open Skies have, in fact, turned to the benefit of the much U.S. airline industry. Those aspects of the U.S. airline industry that have gotten deeply involved in alliances have certainly benefited dramatically from this process.

I have some prepared comments, but because of the opening remarks, I would like to address some of the thoughts and points. And I hear some optimistic comments in Mr. Crandall's speech I'd like to highlight.

First, we're going to start with specific points. KLM's investment in Northwest occurred in 1989. At that time, KLM could not serve under the old bilateral system through Minneapolis or Detroit. KLM made that investment anyhow. At the time, there are people in this room who remember that the U.S. government

took very strong actions against it, with the concern that KLM might bring some aspect of foreign control to Northwest and put severe restrictions on how that control was going to be exercised.

It wasn't until 1992 that the Open Skies agreement was concluded. That agreement, as I understand the politics of it, after objecting in December of the previous year, had belonged to the major carriers, United, Delta, and American, who were complaining they were not able to get access to Europe under this bilateral system. They indicated they were prepared to try anything, and so Open Skies was the product of that anything—and only the Dutch were foolish enough to come forward and try to get a piece of that package.

The investment that KLM made, as I said, was in 1989. The financial crisis through Northwest occurred in 1993. So the deal with open skies was not based upon some kind of rescue package with Northwest. It's just naturally correct.

But as to the rest of Mr. Crandall's speech, I take great heart in the fact that he agrees that it's a good idea for U.S. airlines to be global; that he agrees that it's a good thing to get rid of these old restrictions. He sees that there's a need for more than just those restrictions being removed. That's the whole essence of the Open Aviation Area. The Open Aviation Area proposal by the European Commission (EC) is a new concept. It's not about exchanging traffic rights or getting better benefits for one side or the other. And while much has been made about the consolidation potential in it, I'm on record for saying I don't think it is necessary for consolidation or that it will speed consolidation.

The view about this, the Open Aviation Area, has to do with the fact that you now have a European authority who has control over issues like slots, issues like airports, and issues like, ground handling—all the issues that Bob Crandall pointed out were essential to a good agreement with the United States. Moreover, they have asked the United States to include them in any final open aviation agreement with the United States, including setting up mechanisms to see that these provisions are enforced.

You're dealing now not with individual European nations but with the European Union, who, on issues such as state subsidy, has shown enormous backbone, even in the face of recent economic conditions. So it seems to me that the stage is set for serious negotiations between the U.S. and Europe. And while labor and the military here in the U.S. have some essential issues that they have to redress in this, I think the proper forum for redressing it is against the background of these talks. If these talks are about things that are ultimately good, then whether or not they're going to be immediately relevant to the major network carriers at this time, the fact is it sets the stage for people to be more creative in the ideas that they might employ in the exercise of the business.

One of the things that KLM noticed when it got involved in its alliance with the antitrust community and in an Open Skies context was that it didn't have to operate all the routes itself. In fact, it started to realize that it could, as it integrated more and more with Northwest, rely on Northwest to provide air service; that is, have others provide air service. That concept is very new in our business, and Northwest and KLM have gone further than most. But there's much, much further to go in the integration of alliances.

If you look at the hotel industry, where you can walk into a Marriott Hotel here in Washington, or in France, or in Bangkok, and feel that you're in a Marriott Hotel. You don't know who owns the hotel. Marriott doesn't own most of the hotels that it markets. The aviation industry, on a global basis, the network carriers, on a global basis, are dealing with the competition of ...252 other airlines in the context of an Open Aviation Area where we don't have to worry about issues, like who has ownership. Deals can be cut.

KLM doesn't care whether it's a blue-tailed aircraft or a red-tailed aircraft, we share the revenue. But it doesn't matter which side gets the most flights. If you're in labor, of course it does...The military is certainly sold on the idea that nationality has something to do with loyalty of enterprises.

But those issues aside, from a commercial point of view, with the old rules, the old reasons for the old system are gone. And they pose an impediment to the kinds of deals that we can construct. If you ask people who are involved in these alliances, and you heard names, like, Sky Team and Star Alliance, who owns Star Alliance? Who owns Sky Team? The answers are vague because how do you own an airline marketing arrangement that's multinational? How can you beat those organizations up if you start to get into areas that yet might be characterized as an air carrier, because the definition of air carrier is a kind of broad, legalistic definition and different with different jurisdictions? How should we develop these concepts to give you the kind of ease of doing business that is essential in today's world?

Lance Armstrong won...the Tour de France bicycle race. Almost a month of bicycles up and down mountains, all around roads. And all the time he was racing he was wearing the helmets that have the air resistance. He has a special suit. He shaves his legs because the air has the—all these little tiny things were all the little things that were necessary to get him across the finish line 61 seconds ahead of—who was number two?

**Unidentified:** Jan Ullrich.

**[LAUGHTER].**

**Mifsud:** Who's number three? The point is that in a tough competitive environment all these things that are now sitting there are elements that stand in the way. There are monuments of that, which are from an old time. I believe that the labor concerns are rationalized, and that a careful analysis from a labor perspective, which an open aviation area is a benefit. I think the same can be said of the military. Thank you.

**Smith:** Thank you, Paul.

**[APPLAUSE].**

**Smith:** Our last panelist of this panel is Dorothy Robyn. Dr. Robyn is, I guess we know her through another Bob Crandall, the Bob Crandall from Brookings...Her report on, the Brattle Group's report on aviation issues, I think, is one of the finest pieces that's been done...on this topic. She served in the Clinton Administration to coordinate overall economic policy regarding transportation, aviation, aerospace.

**Dorothy Robyn, Senior Consultant, The Brattle Group:** Thank you, Fred...Let me just say, I'm new to the consulting world. I spent my career teaching and in government. There really are people who don't necessarily give you the answers you want. They're intellectually honest. The colleagues are a group of Harvard, MIT, Ph.D. economists. And we spent a lot of time making sure that the client understands sort of what we think on an issue because we are intellectually honest, and we look at questions honestly and give you an honest answer. And that may or may not be what you want to hear.

The Commission, two years ago, put out an request for proposal (RFP) for economists to analyze the impact of the liberalization of the U.S.-EU air area. We submitted the proposal and were selected and spent the better part of a year doing a report, half of which quantifies, and half of my colleagues did quantify, but the benefits of complete liberalization focusing on the trans-Atlantic and within Europe for reasons I'll say in a minute. The second half, which I wrote, looks at the major concerns we raised about liberalization. We should've talked about that would've, I needed another chapter.

**[LAUGHTER].**

**Robyn:** We looked at the natural security waiver and environment and safety. Why did the Commission ask us to do this?...Our open skies strategy has...had the effect of keeping the Europeans in a corner. It can't do that now; we have access to most of their market, with the big exception of Heathrow. They do not have symmetric access, and, more importantly, they can't consolidate internally because of the

effects of this patchwork of bilateral agreements. So we're now in a position where the European Commission is advocating a more pro-competitive position than the U.S. government.

My attitude is, why not open this up? Why should we treat the airline industry any differently than every other industry, including telecommunications? The reasons that we established limits on ownership and control, which is the real top political issue, those reasons have vanished. They were valid in 1926. Arguably, they're not valid now. So I would turn the argument around it, Bob, and say, why treat this industry differently as his successor did a couple of years ago. Why do we have flag airlines? We don't have flag shoe companies. We don't have flag travel companies. Why are airlines any different?

If what Bob says is right about airports, and I assume that it is, I think we're in a great position now to negotiate because the Europeans want this; they need this more than we do. They are very, very eager to negotiate this agreement because they need it for their own internal consolidation, among other reasons. So we're in a great position in these negotiations to demand the kind of thing that Bob laid out.

Let me say a little bit about our report. I'm not going to talk about the benefits. They're laid out in excruciating detail. We quantified three separate efficiency effects: cost savings, rates effects on transatlantic airline routes, and output effects expand, actually expanding capacity for non-Open Skies markets. We have, in terms of the benefits to consumers on an annual basis...a big number, not a huge number, \$5 billion. The majority of those benefits are in Europe granted; that's why the Commission is pushing for this and not the U.S. government. But there are significant benefits to the U.S. on the trans-Atlantic.

Those are long-term benefit numbers. We're not going to have them next year; we're going to have them in the long term. But they're conservative numbers. This gets back to the nature of my colleagues. We don't quantify things that we can't defend. We do a lot of work in litigation. My colleagues are used to testifying, and they don't issue conclusions for a testimony that they can't back up. So these are conservative numbers.

We did not even try to estimate benefits in the U.S. domestic market. We think there will be benefits, but it's hard to articulate to other economists why there will be benefits in the U.S. domestic market given that you have complete open entry here now, and somebody once said to me, "Richard Branson doesn't know anything that David Gelman doesn't already know." You've got complete open entry here. I think there will be some benefits, but we can't articulate what they are.

All right, let me talk a little bit about the impediments to this (indiscernible) written chapter on Bob Crandall's opposition, and Paul has alluded to those. It would be national security and labor. DOD is concerned about the CRAF program, the Civil Reserve Air Fleet program, which is a terrific program, very critical to U.S. military preparedness. It's a *quid pro quo*: U.S. airlines pledge their aircraft for use in a military emergency in exchange for exclusive access to about \$2 billion of U.S. government peace time business. It's a 50-year-old program. It works very, very well. Folks at DOD are concerned that foreign ownership and control of U.S. airlines would jeopardize DOD's dependable access to these aircraft in a time of emergency.

In the report, I go through a list of assumptions that underlie DOD's concerns, and evaluate those, and conclude that some are valid and some are not. Let me cut to the chase and say there are two concepts that I think serve to alleviate, should alleviate, most of DOD's concerns. The first is the concept of right of establishment, and this is really not a common term at DOD. They tend to think that if Lufthansa were to buy United Airlines that United would then become a German airline and would be operating in the U.S. as a German airline. That isn't what would happen.

United would continue to operate as a U.S. entity. It would do that for business reasons because the alternative would be operating in a huge cabotage operation, which would make no sense. They can also do it for legal reasons because to operate in the U.S. domestic market, they would have to operate as a U.S. carrier. So they would exercise their right of establishment rather than pure cabotage right.

If it is a U.S. carrier, DOD has the same leverage over it that it has over U.S. carriers today; it could take the same sort of steps. If even the German government were to put pressure, it can take away the license, it can seize the planes, and it can call up reserve pilots. There are a variety of things. So right of establishment takes care of most of DOD's problem.

The other concept that's critical is the Exxon-Florio [statute passed in 1988 that requires a national security review when foreign firms seek to purchase military-related assets in the United States] Committee for Investment in the U.S. There is a feeling among a lot of people at DOD—and this tends to be a concern that's fanned by labor—that if you eliminate controls on foreign ownership then, you know, Osama bin Laden can come in and buy Delta Airlines, that Iraqi Air can come and buy a U.S. airline. It doesn't work that way. Any foreign purchase in any industry can be rejected and by, through a Treasury-led process, the Committee for Investment in the U.S., set up under the Exxon-Florio Amendment to the Defense Production Act.

There is a scenario that I think is a valid concern to DOD, but I think there are reasons that, other ways of dealing with that. If a U.S. carrier, whether it was foreign owned or not, wanted to move it to long-range planes, base its international operations offshore...it could do that, along with those long-range planes are the planes that DOD wants access to. For reasons I'm going to say in a minute, I think that kind of re-flagging (indiscernible) is very unlikely.

Let me just say one last thing. DOD has done a big report. They commissioned a very big report. There are many people in this room who have worked on it...It was done by Institute for Defense Analyses. It's all about the CRAF program, and (indiscernible) air fleet. They looked very curiously at this issue because their sense is that this issue is sweeping. (Indiscernible). If the stronger (indiscernible) safeguards were adopted, DOD could effectively manage the (indiscernible) the national security department, even if (indiscernible) foreign munitions control. And I think that DOD is educable. I think they are capable of being educated, and I think that they're in the process of getting educated. And I think this is a solvable problem.

On the labor question, let me just underscore what Bob said. We looked at the labor substitution issue. In a US-EU open aviation area, would there be substitution of foreign labor for U.S. labor, which is always a concern? We concluded that there is very little possibility to enact labor substitution, and the reason is that most of the revenue for U.S. airlines, 75 percent of their revenue, comes from their domestic routes. Under U.S. immigration law, you have to have U.S. planes on domestic routes. That gives U.S. airlines, a lot of leverage in preventing a U.S. carrier from moving its international operations off shore, as one former airline executive said. If a U.S. airline were to move its international operations to a foreign base, that would be a declaration of war on pilots. Pilots are largely unsupervised, and they have so many ways of getting back at you. So I think that's unlikely to happen, indirect labor substitutions, and that's both and good for the reasons that Bob said.

I don't think this is going to lead to a sort of a revolution in terms of labor contract relations and labor control that some people are looking for. I don't think that will happen. I think over time there may be some indirect labor substitution as carriers like Virgin and some of the European (indiscernible) carriers expand their share of the market. But that will lead some indirect labor substitution from higher wage US to lower wage airlines. But the fact is, European pilots are paid not much less than U.S. pilots are paid, about 15 percent less on average. Yes, the Eastern European pilots in the accession countries are paid significantly less, but there are only about 4,500 of them who are fully trained on the (indiscernible) equipment. And that's just not a big enough number to have a significant impact.

The final observation on the labor side is that this whole notion of flags of convenience, which is what you hear from Alvin and others, I think, is a misplaced notion. And you hear this not just from labor, but from people at the International Civil Aviation Organization (ICAO) have picked up on this. Even my former colleague and dear friend, Allan Mendelson says it. I'm concerned about flags of convenience. We don't want to have flags of convenience harking back to the maritime experience. This is not the

maritime industry. The U.S. is not going to fly flags of convenience for the reason I just alluded to. Pilots have too much power. European airlines can already hire workers from low-wage European Union accession countries, so they have no reason to fly flags of convenience. And even if there were a re-flagging of an airline, even the high safety and environmental standards in the U.S. and Europe, it's not going to have the sort of effect that it did in the maritime industry. So I think the whole flag of convenience discussion is a mischaracterization of what's going to happen.

Let me just make one final comment in closing. I agree with Bob's point that access to capital is not what this is about, and we're very clear about that in our report. The U.S. capital markets are huge. If a U.S. airline can't get access to capital in their current situation, there is probably a very good reason that they can't access to capital. And liberalizing the U.S.-European aviation area is not going to change that.

**[APPLAUSE]**

### **Question and Answer Period**

**Smith:** Well, we've had the positives and the negatives now. Let's go forward. I think it's important to realize that some of the questions have been raised already. First is the uniqueness of the concept of flag airlines, that there are very few industries in America that actually do have this kind of national ownership idea. The nuclear industry, I think, is one, the airlines, ownership of spectrum is the other. I don't know if there are any others out there that do that. So it's a very rare thing...One question is, why these successions and whether or not the global economy really needs it any more.

The other is this whole question about the extent to which alliances are going to now go (indiscernible) that's good enough; the temptation to believe that living together is all you ever have to do, marriage is not ever necessary maybe. But there are other questions about the greater commitment and the greater ability to share many ways that maybe make it worthwhile.

So often..we don't believe in free trade because we believe in "fair trade," and those of you know the difference. Fair trade is essentially, you know, we agree to deny our consumers travel rights because you deny your consumers travel rights...We're threatening each other to destroy ourselves in peace time, which was the fortune of avoiding it in war time. We basically hope to reach a better outcome. Sometimes that works, but it is a convoluted process. And we shouldn't be surprised sometimes that maybe the best way to get open skies is just to go directly for Open Skies.

As I mentioned, I was in the railroad industry for many years. The history of transportation in America is that the U.S.'s first transportation system, the railroad, was essentially built with German and English capital. Not necessarily that the capital was all that good; it wasn't in the United States at that time. But because it also provided expertise, differential knowledge, and risk sharing—and especially when things went bankrupt—there was the opportunity to gain knowledge. To some extent that might be true here.

**Unidentified:** You suggested 252 was (indiscernible) because three was about right. You know, we do have a rule of three in corporate organizational theory that suggests that industries do tend to gravitate towards that. To what extent will you see the US three for three, the European for three, (indiscernible)?

**Mifsud:** Well, the big three are in the U.S. There's no question I suppose. I don't think the number would really be three, but I think you would have actually probably three truly global airlines that carry you everywhere in the world. But you also have a whole series of regional airlines. And you'll have an ongoing number of low-cost carriers that would pop up just as we see in the U.S. and they're seeing in Europe. I suspect you're also going to see that phenomenon internationally. So it's not just three airlines; it's a whole series of different types of airlines, but I think you're really looking at three carriers, and we try to see this from the alliance template forming to kind of a global line.

**Smith:** We've got a question back there.

**Irv Chapman, Bloomberg Radio:** I wanted to get at the question of overcapacity, but the first alliance by United, if the reputation of Lufthansa for superior service and punctuality overwhelm that of United, why shouldn't they be (indiscernible)? They own them.

But on the matter of over capacity, let's not presume that the recession in travel is (indiscernible) because not so long ago, we were hearing about (indiscernible) a year. And if you remedy overcapacity, will I again have to pay \$2,000 to fly to Chicago or Paris?

**Mifsud:** Well, I'm hoping that we can come up with a different example besides Lufthansa and United. Maybe we can say America or something. But on the overcapacity issue, I don't think you're ever going to have to \$2,000 to fly just about anywhere again. And you really can't underestimate the impact of the low-cost carriers and how Southwest has really emerged as the number one domestic carrier in the U.S. at a trend that is frightening for some of us. You just look at aircraft orders and things that are in the pipeline to low-cost carriers.

The overcapacity is artificial, and it's going to go away one way or the other. And it doesn't necessarily mean air fares are going up. It may mean that if you're traveling to Boston to Sacramento, there might not be 12 hubs to choose from; there might only be six. But I don't really think there's an alternative to it. I think that the current structure we have is not sustainable.

**Smith:** Over here.

**Dan Kaplan, Glassman-Oliver Economic Consultants:** I'm sort of intrigued by this capacity issue. What is it? Is it a capacity issue or is it a cost issue? And secondly, how do you imagine that EU agreement reducing the American capacity (indiscernible)? And how does that square with the problem in the study?

**Mifsud:** I think if we look at what happened after 9/11 and the dramatic drop-off in travel, these aren't just about the transatlantic markets. A carrier like United, or American, or First Europe is, you know, a typical city airline now with three flights a day or four flights a day, to, I think Chicago, London. If we need to reduce capacity by 20 percent, it's pretty easy for us to do. We can cut frequency, and we'll have some services that only operate X number of days a week. But if you're a carrier—I'm not going to name names—but if you're a small European carrier and your service pattern is you serve Washington three days a week, New York two days a week, and Chicago three days a week, how do you cut your capacity 20 percent? You don't. You just leave it there, and so you don't get capacity adjustments out of this kind of service. So there are abilities, better abilities to adjust your capacity.

**Smith:** One here, one here...Yes.

**Eric Kulisch, American Shipper magazine:** I had a question about capital. The Transportation Department has proposed raising the ownership limits from 25 percent to 49 percent of voting stock. In light of this discussion, it seems like kind of a incremental step up at most. Do you see any benefits to that? And it seems like the DOD is not against that. What would be the benefits of going 49 percent, and, you know, will that increase investment in any way by foreign carriers?

**Robyn:** I think it's largely a symbolic step, but I think it's an important one. That is something that the last three presidential administrations have all supported, the George Bush, Sr. Administration, the Clinton Administration. We were never able to actually send the legislation forward, so the current administration has gotten beyond where we were. The Air Transport Association (ATA) endorsed raising the cap as part of the Baliles Commission in 1993 [the national commission initiated under the Clinton Administration that called for shifting air traffic control functions from the FAA to an independent corporation], and the Clinton Administration accepted that recommendation. When Charlie Hunnicutt and I tried to, we drafted a provision to do that, and it was circulating within DOT in 1998 or 1999. Of course, it was immediately leaked to the Hill, and Sam Whitehorn called me from the Senate Commerce

Committee and said, "No Democrat will co-sponsor your bill if this provision is in it." And I called ATA, and they said, "We'll be neutral on that issue."

You know, we converted back in 1993 because we needed foreign capital, but now we don't need foreign capital, and the line is much blurred between labor and management. Well, I think we're now back to the point where they do support it. They put out a statement indicating support.

It won't change the control of the situation. I've heard that some U.S. airlines don't want to waste political capital on the Hill because it doesn't actually do anything. But I think it's symbolically very important. And I think it's notable, you know, that it wasn't in the FAA bill that was sent up originally; it came out later. That's because it took DOD a while to sort things out, but they did eventually approve it.

The European reaction when they saw that provision which they had heard was going to be in the bill and was not in the bill, they said, "Oh well, the U.S. government is holding this back for negotiating purposes. That's not true. I mean, the Bush Administration wanted to get it in there and couldn't. So the bottom line is I think it's not, it's symbolically very important, but not substantively.

**Richard J. "Jack" Fahy, aviation attorney:** I've listened to your arguments. I don't find them very persuasive to a U.S. carrier, a member of the U.S. industry, as to why it should support this open area. Mike's argument is that it's going to reduce all the capacity, which is, I'm not quite persuaded that the same, (indiscernible) are going to be here, the same number of employees, if it's a European merger. I can't imagine, for example, somebody acquiring a weapon with the Greek government and we not imposing a condition, and non-stop service has to continue from Athens to New York. So I don't think that, you know, that it doesn't seem that the over capacity argument is very persuasive.

And secondly, you haven't responded to Bob Crandall's argument that...we're going to get structural inhibitions in Europe, like access to Heathrow or access to Frankfurt, that there's going to be anything in Europe for U.S. carriers. If they cannot expand at those major airports, what is in it for the U.S.? Paul says that a bilateral, the agreement itself is going to open up these airports. But the question is, who's going to enforce that? Is it going to be the national government? It's unlikely that the U.S. is going to get anything out of that. Is it going to be the European Union or are we going to put ourselves in the hands of the EU to protect U.S. carriers and some European companies? I wonder if you could elaborate a little bit more on how you're going to meet Bob Crandall's suggestions. OK, secondly, what benefits would U.S. carriers have?

**Mifsud:** Some U.S. carriers are more deeply involved in alliances than others and have made much greater headway in the integration of alliances. So for those U.S. carriers that don't have strong alliances, don't have antitrust immunity, don't have trans-Atlantic code sharing of their nature alliance broadband, I don't see very much benefit in changing the rules of the game. But for those carriers who are involved with their European partners and who are looking for greater and greater levels of integration, I think we have a whole different game.

I think when you ask who's going to enforce it, the answer is clear. The European Union will enforce it. I think it's also clear, the recent record is very clear, the European Union will enforce these kinds of agreements strongly against the member states. The Greek government will not be able to require that Olympic Airways fly to Athens or New York.

You know, this is an economic audience. I'm a lawyer, and so I'm coming at this from a lawyer's perspective. And I see all the time in the discussions that I've been involved with regard to alliances and potential, I've been involved in more potential alliances than anybody in the room. And so many times, the lawyers say, "Oh no, you can't do that because the bilateral doesn't permit it," or, "No, you can't do that because the ownership rules don't permit it." It's the ton of things that we work around, and we don't even see that we're working around it. There are so many pebbles in the road that we don't even notice them anymore. It's about getting rid of those so that you can come up with new and more integrated alliance structures.



**Fahy:** But, Paul, you already have antitrust immunity. Why do you need this further agreement? Don't you have all you need to—

**Mifsud:** I agree with Bob Crandall and many people in the audience that if you look at the way you do business today, what do you need it for?...I'm talking about what more could be done, if you didn't these restraints, what kind of imaginative things we can't do now that might be done? And I gave the example of the hotel industry. But there may be other examples as well.

**Smith:** One thing we did find out was the history of innovation and regulated industries is that it's not very good. And we don't always know what those creative innovations are going to be.

**Crandall:** This is really quite an extraordinary discussion because everybody is sitting here talking about reducing competition. That's what Mike's talking about, when you reduce overcapacity you reduce competition. Let me remind you and everybody in the room of this reality. In the airline business, quality is frequency and availability. That's quality. It's not the fancy caveat and all the other good stuff. It's how often do you fly and are seats available. That's quality. And now what I hear Mike saying is he prefers the Soviet style of planning.

[LAUGHTER]

**Crandall:** Now they have too much capacity, and what are we going to do? We're going to eliminate some of those 256 testy competitors, who, by the way, won't be there to prevent the fair comparison from going up to 2,000 bucks. That's where it's going. Now if you take that capacity and you don't take down your costs, your fares are going up. So the Competitive Enterprise Institute is sitting here talking about how to create more effective monopoly.

[LAUGHTER]

**Crandall:** That's exactly what we're talking about, folks. And Dorothy is sitting there saying that there are economic benefits, and I don't hear about any economic benefits except Mike wanting to get rid of some of those testy competitors. That's what this is all about.

**Robyn:** I certainly endorse Mike's rationale for the, in fact one of the three positions, the effects that we quantify, is the standard capacity that you would get in the (indiscernible) markets. No, I agree with everything he said about the correlation between capacity and competition.

The single biggest benefit that we quantify is in the cost area, and the majority of it does come on intra-Europe routes. But if you look, there is a huge difference between the costs of, the high costs and the median costs of carriers in Europe within a particular region. We looked at this on a route-by-route basis. We did not assume that U.S. airlines would be going into Europe. We didn't have the data to make that assumption. This was just what happens if the median cost carrier in Europe, whether it's through consolidation or increased competition, we don't discuss it (indiscernible) any way. But if they are forced to, if the high cost carrier is forced to get its costs down to the median costs, not the low cost, but the median cost carrier, what sort of savings do you see? And you see some very big savings, both within Europe, but also on the trans-Atlantic. So you will get increased competition.

You can't have the maximum degree of competition given the kinds of restraints that we imposed on the system. And I think Dick's question, you know, what's in it for U.S. airlines, I mean, that isn't the question that we asked, and that isn't the question the U.S. government should ask. Obviously it's a good question for Mike here. But what is the incentive for consumers? You know, a little conflict can better serve us here. Let's let them in. I mean, that's what I hear about from U.S. consumers, and they're better served by competition. And this will allow the sort of competition that every other industry engages in.

**Mifsud:** You can set your capacity two ways. You can have the market set your capacity or you can have the government set your capacity. And I think the situation we have now is that the government sets the capacity. It's true that if every city in the United States over 100,000 people had its own airline hub, there would be more competition in the country. But it's not the same model. And what we're talking about is trying to allow the European market to go through a process where the amount of capacity is determined by market forces so that if Alitalia won't stay away from Air France, if Air France takes over Alitalia, there will be a reduction in jobs, and there'll be a reduction in service out of Milan. And there will be reduced capacity, but that capacity that's there now can't exist in an open and competitive market.

A lot of the 252 carriers now would not exist if they weren't receiving large payments from their government. And what we're talking about is trying to get rid of that and let the market work. And, yes, you will end up with less capacity.

**Smith:** I share that because I've rarely been accused of being a pro-government monopolist. The argument that merger is necessary, (indiscernible) to capacity expansion has always been around. The argument was when we went from the diversity of mom and pop stores in every area to the handful of monopolistic supermarkets, we find dramatic drops in consumer welfare and competition. But as you well know, it's not the number of competitors in the market place; it's how aggressively and competent they fight each other.

There is, of course, the issue of whether or not the major limits on competition are political or private. That's part of what this whole panel and other panels are about. I think all of us agree that's not the purpose of this conference. The great rigidities, airport restrictions, the inability to build private airports, to expand air space, and to use air space more efficiently are critical and certainly indigenous of all the issues we're concerned about. But we can't address all the issues in this conference. We have one down there and then here.

**Joanne Young, Partner, Baker and Hostetler, LLP;** Nine-eleven showed us how the aviation industry can be different. It showed us that an aircraft really can be a weapon of mass destruction. The Iraqi war showed us that we can't always count on the international community to support our national objectives. I think even NATO was a reluctant player in that. At the same time, Defense Department people, special ops people have impressed on me...the absolute importance of readiness for emergency responses in the Civil Reserve Air Fleet (CRAF) program.

My question is that if there was, in fact, another aviation-related attack in the United States— and we've seen in the media recently about children, powered rockets and so forth—how do you see in an open aviation community the President, the administration, having the ability to shut down aviation immediately and call up CRAF program perhaps for an immediate response if there were political questions and the ultimate owners of these U.S. carriers being foreign had concerns that the U.S. was acting too impetuously?

**Robyn:** Let me answer that with, first of all point out that 9/11 had nothing to do with ownership. And our ownership and control obviously were of no help to us there. So it's a separate issue.

In terms of the response, let me answer with one word, VISA, the Voluntary Integral Sealift Agreement. This is the maritime counterpart to the CRAF program at DOD. The biggest player in VISA is Maersk. It's a Danish-owned shipping company. MLL Maersk Lines Limited, is the (indiscernible) based U.S. integrated under U.S. maritime law, an entity that carries half of all of DOD's peacetime cargo, that has had top secret clearance for 20 or 30 years.

DOD has figured this out on the maritime side, I think, because they've had to. The bottom line is, if entities operating within U.S. commerce had to operate as U.S. airlines, the federal government has the same control over it as it does over any other entity. These are ultimately economic actors. If an airline wants to commit financial suicide by defying the federal government and losing its license, there's

nothing you can do about that no matter what the ownership is. But that makes no sense. We figured it out on the maritime side, and it shouldn't be any different on the air transport side.

**Smith:** Paul.

**Mifsud:** The DHL case provides [an] example. DHL carried under the CRAF program in a recent conflict. Germany opposed the war, yet there's a cycle case being made by a substantial portion of the small package industry that DHL is actually German. So we see that a company incorporated in the United States participating in the CRAF program cannot bring under the circumstances (indiscernible) by the military. And as Dorothy pointed out, it was something Mike said, maybe somebody knows the actual number, but I think something like 70 percent of all goods and materials moved to the Iraqi war went on foreign transportation.

**Smith:** Let me have you thank our panelists.

[APPLAUSE]

[BREAK]

**Elliott M. Seiden, Partner, Garfinkle, Wang, Seiden & Mosner:** I'm delighted to be here today to introduce Michael Levine as today's luncheon speaker. Just before I took the podium I had a brief word with Mike and he asked me would I please lie. And I told him, no, I would tell the truth, but in Mike's case truth is frequently stranger than fiction.

Any time I have a chance to spend time with Mike Levine, it's a true delight. There is simply no better way, I believe, to make oneself familiar with aviation issues...or almost any other of the many issues that Mike has a great interest in than to discuss them with Mike Levine. And so I think that we're all in for a treat today in hearing what Mike has to say about the issues we've been discussing. If there any aspect of aviation that Mike Levine has not thought about, it probably doesn't exist.

Mike Levine currently is adjunct Professor of Law at Yale Law School. Before joining the faculty at Yale, Mike served in a similar capacity at Harvard Law School. The academic section of Mike's illustrious career is much too long to detail here, but I would like to note that he previously served as Dean of Yale University School of Management, and held professorial chairs at Cal Tech, Yale, and USC, and has done pioneering work on airline deregulation on the application of market mechanisms to airport congestion, the origins of regulation, and the behavior of regulatory agencies. So Mike definitely qualifies as an egghead.

He's done much more than just his academic work, of course. Mike has a crossover career where he is going to work his theories in a very practical and very productive way in a number of airlines (indiscernible).

He's had extensive experience working in the airline industry. He served as an Executive Vice President at both the old Continental Airlines—actually there are several old Continental Airlines. Mike was in the original old Continental Airlines, and at Northwest Airlines, which was his most recent position in the airline industry, as executive vice president in charge of marketing, pre-planning, strategic planning, and everything else that ever came up in the airline because Mike had an opinion on all of it. He also was CEO and President of New York Air.

Mike was responsible at Northwest for, among other things, overhaul of the Northwest domestic and international route system, for its fleet strategy, for developing and executing Northwest's path-breaking alliance strategy.

The five years that Mike Levine and I spent working together at Northwest were, I feel, remarkable years of accomplishment and marketing creativity, most of it because of Mike Levine.

Earlier as a government official, Mike was instrumental in bringing about airline deregulation. In 1978-1979 he served as General Director, International and Domestic Aviation, which was a senior staff position, at the U.S. Civil Aeronautics Board, and devised many of the mechanisms and practices used to deregulate the airline industry.

Like all of you, I look forward with great anticipation on yet another occasion to learn from Mike Levine. Mike.

**[APPLAUSE].**

**Michael Levine, Yale Law School:** Thank you, Elliot. I'm going to change my request. Instead of asking you to lie about me, I'm going to ask you to adopt me.

**[LAUGHTER].**

**Levine:** I find myself in a very interesting situation here because in general I have spent most of my career struggling to free up airline markets and to demonstrate that you can perform, that companies can perform well in freed up airline markets. On the other hand, the title of this is very broad, and it presumably claims to be inclusive, but in some ways I am sympathetic to the idea that several people have mentioned and that even my old friend and debating partner, Bob Crandall, has mentioned that there are some complexities in this that perhaps haven't been fully explored.

After all, those of us who have long favored open markets in air transport can hardly be against removing the last barriers of competition.

In fact, most of those involved in the ongoing policy discussion, except perhaps certain labor interests, and (indiscernible) some form of (indiscernible) in aviation, though we have different concerns of what mean by that. And much of the rhetoric we use to discuss it is very imprecise. We often talk past one another, and in the process condition our support for the concept on practices that others find as practical or objectionable.

Our European friends talk about globalizing markets as an extension of EU practice. Many Americans use the language of globalized markets as an extension of U.S. practice. But neither the U.S. nor Europe proudly practice and pursue fully open markets, and we may be a long time creating them...given political realities.

On the other hand, everyone agrees that while the aircraft work market is currently stuck between mercantile bilateralism and plurilateral trade freedom, markets involving the most developed countries are open to a degree that would have been considered unthinkable 40 years ago—and was, in fact, choppy when first proposed in the post-Chicago era 25 years ago. Even most closed markets of any importance, like some of those in Asia, are considerably more liberal than before, thus moving toward even freer trade under the rubric of globalizing aircraft work markets is clearly desirable, and it should be possible if we are careful about how we discuss it and careful about talking about what we want. So we need to talk clearly about what we're talking about since we can't even marshal arguments in favor of further market opening policies without agreeing on the subject of the discussion.

In my opinion, we are, or at least should be, past the point where labeling as perfectionists those who favor different next steps and further market opening from those favored by the speaker of the moment and predicting a dire judgment by history will advance the ball.

Those in the U.S. who have fought for years to open tightly closed international aviation markets in favor of multilateral agreement, but have reservation about cabotage or even about the right of establishment [allowing foreign airlines to own domestic carriers], probably don't think of themselves as protectionists and aren't likely to be persuaded by being called that.

Those in Europe who we now (indiscernible) to sign a multilateral agreement with the right of establishment and all the market access restrictions removed are equally unlikely to consider themselves protectionists because they have a less liberal airport access policy than the U.S. and are unwilling to grant preferential airport access to right all past protectionists' wrongs. That's not to say that everybody is right, God forbid, or that we're not entitled to prefer to argue for one path of further liberalization over another. But the discussion would be helped and policy is more likely to continue to liberalize if we can be more precise about what we are demanding and more careful about projecting what is likely to be achieved.

Let's start with the fact that we really don't have an impressive for the nominal objective we seek. There are no fully open and fully global—that is, both fully open and fully global—markets in transportation or any other important infrastructural service. The international maritime regime often cited this morning is a quite open market accessible by almost anyone. In fact, Mike complained about it from the standpoint of environment safety rules, that it's too accessible, except for maritime activities has subsidized. The regime confers essentially unlimited international market access and fairly liberal rights of establishment.

But the maritime regime universally reserves cabotage to ships registered in the coastal states, and in the process for protecting the coastal trade often even when it's (indiscernible). It's a less open market that some are now arguing for in aviation.

The EU air transport regime that's been offered as a model is not in any important sense a global open market in aviation. To the extent that we can conceptualize the EU as a free trade area with coordinated commercial policies, it represents a regional open market in which sovereign states have agreed to harmonize the right of establishment, the right of cabotage, and the free movement of labor, and recently the right to negotiate with other countries for market access, in itself, governmental mechanisms to police and administer the conceded rights.

But the states have retained tax, labor law, social welfare jurisdiction, as well as broad foreign policy and defense jurisdiction; and the community administrators emphatically rejected the unlimited right of establishment in multilateral international market access for all non-member states.

If we try to argue that what the EU has created is an open domestic market in a federal state, then we must first understand that this doesn't represent globalization, and, therefore, it is not an example of that we see. No one has proposed a trans-Atlantic federal state, much less a global one. Probably more important, we must in addition look at the fact that this putatively federal state has so far been granted and exerted varying incomplete powers, as I've already noted, and that even the conception of the EU as a federal state has not been agreed to by many of its present and imminent members.

Finally, with respect to the world at large, this so-called state is not an aviation or many other activities currently committed and practiced in globalized open markets, like agriculture.

Despite U.S. claims that it's pursuing global open markets, it's a commonplace of the dialogue that the U.S. reserves the opportunity to serve its domestic market to its own citizens, since that's what we're talking about today, and imposes obstacles to travel by employees, government employees, on non-U.S. airlines.

With no example to look to, and largely self referential restrictions, trying to define what we're talking about when we talk about moving toward global open markets becomes (indiscernible). What do we really mean and where are the real differences between us? Are we talking about a world in which nationality doesn't matter? Of course not. Every legal commercial enterprise has a nationality. It determines governance rules, taxation, and a host of other matters. What we're talking about is a world in which the nationality of ownership and control is delinked from some or all rights of commercial access. We're not talking about denationalization of aviation enterprises. We're simply talking about

delinking commercial access from nationality. Just as in normal businesses, non-protectionists, nationality issues, and air transport may effectively require that business be done through local subsidiaries with nationality different from the (indiscernible).

Are we talking about maritime (indiscernible) open access, complete with flags of convenience, extended even further into domestic markets? I don't think so. No serious person I know is prepared to leave aviation safety, financial responsibility, and environmental compliance to the registry offices of every sovereign state in the world.

Even the multilateral regime represented by the International Civil Aviation Association (ICAO) [created by the 1944 Chicago Convention on International Civil Aviation] is not thought to be rigorous enough or even they have not been forced to allow automatic recognition of self certification by national aviation authorities. Are we talking about a world in which security of foreign policy considerations doesn't matter when it comes to granting market access, international or domestic? I think September 11 ended any thought that idealists among us might have entertained that we go that route.

So what are we talking about in fact? Well, I submit that what we're talking about when we talk about global open markets is granting expanded rights to compete in geographically defined markets to selected countries and operators. And I want to repeat that. We're talking about granting expanded rights to compete in geographically defined markets to selected countries and operators. Once we focus on that, an awful lot of the hand waving may go away. Most important, questions to be answered are: Just what rights are we talking about, in what geographic markets, and to whom?

For domestic markets, do we mean cabotage, the right of establishment or relaxation of the definition of ownership and control? For international markets, between and among what points are we talking about offering rights, and on what basis are we talking about access to resources, especially the infrastructure of resources necessary to exercise them as Robert Crandall has so eloquently discussed this morning? Does the grant of a right of access imply some minimum standard of airport facilities access? Are all access rights to be grandfathered? If so, where facilities are at capacity, from where will resources, if any, be taken for reassignment, and on what financial terms? And will so-called non-discriminatory airport planning policies limit competitive opportunities as did Paris or Milan?

Should they be on the table also? To whom are we granting the rights we're discussing, to airlines nominated as of right by eligible. But by airlines nominated as of right by the states eligible to nominate airlines, to airlines that satisfy the requirements of the granting state, only to airlines that satisfy both tests? Do we mean to do away with designation? If not, we can't do away with nationality. If so, if we are going to do away with designation, how do we know who's eligible to exercise the agreed rights?

Other factors may make it hard to eliminate nationality. If we grant cabotage rights and the signatory country wishes to designate an airline to exercise rights entirely within the boundaries of another signatory state, must the state in which it will operate accept the designation if the designated airline doesn't satisfy the technical, commercial, and national security requirements that it applies to its own airlines? What will be the primary tax liability for cabotage operations, especially for operations that represent an important fraction of the performing entities' business or profits? What labor laws will apply to its flight and cabin crews? Who will administer its operating certificate? We can preserve nationality by broadening market access by agreeing to the right of establishment so that citizens of one state can create an entity with nationality in another.

If we grant the right of establishment to nationals of other countries, does the country of which the controlling entity is a national have the right to object? For example, when we grant the right of establishment to foreign entities subject to all the requirements that we impose on all our own airlines, does the country of nationality of the controlled interest relinquish all of its foreign policy interests in the behavior of its citizens? For example, in the event that its aircraft are commandeered for service in a war to which it vehemently objects? Is it obliged to assist us in enforcing our requirements, for example, by returning aircraft rescued from their security obligations?

To the extent that we mean to grant reciprocal rights of establishment based on a balance of opportunity, the countries that adopt domestic policies that aggressively favor new entrance have the right to object if the rights that are offered without discrimination to other signatory partners to new domestic airlines are less protective. And, therefore, seem less valuable. In other words, if the opportunities granted to the airlines of one state to operate in another state are less valuable because they're less protected than they are in the granting state, who has the right to object and on what terms? Do you have to define what market access means in those terms as well?

For both international and domestic markets, are we talking about a right to merge or consolidate free of the structures of competition law? I submit not. This is less of an issue than it seems, although not necessarily in a way that will make mergers convenient or easy. As a matter of standard competition, any legal regime that is impacted by a merger and in which the merged entity has substantial commercial presence can claim competition jurisdiction, at least as to the activity that takes place within its borders. And the U.S. has sometimes has been more aggressive than that in claiming jurisdiction, as many of you know.

Globalization of aviation in the sense of turning air transport into a more normal business need not depend on agreed suspensions or modifications of competition law, although that view may disappoint some of its proponents. Of course, in theory and practice, there may be good reason and substantial negotiating incentives for agreed harmonization. But that's not about globalization. That's about competition policy, and not unprecedented either.

Partly harmonized competition policies differing among states and between states, and the preemptive authority exist in both the federal United States and in the European Union, and have existed informally in discussions between the U.S. government and the EU for some time in other industries.

As a matter of globalization and with respect to mergers and acquisition, if we're being precise, all we're really talking about is avoiding the loss of commercial rights if nationality changes as a result of a merger or acquisition. Again, you can reduce an awful lot of this to just a couple of fairly simple propositions, unless you're awaiting the arrival of the competition Messiah.

I can't resist adding parenthetically that much of the thinking that globalization will unleash a torrent of mergers that will provide survival insurance to struggling airlines is, in my view, badly misplaced. Airline mergers historically raise, rather than lower, costs and make airlines more vulnerable to labor actions than pointed out. There is a good case to be made that keeping airline production functions separate and coordinating the network functions through alliances is actually a superior, not a temporary and expedient, form of organization. If a torrent of mergers is permitted to occur, the participants may drown. The recent example of American and TWA is instructive. Sorry, Bob.

I do not raise these matters to put obstacles in the way of opening air transport markets further. That is a cause to which I've devoted much of my professional life. Rather, it's my contention that until we start talking precisely about what we mean about liberalization, what sorts of liberalizations we mean and for whom...objections...can be raised whenever the subject is brought up, and reasoned discussion is lost in the ensuing confusion.

If in the end we're not talking about extending or redefining cabotage, except as leverage to reach the right of establishment. The cabotage objections are irrelevant and shouldn't figure in the debate. But if we really want to raise the possibility of cabotage, we need to address the issues that I have raised earlier. When we see how complicated the issues, including the political issues, are for anything but incidental cabotage, and probably even for that, and how little of value it adds to the right of establishment, we may conclude that the game is not worth the trouble and drop cabotage from the discussion, thus improving it.

If we understand that the right of establishment imposes all the obligations on a foreign-controlled entity that are imposed on domestic entity, then we must recognize that principle objections by self-styled free traders to allowing it has to be limited to those issues where the reach of domestic law may be inadequate or the opportunity value of the exchange of rights may be impaired—namely the security, defense, and access in competition policy questions that have been raised here.

To the extent that ways can be found to address those issues satisfactorily, focusing precisely on them may shift the burden of proof to those who object, given that we now accept controlling foreign investment and industries from telecommunications to supermarkets.

If we understand that the rights we're talking about will be extended very carefully and only to countries whose financial and operating integrity can be credibly ensured, and that ways must be found to reflect security and foreign policy concerns in the arrangements we reach, we may take a lot of the emotion out of the discussion. If we understand that making sure that cross-border mergers and acquisitions don't extinguish commercial rights, doesn't commit one to any particular competition policy, we can make more progress than if we allow differing views on concentration to prevent progress on the nationality issue.

In the same way, focusing precisely on issues may encourage creative solutions. For example, there may be finer tools to alleviate the Defense Department's CRAF concerns than a blanket citizenship requirement. It may be necessary to focus more precisely, as Dorothy Robyn suggested, on what arrangements are required to make sure that airlift is available in the event of a conflict not supported by allies by reference to the sealift provisions. How is it that the DOD can ensure secure sealift from foreign companies but cannot devise a system to guarantee that U.S. companies controlled by foreigners make their aircraft available in times of national need? Perhaps some techniques used for sealift can be adopted and new ones devised. A similarly focused discussion could take place with respect to U.S. airline access to Europe's access requested airports.

In short, we must specify just what expansion of rights we're talking about, where, and for whom, and then focus on each defined obstacle to further liberalization. We must move away from generalized and over broad statements of the objective.

There are relatively few issues that are obstacles to further progress carefully defined. We should address them precisely. We've come a long way in liberalizing aviation. Let's not risk backsliding, confusion, and opportunism as we look for the way forward from here. Thank you.

**[APPLAUSE]**

**Smith:** I'd like to take some questions.

**Unidentified:** I agree with most everything you said. I agree with most everything you said, other than when you talked about the cabotage issue and you talked about the value of the cabotage. And I've been wrestling recently with this whole idea of going into negotiations like this and taking each of the particular rights or benefits that are looked and try to ascribe a value to the existing system. The whole idea is to liberalize the market. When you start to ascribe value to the way the situation is now, it might be different for the labor unions who perceive this as a value in a different way as it is, for example, for Europeans who receive it maybe a third way when we get into evaluating these things in advance. Doesn't that add another layer of complexity?

**Levine:** I think it adds a great deal of simplification if you ask yourself what cabotage is really worth. The fact is that unless you can deal with the kinds of questions that I raised, you can't turn cabotage into an agreement. And I think those questions are incredibly thorny questions; they're very difficult questions. I have no objection to cabotage in principle, but I don't think it's worth trying to solve those questions in the context of either negotiation or public debate, and especially in terms of a congressional debate, in order to get European access to the United States domestic market. It just makes no sense to me that



cabotage is part of the peaceable kingdom that will occur. When the Messiah comes, the lion lies down with the lamb and so on, I don't doubt. But that it is a necessary part of useful further liberalization I have come to really question.

**Smith:** Back there.

**Unidentified:** Since September 11<sup>th</sup>, has anything in the war on terror surprised you in how you see deregulation and competition being affected?

**Levine:** Well, the thing that has surprised me the most, and probably shouldn't have if I had reflected more carefully on my own thinking about the origins of regulation, is how heavy-handed, indiscriminating, and grandstanding the government's response to the threat to airlines has been, and how much unnecessary and probably not very useful burden has been put on the system, making it much less useful for everyone, thus handicapping both the traveling public and the airline industry.

I don't doubt the seriousness of the security threat. September 11<sup>th</sup> was just as shocking to me as it was to everyone else. But I have been really surprised that the government has been unable—and when I say, the government, I mean the folks on the Hill as well as the folks in the administrative branch—been unable to be more discriminating, more careful about what they have done in response and better targeted about what they have done in response. There's been a need to strip search preachers from Des Moines and 93-year-old grandmothers of every nationality. I don't think that's been terribly useful. On a good day, they've managed to cobble together a system that doesn't feel too bad. On a bad day, it's disgraceful.

**Smith:** I think we can all say amen to that.

**Unidentified:** Mike, what I heard you say was in approaching globalization, it's more to define the issues and understand what is included and what isn't included. Looking back as a keen observer of airline regulation and a participant, what pluses and minuses of that process might you have learned, and then what (indiscernible) global solutions?

**Levine:** Well, the most important thing I learned was how long change takes, even when you create the institutional possibility for change. And that's because we did, as regulators always do, grossly underestimate what people will invent to protect themselves when institutional arrangements are changed. Samuel Johnson once commented in a very famous quote that the prospect of being hanged in a fortnight wonderfully concentrates the mind.

We thought we were unleashing an avalanche in 1978, and I suppose sitting here now, we did. And much of what's happening now is what we predicted would happen. But we didn't think it would take 25 years for the snow to reach the bottom of the mountain. And that suggests to me that those who imagine that there is going to be a radical transformation, even within the European Union, and the United States, and in the markets between them if we go to some sort of open aviation area, are going to be disappointed. Those who are slated or marked for death will not go quietly. Those who have designated themselves for triumph may discover that that designation produces in them first a kind of arrogance that keeps them from thinking clearly, and secondly, a vulnerability to their labor forces that will keep them from reaping many of the benefits that are on offer.

And so I would predict that this process will take quite a while. The process of finding out what the market will ultimately look like will take quite a while. As several people have suggested, there may be surprises. Certainly we didn't predict the importance to the hub and spoke system or the complexity of a system of common production, the fair complexity that the system of common production that the hub and spoke system represents would produce. And those are really important surprises.

So I don't know just what the trans-Atlantic open area would like five years, 10 years, 15 years from now. I would predict that it wouldn't look as different five years from now as most people think it would.

**Andy Compart, *Travel Weekly*:** Along those lines, there's been some debate already about what the benefits, supposed benefits, would be for airlines or for consumers of this globalization and open market, however you would end up defining it—and you just said how hard it will be to predict, so maybe this isn't a fair question—but can you give some idea of whether you think, will there be a benefit for airlines or consumers? And if so, what—

**Levine:** Well, for consumers, let's say in the U.S. domestic market, the benefits will only come if for some reason the U.S. starts exhausting its supply of people who are entranced by leather helmets and goggles. And what we need is a new round of international suppliers. I commented to another publication once that the history of aircraft financing is the history of finding a new round of players, inventing a new instrument to bring new money into the game every five or 10 years when it becomes clear that the last round of folks lost their money financing aircraft.

[LAUGHTER]

**Levine:** So maybe something like that will occur here, and that would be a benefit to consumers.

For the Europeans...access to the U.S. market will be, I'm sure, not as attractive in practice as it may seem in theory. But I could be proven wrong, which is, I guess, a third virtue Paul Mifsud keeps saying correctly, and Fred has commented this morning, that one advantage of loosening regulation is that if the regulators could have figured out exactly what would have been right the first time around if at least they were having a good day they would have tried to achieve it. The fact is those things are very hard to predict. And in open markets people can invent things that the regulators either couldn't think of or were inclined to stop for political reasons but ought to have gone ahead.

There's no question that on the European side, the freeing up of their aviation capital markets and structural markets from the penalties imposed by the nationality clause is by far the most important thing in this game. To the extent that U.S. consumers benefit from having European airlines offer them services, that's good for U.S. consumers. But the territorial sort of nationality benefits there are likely to look European, even as happy American consumers buy tickets.

I think the most interesting question raised is the one that was raised by Bob Crandall. I happen to disagree with his comment. I don't think that a liberalized market will necessarily boil down to just a few airlines very tightly dominating their routes. That was the strategy that was tried domestically in the U.S. market and did not succeed. I don't see why it would succeed internationally. There are some differences between international long-haul markets and domestic short-haul markets. Some of them make it harder for (indiscernible) operators to compete. Some of them make it easier actually.

On balance, my guess is that those markets will be competitive, and they'll be more competitive to the degree that there are real set of freedom opportunities, particularly for what I would call—showing my age—quasi-charter operators (people don't care about charters anymore; that's one of the benefits of deregulation)—operators who operate relatively limited frequencies at extremely high-load factors to people who are only price conscious and who will keep the fares at the bottom of the market relatively low, which acts as a discipline on the network, network carrier.

I think the people who have the most to lose price wise are business travelers in non-stop markets between hub markets that end up concentrated. They will benefit from much more frequency and availability. Most of them seem to prefer to the second alternative to the first. If you go to the folks in Minneapolis, or in Chicago, or Atlanta and say, "Here's your choice; you can be a spoke or a hub, but if you're a hub," the folks are going to pay more, they say, "Thanks, I'll pay less and have more service." But if you really push them to the wall, they don't want to give up the service. So you may see some of those effects. I'm sorry; it's a very long answer. But I don't think there's a simple one-word answer to that.

[APPLAUSE]

**Braden Cox, CEI Technology Counsel:** President George W. Bush appointed Michael W. Reynolds as Deputy Assistant Secretary of Transportation for Aviation and International Affairs in October 2002. He was named Acting Assistant Secretary for Aviation and International Affairs in June 2003. In this position, he serves as a key policy advisor to Transportation Secretary, Norman Mineta, on a wide range of domestic and international aviation issues. Since 1995 he has served as aviation counsel to the U.S. Senate Committee on Commerce, Science and Transportation. During his time on Capitol Hill, he was involved in the development of all significant aviation policy legislation passed by Congress.

In 1997, he took a six-month leave of absence from his Senate position to serve as General Counsel to the National Civil Aviation Review Commission. Prior to joining the public sector, Mr. Reynolds worked as a litigator in a San Francisco area bay law firm. Join me in welcoming Michael Reynolds.

[APPLAUSE]

**Michael Reynolds, Acting Assistant Secretary for Aviation & International Affairs, U.S. Department of Transportation:** Thank you very much. I appreciate the opportunity to be here, and I'm sorry I missed this morning's remarks. But I'm glad I was here for the lunch speaker. So I hope that if I cover anything you might've heard already, well, my apologies. But I will proceed ahead.

As I think everyone knows, under the current system of international air service agreements, which are bilateral for the most part, there are essentially two sides to the issue of cross border airline investment and ownership. First, and most important, there is the extent to which any particular state allows non-citizens to be involved with airlines operating under the authority of that state. Second, there is the extent to which state A will accept state B's designation of an air carrier that is now owned or controlled by citizens of state B. And I think these were hit upon in Mike's speech a few minutes ago.

With respect to the first, it is abundantly clear that airlines and their governments are becoming much open to loosening traditional restrictions on inward investment to improve access to capital and remove barriers to competition. In fact, as everyone here is aware, a couple of months ago, the U.S. Department of Transportation submitted to Congress a request for consideration of a proposal to grant U.S. airlines greater access to foreign capital markets. The request raises the permissible level of foreign ownership of voting stock in U.S. airlines to 49 percent provided that effective control remains in U.S. hands. This change would make U.S. law broadly consistent with the EU rules governing ownership and control of EU member state airlines.

It is the Department's sincere hope that Congress will take up and pass this provision in the near future. Liberalizing national ownership rules is something is endorsed by many, including the Air Transport Association.

Investment restrictions are a sensitive subject, but given the vital contribution that air service makes to the world economy and to our daily lives, we must begin looking at ways for airlines to have increased access to the pool of global capital.

The administration believes that it is important that airlines have the ability to attract capital investment necessary to ensure the continued ability to promote trade and economic growth, and to give our citizens access to new services. Facilitating a more global financial and ownership structure for our airlines is an important goal, and government policy makers can certainly help in this regard.

The proposed change in U.S. ownership laws would help make our carriers more competitive internationally. It would also make, as I said, U.S. laws more broadly consistent with those in the EU and with other trading partners.

The easing of restrictions on foreign investment in U.S. airlines has been one of our most challenging and controversial aviation issues for many years. But changes of this kind clearly offer the potential for significant public benefits by granting airlines greater access to that global capital market, encouraging more efficient market-driven networks and creating opportunities for new entry.

There has also been progress with respect to the issue of whether one state will accept air carriers designated by another state, even when the air carriers may be owned by citizens of a third state. This topic was perhaps the most prominent individual issue discussed during ICAO's Fifth World Air Transport conference in March. There was overwhelming support at the conference for liberalizing airline designation criteria, provided that there are clear lines of responsibility for safety and security oversight.

The U.S. has already taken steps along this line in the Multilateral Agreement on the Liberalization of International Air Transportation, or MALIAT. Under this landmark agreement, the substantial ownership provision, which is normally part of a bilateral, has been eliminated; thus, the U.S. has shown a willingness to be flexible in this area under the right circumstances.

More broadly, as Mike Levine notes, we have come a long way on liberalization, and we hope to continue down that path. U.S. DOT will continue the process of liberalization of international markets with assistance from our colleagues at State. Open skies have been a major part of the agenda for the Department for past administrations and will continue to be. And they've enjoyed bipartisan support. We already have 59 of them, and we believe that they form a firm foundation on which to build. Nevertheless, despite that much has been accomplished, much remains to be done.

Open Skies have not yet been achieved with major U.S. partners, such as the United Kingdom, Japan, Mexico, Canada, and Brazil. Those types of agreements run the gamut from those, like, the United Kingdom that require systemic change, to those, like, Canada, that require more discreet perfecting in one or more areas.

The U.S. government will pursue all reasonable opportunities and options for moving international aviation liberalization forward. And clearly the upcoming negotiations with the European Union present such an opportunity. We have talks coming on that; I imagine they've already been discussed, if not at length, at least mentioned in earlier discussions, and we remain very open minded going into these discussions.

So at this point, I'll just leave it at that, keep the remarks short. I'm certainly willing to take any questions that folks may have later, and leave it to some of our panelists here to speak. Thank you.

**[APPLAUSE]**

**Cox:** Thank you, Michael. Next we have John Byerly. John Byerly was named Deputy Assistant Secretary for Transportation Affairs in 2001. He oversees the State Department's active engagement on a broad range of international transportation issues, including the negotiation of air services agreements, development of civil aviation and maritime transport policy, airline and shipping, doing business problems abroad, transportation security, and coordination of international transport-related activities of the Departments of Transportation, Commerce, and Homeland Security. It sounds like you have a busy job there, John.

Since joining the State Department in 1979 as a member of the Office of Legal Advisor, Mr. Byerly has held a number of positions covering a spectrum of duties in American foreign policy, national security, and international economic relations. He is a career member of the Senior Executive Service and was the Department's first ombudsman for civil service employees from 1989 to 1992 reporting directly to the Secretary of State in a position held concurrently with his job as an Assistant Legal Advisor. Let's welcome John Byerly.

**John Byerly, Deputy Assistant Secretary, Bureau of Economic and Business Affairs, U.S.**

**Department of State:** Thanks very much. It's really very hard—indeed I think it's impossible—to follow the likes of Bob Crandall and Mike Levine and hope to have anything insightful to say. It's an honor for me to be included in the program with speakers like those two, as well as good friends, Paul, Dorothy, Brian, and the two Mikes. I'd like to commend the Competitive Enterprise Institute for organizing this discussion because it's a discussion like this that can move us forward.

I'd like to talk a little bit about the U.S.-EU negotiations. They really offer an extraordinary opportunity for America and for Europe to take stock of what we've accomplished in trans-Atlantic aviation over the past decade. I think they're remarkable achievements, and to explore how we can build on this. Those achievements began with the 1992 U.S.-Netherlands Open Skies agreement, negotiated in the first Bush Administration, and then continued with 14 additional Open Skies agreements we've signed during Clinton and Bush II, with existing or soon-to-be EU members. And I use the term "remarkable" because the scope of what's already been accomplished with Open Skies is sometimes lost in the debate over the Commission's recently granted mandate to negotiate a comprehensive agreement.

When I began work in international aviation back in the 1980s, the negotiations I lawyered were focused on agreements that limited the number of airlines that could fly between countries, the specific cities they could serve, the number of flights they could operate, and the government approvals. They needed to offer fares that were lower and would benefit consumers, in some cases the types of aircraft they could use or even the number of seats they had to rope off and fly empty. In short, it was an aviation market that was regulated up and down, right to left.

That changed radically, permanently, and indisputably for the better, in my view, with the bold American Open Skies initiative. In today's bilateral Open Skies markets, airlines can serve all cities in both countries without limitation on the number of flights, the type of aircraft, the order and routing of the cities served, or the fares that are offered.

Obviously the United States—this is no surprise—would like to expand the scope of Open Skies to the other 10 states that are now in or soon will be in the European Union. Those include the United Kingdom, Ireland, Spain, Greece, and the six out of the 10 accession states with which we either have no agreement or have a more restrictive accord.

But I'd like to say that Europe will find in us a negotiating party that's ready, willing, and able to discuss an expansion of opportunities for airlines and consumers that could extend beyond the established open skies model.

Negotiations won't begin until October. I'll be at the table, and I'm not going to offer here today an advanced list of concessions by my government, but we in the government—together, with the airlines, our labor unions, our airports, and communities—will be ready to engage in an open results-oriented discussion, and we hope it's one that can move the ball forward.

With that in mind, and with the desire to leave most of the time for questions and answers, let me offer three guideposts for the negotiations.

First, both sides will need to show a lot of patience and a willingness to listen. Some of the EU's proposals raise very difficult issues for the United States and American stakeholders. Just as we in the United States will have to examine European proposals carefully and with an open mind, we hope our European colleagues will seek to understand our concerns and will work with us to explore solutions. National security issues are involved, including the essential role that U.S. airlines play and will continue to play in the Civil Reserve Air Fleet. We rely upon that in the United States to transport troops and cargo in times of war and national emergency. That need's not going to go away. Obviously we're going to protect our ability to provide that vital capacity.

Some European proposals on cabotage and investment would require statutory amendments. Those amendments won't happen overnight. Ultimately you're going to have to have buy-in from U.S. stakeholders and eventually the U.S. Congress. They'll have to be persuaded that such amendments are important and they're valuable. Persuasion, if it happens, won't happen overnight. Discussions like these today are an important first step in the process.

The second guidepost: Watch out for re-regulation. The original trans-Atlantic common aviation area document prepared by the Association of European Airlines referred repeatedly to regulation, appeared to envision a form of governmental monitoring and intervention in the market place that's anathema to the Open Skies approach we've endorsed. The European Commission has told us that it does not endorse such a heavy regulatory element. That's very good news.

We do remain concerned, however, about a recurring fixation among some in Europe on a "level playing field" and a demand for sweeping harmonization of rules in areas as diverse as competition law, consumer protection, security requirements, safety rules, and environmental controls. No one can oppose a level playing field. Motherhood, apple pie, level playing field—they all have our support, and harmony certainly sounds better than disharmony. But when the concept of a level playing is transmogrified into an obsession with the height and width of each blade of grass, we get worried. The focus of any aviation agreement should be on fostering vigorous competition in the marketplace and getting government out of the way, except for the compelling interests; things like aviation security, aviation safety, core antitrust principles, and basic consumer protection.

Similarly, the not infrequent call for more robust dispute resolution and rapid fire arbitration sets off some alarm bells in the United States. Once again, the concern is that the wolves of regulation should not be allowed to creep back into the marketplace by donning the sheepskin of barrister wigs and arbitrator's robes. (I apologize for a horribly mixed metaphor.)

Obviously you've got to strike some sort of balance. I think it's fair to say that for the United States, we'll opt for less intervention, not more, in cases (indiscernible). I hope that's case.

A third and final guidepost: Let's not let the perceived perfect be the enemy of the undeniable good. I'd like to pick up precisely on the theme that Mike Levine sounded in his remarks. The United States has suggested that both sides should look at the possibility of a so-called early harvest agreement or agreements that, while not including everything either side wants, would represent a reasonable and balanced first step forward. Our intention, I want to be clear, is not to snap up everything we want and leave all of the EU's demands unfulfilled. We have far too much respect for the intelligence and negotiating abilities of our colleagues in Brussels to think that's possible. More important, it'd be the wrong thing to do.

We in the United States would do ourselves no service if we sidestep the opportunity to examine and grapple with the proposals to go beyond our open skies model. Yet precisely because these negotiations will venture into uncharted territory, it'll also take a lot of time to reach a final destination. If in the course of that journey we see an opportunity to advance the interests of both sides, again in a balanced and reasonable way, whatever that means, we should seize it.

Early harvest is not a U.S. demand, but rather a suggestion of how we might proceed if the opportunity presents itself. It could not only bring early benefits to trans-Atlantic aviation, but it could also give momentum to more comprehensive negotiations that would continue.

Many thanks for including me in today's symposium. I look forward to hearing Brian's comments and then to your questions. Thanks.

**[APPLAUSE]**

**Cox:** And with that, last but not least, Mr. Brian Havel, Professor of Law at DePaul University College of Law. He's also the Vice President of the International Human Rights Institute and Chair of the International and Comparative Law Committee. He was formerly associated with the New York international law firm of Paul, Weiss, Rifkind, Wharton & Garrison, where he practiced for five years in the areas of international antitrust and corporate litigation. He holds three graduate law degrees. At DePaul his scholarship has focused on the law and policy of the global airline industry. He's published extensively in this area, served as co-chair at a recent U.S.-EU aviation liberalization workshop, and is currently establishing an international aviation law institute at DePaul.

Interestingly enough, he's also explored the insights of Chomskyan linguistics applied to the structural understanding of the U.S. Constitution and various aspects of the phenomenon of collective memory. And with that, Brian Havel.

**[APPLAUSE]**

**Brian Havel, Associate Professor, DePaul University College of Law:** That last comment about Chomsky, Braden, will give me the egghead appellation immediately. I, as you can imagine, feel like a somewhat of a Trojan Horse European here. I'm of European background, and I think perhaps offer perspectives from both the United States and the European Union.

Fred Smith closed this morning's session by talking about ways to consider democratizing opportunities in the aviation industry, perhaps returning the focus to consumer welfare from producer welfare issues, which predominated in this morning's discussion. And then Bob Crandall in a remark addressed, I think, to Mike Whitaker, emphasized quality and availability as primary concerns of this newly transmogrified aviation industry that we are considering at forums like these.

I'm just back from Europe. I got back last night, so a slight jet lag does not remove from me the amazement that I have felt at the condition of the European aviation industry where it's now possible to find flights which can take you all over Europe for less than the cost of a cup of Starbucks decaf tall latte skimmed—absolutely amazing: £1, for example, to fly from Manchester to Belfast on BMI Baby, the new BMI discount operator. I paid £4.50—though not in euros yet, I remind you—to fly Ryan Air from Glasgow Prestwick to London...There's a myth thread running at the moment called the puzzle of Ryan Air. Here's the puzzle for you. Ryan Air just released 300,000 seats from Glasgow to Dublin for 50 p's; they say in Britain, 50 pence each. That's about 75 United States cents. Let's bring the Europeans over here!

**[LAUGHTER]**

**Havel:** Mike is suspicious about falling prices. I say let's give them the chance, and I'd like to address that issue, the specific context with you today if you will indulge me.

I wrote a book a few years ago, typical academic's approach perhaps. I advocated rather complex institutional structures for this new international aviation industry. I advocated a comprehensive Open Skies agreement that would include an open skies commission, an international court of aviation appeals, and other structures that have been described by John Byerly as ringing alarm bells at the offices of the Department of State. In fact, I don't know if he intended this, perhaps it was Freudian, but he did make a disparaging remark about sheepskin barrister's wigs. And as a barrister, of course, I took exception.

But, you know, advocating those institutions, those new complex structures as I did, was, I think, justified at one level. There is in this industry, and I think Bob Crandall reflected it in his address this morning, a sense of exceptionalism, the same sense that I think pervades the United States these days, that this a special industry, and you've got to find special solutions for this industry that don't apply anywhere else. And it's no good talking about the WTO and all those other dreadful trade organizations.

Come back to the aviation industry and focus on that. And I think the proposal that I'd like to make today or the direction which I'd like to move today respects that concept of exceptionalism.

There's been a lot of speculation. We spent the entire morning talking about the EU-U.S. Open Skies agreement, something that I hope will happen. But I think there are ways to move more expeditiously towards change in this industry. And that's what I'd like to talk about.

I think that maybe the only thing we need to do for the next 10 years is, very simply, to tackle what Barry Humphreys of Virgin Atlantic—he's the Vice President for External Affairs of Virgin Atlantic; now, I know Virgin is notorious for hyperbole and perhaps for apocalyptic statements—but he did say, and I agree with him, that the retention of the nationality restrictions borders on madness. That's what I want to talk about. I want to focus on that issue because I saw it coming through time and time again today. But that's really where we can make the biggest change in the foreseeable future, and I think I detected it between the lines of the two government representatives to my right. I'm really going out on a limb now.

What's the alternative, bankruptcy, government aid? Just at the time when the Europeans had abandoned their government subsidy approaches, we stepped in with our September 11 packages. I just describe them as packages. Why not have more flexible financial markets even if we can't predict, as Mike Levine said at lunch, the exact consequences of doing this to cope with the downturns that occur in this most cyclical of industries?

Mike Levine talked about getting a new round of dollars. Every 10 years you've got to find new investors. Well, let's bring the Europeans in, as I said. Let's give them the chance to do this. And the U.S. airlines are coming on board it seems to me. Mike Whitaker this morning I think was very clear that he supports, United supports, this approach towards removing the nationality restriction. Mike has been quoted in another place, not with hyperbole, as saying that this is a promising policy auction whose time is ripe. And I quote those words addressed, I think, to the 2003 ICAO conference.

He also mentioned at the very beginning of his talk this morning that we have failed to deregulate the US airline industry. I think that's a very telling point. I'm being hyperbolic a little bit in paraphrasing what he said. But we still have in this deregulated industry not only a failure to tackle our international relations, but a citizenship purity test. When I say it like that, it really does sound like an anachronism, doesn't it—a citizenship purity test. And as we restructure this industry in the wake of a pernicious economic legacy of the last few years, surely we can talk about changing this test.

My colleagues here from the government I'm sure are very familiar with the vast expenditure of legal brain power and ingenuity which goes into this citizenship test, the ownership and control concepts, which they reap conjunctively, ownership and control. I'll come back to that in a few minutes. They require it; they require 75 percent ownership by U.S. citizens, and two-thirds of the board of directors, and other managing officers, and the president, of course to be U.S. citizens. They require effective control of the corporation by U.S. citizens. And then they speak when they look at these issues darkly. They speak darkly, ladies and gentlemen, of the shadow of substantial foreign influence, the kind of thing that frankly you have to do behind closed doors, I suspect, these days.

But DOT and the officers of the DOT have come up with criteria to examine this question of citizenship purity. There are the direct criteria, the direct indicia, which are, of course, the tests on ownership of stock. And then you have all those indirect tests, the ones that include, are you sharing the same offices as the foreign national? Does the foreign national have more representation? Has it invested in debt equity in your company? Does it have any veto powers over significant government of the corporation, and so on—all of these indirect influential factors that occur in the analysis of the citizenship purity test.

It's a forensic process. It's a litigation process, in effect, and it produces extraordinary results. Because it's a forensic process, there is no a priori validating or invalidating factor that's going to determine the outcome of the case. It has to be done on a case by case basis. Factors are assembled, and when factors are assembled, ladies and gentlemen, when facts are stacked up, inevitably, as you know, those



of you who are litigators, you eventually have to put a thumb on the scale. You eventually have to decide what is going to be the determining result, which factor will most influence the outcome here? The German psychologists had a word for it; it's called gestalt. This is a gestalt exercise, it seems to me, based on my review of the cases, two cases in particular. This is the first time anybody's had a chance to cite case law today. I'm pleased to do so very briefly.

*Daetwyler*, 1971, is sort of regarded as the seminal decision. And then, of course, Paul mentioned earlier Northwest and KLM decided, first in 1989, and then with a good deal more liberal intent, I think, in 1991 when KLM and Northwest came back for modification of the original order.

*Daetwyler* is a fascinating case. It involved a Swiss businessman, who was trying to set up an air freight corporation in the United States. Basically he put together the corporation using U.S. citizens. The corporation was entirely owned by those citizens. Those of you who have looked at the case—it's a long case—will see an interesting thing. It's not just the Civil Aeronautics Board (CAB) decision that you can read, but also the decision of an administrative examiner. And the administrative examiner, with live witnesses before him, was very clear that he thought that the program to set up these shareholders in the United States was authentic; it served a public purpose. The CAB disagreed. And it's interesting that the CAB disagreed because they were heavily lobbied by the trade association representing the air freight companies, which were rivals to Mr. Daetwyler's new corporation in the United States.

This extraordinarily impressionistic and subjective case is nevertheless the determining case that still applies in DOT analysis. Yet there is no dominating predictive fact, nothing which you can say determines absolutely the outcome of the case. You can look at Mr. Daetwyler's associations. He had less than 25 percent of stock representation. He had less one-third of representation on the board. Admittedly, the company was associated with other companies in the Daetwyler group. But the challenged corporation was American owned with American shareholders. And the administrative examiner said, "OK, there's a degree of influence there." But how do you determine the nuances which separate the degree of influence found by the examiner from controlling fact, which was the outcome reached by the Civil Aeronautics Board?

In the KLM-Northwest case back in 1989, the first time the request was made by KLM and Northwest for approval and the citizenship challenge, the Department of Transportation found that the competitive relations between the parties was the deciding factor in not being as generous to KLM-Northwest as it might have been. But the second time when they came back in 1991, there was another factor at play, an aeropolitical factor, and that factor, of course, was the impending agreement—Paul mentioned it this morning—between the Netherlands and the United States. And the Department of Transportation specifically said that its laxity, its preparedness to modify that initial order in 1989 would be influenced, would be contextualized, by this pending agreement between the Netherlands and the United States, which came finally in 1992.

Two cases, shifting modes of interpretation cannot be acceptable to lawyers trying to negotiate their way through these labyrinthine negotiations with the Department of Transportation. Impressionistic and unpredictable criteria, what comes into play? Reading the intent of a foreign citizen, Mr. Daetwyler, what was he going to do? The examiner said, "Shouldn't we know something about his purpose, the competitive relationship between the parties, or, in fact, the final issue, the aeropolitical consequences?" Instead of simply looking, a simple examination of the restrictions on the voting powers of the voting equity held by the majority owner, that would be the simple way to do it.

You have recently an act of Congress, by the way, which I think is directed to this new...investigation involving DHL, DHL and the issue of the dominant foreign customer, which Paul mentioned at the end of his remarks this morning. Public Law 108, the Emergency Wartime Supplemental Appropriations Act provides that any company that has more than 50 percent of its customer base resourced from outside the United States should be deemed under foreign control for purposes of DOD contracts. This enactment is entirely outside, I think, the tenor of the remarks made by John this afternoon in terms of moving forward with Open Skies and moving forward with a more generous approach.

It creates another impressionistic, unpredictable factor, even though it's related specifically to DOD contracts, military contracts. It is nonetheless clear that it could be used by the DOT on the basis that it presents another external, unpredictable gestalt factor to decide a set of factors which isn't immediately clear when they're weighed up category by category.

The European Union is very similarly engaged in impressionistic activities, as those of you who are familiar with Sabena and Swiss Air decision would probably be aware. And, again, the European Union legislation focuses specifically on the notion of decisive influence, a very similar approach to the American legislation.

We're obsessive at home about the citizenship purity test, and yet we're complacent abroad. Jeffrey Shane has mentioned that we are permissive with respect to the citizenship purity requirement that appears in our international bilateral agreements. Other countries must have the same condition for their airlines—substantial ownership and control by their nationals—before we will recognize them for admission to the United States under our international bilateral agreements. And yet we have consistently waived that requirement. We're so strict about the way we look at these citizenship purity tests inside the United States, but internationally we're much more permissive and we have waived them. And John Byerly will know that recently when the European Court of Justice struck down the nationality clauses that restrict, for example, Alitalia, from flying out of Paris De Gaulle on the France-U.S. bilateral, requiring in effect that Alitalia received permission eventually to do that.

The United States responded by saying that, in fact, we would be prepared to accept a condition like that; we'd be prepared to open up those bilateral restrictions with respect to the nationality clause in Europe. We've been cooperative with Argentina's national airline when it found itself taken over by Iberia, [and] Allan Mendelson's famous case, the recent cargo line decision, where we approved the designation by Luxembourg of an airline, which is, in fact, 100 percent owned by non-Luxembourg nationals. So we clearly have found ourselves being more complacent.

If these are ad hoc outcomes, they lack certainty, and we still don't know whether, in fact, if we allow this sort of thing to happen, other countries will accept these changes of policy by the United States. Will Japan accept what we have done with Europeans, for example, if we go forward with that? Will Brazil accept? I don't think for airlines, which want knowledge-based future planning, that these are acceptable outcomes. Jeff Shane recently said that the United States is prepared to look creatively at nationality clauses. We certainly do not treat the traditional formula as sacrosanct.

I urge the government to consider these changes, to consider what can happen in the future. The government has already been extremely liberal in the APEC agreement in 2000 where the substantial ownership condition was dropped.

The EU has now developed the concept of the community air carrier, and again there is a prospect for both of these countries to come together in a marquis initiative. And we're not isolated or idiosyncratic in suggesting these changes. We are joined by the International Air Transport Association (IATA), ICAO, European Civil Aviation Conference (ECAC) OECD—all of them proposing the notion of the strong link in substitution for the nationality clause.

I would suggest that we consider some unilateral moves. I would suggest that we consider what would the U.S. do—WWUSD—in terms of its policy changes. I doubt that the Mineta proposal for 49 percent is likely to succeed, at least in the short term. It was mentioned a number of times. I would ask the Department of Transportation why it is, as I mentioned earlier, that the Federal Aviation Act, which is so specific on its face in referring conjunctively to ownership or, I should say, disjunctively to ownership or control, is read conjunctively by the Department, even though as a lawyer and with exegesis in mind, with close reading in mind, it is quite clear that the antecedent of the phrase, ownership or control, is, in fact, the voting interest of U.S. citizens.

And, therefore, it is quite clear that the Department of Transportation has defined legislative history and created this complex and, frankly, unsatisfactory system of citizenship review, perhaps without a good statutory justification.

To close, there are three critical questions that face us in the future with respect to the nationality clause. The first is that when we make the change, we preserve effective U.S. regulatory control, even though commercial control now goes to foreign nationals. And we can do this, of course, by the mechanism outlined by Dorothy Robyn in her talk this morning and mentioned by others, the notion of the right of establishment.

Secondly, we will want to make sure that other countries accept our designation of international airlines, which are owned by foreign nationals. And I would suggest to you that the aeropolitical power of the United States is likely to create the situation where those designations indeed are accepted.

And, finally, I would refer you again to Dorothy's comments about freedom of establishment in respect of shell corporations and flags of convenience. I think she addressed those issues very well.

It's time to dismantle the citizenship purity test. I recommend a centralized approach. It was recommended first by the OECD in a lengthy study that we look to the air cargo industry as our laboratory. The timing is perfect. This new DHL case tells us that the national citizenship test is entirely inconsistent with a business, such as modern cargo, which is transnational in its orientation. This notion that there's almost a rite of tribute to airlines—that they have the cargo, which is available in their home country, or all the passengers that are available in their own country, the historical genesis of the notion of all flag carriers—that's no longer acceptable.

Secondly, this is the most creative and fastest-growing sector of the aviation industry, and definitely will show us the way to restructuring and network efficiencies.

And, finally, the political environment is probably right for the air cargo industry. They've already received more liberal traffic rights from many governments. They have seventh freedom rights [the right to operate stand-alone services between two other countries] where passenger carriers do not. And I suspect that the politicians would find air cargo a more palatable option in terms of launching this liberalization process. The U.S. government told ICAO in 2003 that liberalizing cargo may build confidence and provide an important step towards full liberalization.

Economics of change are upon us. They may be unilateral if the U.S. makes the bold steps I've discussed in this presentation. They may be bilateral as they were in the U.S.-Argentina discussion. They may be regional as has happened already in the European Union. Or they may ultimately be, as John Byerly has predicted, multilateral between the United States and the European Union. But it is past time, I think, ladies and gentlemen, to repudiate this most pernicious restriction on the global corporate efficiency of the airline industry and abolish the rule that prevents foreigners—and I speak as a former foreigner—that prevents foreigners from owning national airlines. Thank you very much.

**[APPLAUSE]**

**Cox:** Brian, I want some of those \$.75 flights that come to the United States. And those are tax supported, though, are they?

**Havel:** No.

**Cox:** Okay, I just wanted to make sure. Wow, that's great. This panel, we definitely mentioned a lot of these, about the national ownership rules. Of course, that's an ongoing discussion on the political side as well, and not just academic theory.

Leading off, Brian, you've said that you don't think it's even politically compatible for the 49 percent level. Of course, I would assume you would argue that there should—and you did argue—there should

be even no restriction whatsoever. The EU just recently raised their foreign limit to 49 percent, I believe. And that is the reason the 49 percent has been—

**Havel:** Forty-nine point nine for foreign investment.

**Cox:** Forty-nine point nine, OK. Speaking as an ex-foreigner, you appreciate this. There are definitely some cultural distinctions in discussing this issue. And I assume John Byerly will get into that, and I'd like to actually hear from him and how he perceives the different cultural differences will affect the actual negotiation discussion where in certain countries their citizenry is actually proud of their national airline. And even, we heard earlier that Italians, even Italians don't want to associate with the French. So how to negotiate this turbulent cultural morass in the negotiations going forward?

**Byerly:** I don't think I'd use the word, cultural. I think that there have been elements in the past in every country's laws to look out for its aviation sector. Aviation was viewed originally as a threat to national security, something that needed to be controlled. It was the United States that in 1944 took the liberal view when international aviation was being reconstituted towards the end of the Second World War. The Chicago Conference proposed a multilateral air services agreement that was to our benefit, probably at the time because we were winners in the war and had a strong aviation industry. It was rejected by the British and by essentially everyone else. That agreement withered on the vine. It'll be interesting to see, I think, in the negotiations that begin in October—and it will continue for a while—how the European carriers line up and how their national authorities, which will be present in the room, line up. From what I hear, there does not—and Mike Whitaker alluded to this—there doesn't appear to be an enthusiasm among major European network carriers or the media for fast progress, at least in the private discussions I've had. Some of those carriers seem to be very apprehensive about granting even a greater mandate to the Commission.

**Cox:** I'd like to open up to questions. I'm sure there are plenty of them.

**Unidentified:** Assistant Secretary Reynolds, I'm hoping you can expand a little bit about what the administration is actually doing, trying to do, to get Congress to act on this increase in 49 percent,, whether you think something might move this fall, and whether you're getting any expressions of interest from anyone that's really willing to buy such a large minority stake in a domestic carrier.

**Reynolds:** Well, I'm not familiar with any interests on the private end of someone willing to make a larger investment in a U.S. airline offhand. But there have been discussions with folks on the Hill, and the hope is that there will be some attention brought to the issue. And I believe there has been some expression of interest in perhaps holding hearings on both sides of the Hill on the issue. So perhaps it will be. The debate in Congress will be kicked off, hopefully, in the near future. But we certainly don't control the agenda of either chamber. And we will just have to keep working with them and hope that they will move forward.

**Unidentified:** Notwithstanding the interpretation of the statutory provisions, I agree with John Byerly's statement that any change beyond the 49 percent would require congressional action to change the limits on ownership control beyond 49 percent. At a time when most Americans are putting national security and the economy at the top of their list of concerns, it would appear the sea change in public opinion would be required to go beyond a 49 percent proposal for foreign ownership and control of airlines. My question is to Brian Havel. How would you propose to change U.S. public opinion and get the kind of support that would be necessary to get to the statutory changes made?

**Havel:** Well, I think I'd refer you back to my opening comments about the competitive structure of the European low-fare industry, and the expectation of that could be transferred to the United States.

I agree with you that the 49 percent, Dorothy mentioned this morning was symbolic in its intent. And in fact, it's commercially useless. I don't think any European airline at this point, after the rather burning experiences of the last 20 years of attempting to invest in U.S. airlines without control, would be

interested in a 49 percent non-voting, or voting equity rather, without the assurance of what's commercially appealing, which is control of the airline. So I'm certain that that will not be a factor in changing public opinion. I just don't think it's going to have that kind of impact.

This is something that's going to have come through what I like to call the global webs of influence. I think there is an unstoppable momentum—among the various international organizations I mentioned, with the U.S. government, the policy of Open Skies mentioned by John Byerly, and with the European Commission's new mandate—there's an unstoppable momentum to do this. Maybe people will point the finger and say it's elitist, but on the other hand, so was the airline deregulation process in 1975. It was not something that was a groundswell activity from the people of the United States. And the vox populi, frankly, is not going to be the determining factor. I think it's people sitting in this room and people who know people sitting in this room who are going to make that change.

**Unidentified:** (First part of question unintelligible). Mr. Havel can address why would a foreign carrier want to invest money in a U.S. airline that's losing money?.

**Byerly:** I think the elements of a potential first and earliest harvest agreement, as we understand the European position, they have three legal problems determined by the European Court of Justice that need to be addressed. They are illegalities from a European law perspective in the agreements we have with the European Union members, the computer reservations systems annex, a rather complicated provision of internal pricing in the EU by U.S. carriers, and the so-called nationality clause, ownership, and control provision.

We've already indicated back in January in discussions with individual member states that we could fix, we believe, the first two without any real problem. It's not something that harms us. We thought, in fact, we had European law-compliant provisions. So did the member states when they signed the agreements they rather drafted with savings clauses we thought did the trick. It didn't do the trick, according to European Court of Justice. We can fix that.

The real focus is on the nationality clause. I would assume that from a European perspective no agreement is possible unless they eradicate the illegalities that were identified by the Court. And so we'd have to focus on whether there's a way we can find to meet European legal requirements with a nationality clause that's satisfactory to them, but that doesn't introduce an unbalanced result or an unfair result. Take the U.S.-London market as a prime example. The last thing we want to do would be to make that horrible situation under the Bermuda II agreement even worse through what we do with nationality clauses with other countries, to allow Germany to designate British carriers. They would gain greater rights flying from Heathrow to the United States, and U.S. carriers would get nothing in return. That's just an outcome that won't fly at all.

On our side, we've started the consultation process with our industry, with airlines, with our unions, with airports, and communities to figure out what they want, what they see as very important. Some things are obvious. I mentioned in my remarks that there are 10 countries in Europe where we don't have Open Skies right now. We'd like to have Open Skies, with those countries. In fact, we think several of those countries at a minimum have expressed interest in the past.

They held off or had reservations about moving forward with us because of legal concerns, especially in the case of the accession states. A number of them decided their priorities. Priority number one: Make sure we get in the European Union; that really matters to us. Down the list somewhere: Conclude an Open Skies agreement with the United States. Maybe now that's cleared a way. The Commission has its mandate. In the negotiating room will be the Commission and all 25 member states. Maybe we can make some progress there.

There are other things. We'd like to have a more structured dialogue between the Department of Transportation as a competition authority in the United States and its European counterpart, DG Competition in Brussels. That'd be helpful, not that we're going to harmonize our anti-trust laws or rules,

but rather, through discussion, we can avoid untoward results when alliances are reviewed in other such matters. That'd be a positive, I think, a positive right now for both sides, something we should do promptly.

There are other issues. We have seven freedom cargo rights in some, but not all, of our existing Open Skies agreements. We'd like to have those. We'd like to introduce intermodal rights; that is, trade planar provisions, which we have with Germany and with France, but not with all the Open Skies partners. We'd like to include those.

There may be other provisions we'd like to explore. We're beginning that process with our carriers, and again, this is not going to happen overnight. But we would like to see if the opportunity arises. Those are some of the elements that we think could be included. I'm sure the European side will have things it would like to look at in the equation.

Then the real question in any negotiation is: Can you reach that balance point? Can you reach that place where you feel, okay, that's good enough. Let's see if we can put this together, and then move on with the negotiations in the future. And I think it'd be positive, at least something we should keep in mind.

**Reynolds:** Let me add real quickly to that. While we may not directly be, as you have said, directly be looking for harmonization, I think over time what we're going to find is there will be regulatory convergence just out of practicality. We're seeing that in the antitrust area with merger law between the EU and the U.S., and obviously it's going to happen in this market, too.

**Byerly:** I would add, in fact, that our experience in talking with the Commission on alliances—the American Airlines-British Airways example is a case in point—the first time around there was a huge difference in perception. There were some staff changes, at least in Brussels, maybe a difference in Commissioner. But also I think through the dialogue we had, there was a lot more convergence. Now it wasn't a convergence that made either BA or American happy when the case was decided by the Department of Transportation and was on the cusp of decision by the British Office of Fair Trading. But the analytical approaches started to approach each other much more closely. So I think you could see convergence. We can't promise it.

**Havel:** I want to follow up on that question as to why a European airline might be interested in rescuing a bleeding U.S. airline. I think the initial answer is that the Europeans will begin the process in their own jurisdiction through mergers and consolidations. But after all, this process, if it succeeds, if the citizenship purity tests are removed, will create the opportunity for European airlines, not necessarily to rescue failing U.S. airlines, but to set up their own competitors, subsidiaries in the United States.

And in any event, even if they didn't want to do that, they might be interested in having the route network of a U.S. airline and transferring to that route network their brand identities. Because amazingly, of course, as has happened in the past 30 or 40 years, the flag carriers, so disparaged this morning in a number of comments, have established very strong brand identities, trustworthy identities, which could be transferred to those bleeding U.S. airlines. So let's not exclude the possibilities of change that are being that are being discussed today.

Paul mentioned that a lot of you may be economists. I'm not sure whether that's true or not. You may recall the CAB economic report on deregulation sponsored by Senator Kennedy back in the mid-70s, which predicted that by the year 2000, the United States would have 1,000 commercial airlines. That hasn't happened. Now it's time, as Mike Levine said, to go back to the drawing board and make sure that internationalizing regulation, completing deregulation, and completing that process fulfills the prediction made by those CAB economists.

**Carlos Bonilla, Washington Group:** John, putting aside for a moment the cynical view that the reasons we're engaged in this process is to give a whole new round of suckers an opportunity to lose

money in U.S. aviation, putting that aside, is there a consideration of the weakened financial structure of U.S. industry and its ability to adapt to change?

**Byerly:** Well, Carlos, that's a tough question. The easy answer is, of course, we'll consider everything. Is it a focal point right now in or deliberations? No. We're beginning the process.

I do think the thing that could—and I've heard others in other conferences talk about it—the thing that could conceivably change U.S. thinking on foreign ownership and control quickly is if, in fact, there was a case where a U.S. carrier needed assistance, and the only rescuer in the white hat and on the white horse riding in is a foreign carrier. You could find the political momentum from that carrier's hub's senators and congressmen. You could find the administration saying that sure beats spending a lot more money for state aid or seeing a carrier go under and the damage that could do to a central air service or other policy objectives. That said, I'm not sure there are going to be many European carriers wanting to bail out, invest in, or take over a U.S. carrier. It remains to be seen.

**Cox:** We do have time for one last question.

**Doug Andrew, UK Civil Aviation Authority:** You made quite a strong pitch during your comments about removing barriers taking into account competition and all that. What you (indiscernible) as though removing barriers (indiscernible) negotiate (indiscernible) trade off between (indiscernible) European and American (indiscernible) Europe that the American economy. This is the production of (indiscernible) which you might (indiscernible) deregulation.

**Byerly:** I think if I gave you a good answer about what's going on in my own mind now, it'd be even more incoherent than my remarks, or I'd give away a negotiating position that we haven't even developed yet. This is going to be a long process. The United States is not going into these negotiations, and I will not have, as we start this, a letter of instruction that my bosses in State and Mike and his bosses in Department of Transportation said, "The bottom line for the United States in these negotiations is 48 percent, or 73 percent, or this piece of cabotage, but never any more, or fly America well in Alaska only." We won't have that sort of instruction.

We're going to approach the process to listen, to explore the issues and find out how Europe prioritizes its needs and its desires. It won't be a take-it-or-leave-it whole package approach, I don't think. It's just not the way I believe the negotiations will progress. And we'll make up our minds.

It's going to be very important to engage staff and members of Congress in this process as it proceeds so they understand what's being talked about. The worst thing we could do would be to develop this great idea in my mind or in some Executive branch minds, and then suddenly toss that at Congress and say, "Here's what we've got; please give us your approval. Change the statutes in the following ways." It's going to be an iterative, long, difficult, learning process, and I think that's the way to approach it. So we go in with an open mind rather than a bunch of positions that we will not do this, and we will insist upon this. There are things we want to achieve. We're proud of our Open Skies program; we'd like to expand it, but we're also willing to look at the other issues.

On the issue of regulation, the only point I was making is that if we're able to liberalize, to open skies or even beyond, let's be sure that, through many agreements, we don't take away that liberalization through the façade of lots of dispute resolution provisions, or commitments for (indiscernible) sort of to harmonization. A lot of harm can be done there, and I think our first axiom should be, as with doctors, do no harm. And that's what's were trying to avoid.

**Cox:** All right. Well, thank you very much. Thank you very much, panelists. Let's all give them a hand.

**[APPLAUSE]**

**Cox:** Now for concluding remarks.

**Smith:** This has been, I think, timely and provocative, more provocative than I thought it was when I started planning this issue. Thanks to Bob Crandall for kicking us off to a—kicking, I think, is the appropriate term—to a very fast start. I think, what he said was very, very informative. But, basically, first things first. You know, elephants are out there. Go after them before you start shooting mice. I think all of us agree that there are many more problems than the ones we're dealing with here. And I don't think he necessarily was saying we should ignore these other problems. He just has different priorities as he often does.

The first panel with Mike Whitaker, Paul Mifsud, and Dorothy Robyn essentially went back and suggested that there are certainly are risks involved in these types of changes, but that the gains are really significant, and it really is worth going in this direction. We shouldn't ignore the potential fruit there just because there's fruit on other trees and in other gardens.

Mike Levine, I think, brought us back again to the questions mode. Like all people now who are reflecting on what they have achieved, he's saying, "Oh my God, I climbed that mountain." I think there's a tremendous amount to be learned by the fact that change is always risky. It's always a good idea to check out the ground before you invade Europe because you can make mistakes.

The last panel—we just heard them, Mike Reynolds, John Byerly, and Brian Havel, led by Braden Cox—essentially indicates that both the administration, at least on this side of the ocean, is interested and is prepared to look out for opportunities, both long term and short run, and that we've got a receptive attitude to change from the administration, which is already a tremendous gain in this area. And then Brian, I think, in a very provocative way, raised the whole moral issue of citizenship purity. I like the terminology.

But we're in a policy race. We understand that this is the beginning of something that's been going on and will continue long after we're all gone. Policy races in this sense always occur on racetracks that are awash in molasses. No matter how you run, things keep keeping sticky and you don't go as fast as you can.

But remember that was also true with transportation deregulation. The origins--Jim Miller (indiscernible) elsewhere tells when he was a young staffer at the Interstate Commerce Commission (ICC), I think it was, and one of the commissioners called him inside and said, "Oh, look at this young staffer here. He thinks we can eliminate the ICC." And there was titters, and Jim Miller tells the story, "But I remembered, and eventually I got them."

Political change requires that we have intellectual arguments that make sense, that we have some idea of what we're trying to achieve, that we've reached out and educated the relevant publics. The changes we want to make are legitimate and have gains, value gains.

If you've got a good product, if you've marketed it well, and if you've got lots of people clamoring for it, then you can anticipate the politicians will be eager to lead the parade. We saw that in transportation deregulation where it was impossible until it became obvious that it would happen with Kennedy and others leading a bipartisan effort to bring about deregulation.

We're still a long way from reaching anything like that in a global area. But changes like this are the starting point. And, as I tell my staff, I think you all know from your own experiences, when you're in the middle of a battle, it's awful hard to see whether you're winning or losing. It's a little like a kid playing in the waves at a beach. The tide is coming in or it's going out, but all you know is you're just getting battered around by the waves at the moment.

Whether it's going in or out or not we're not sure, but let's make sure we're fighting to bring it out. So thank you very much. Thank all of our panelists today. I think it's been a good conference. I'll thank you for coming.



[APPLAUSE]