

SELECT COMMITTEE ON  
THE EUROPEAN UNION

“OPEN SKIES” OR OPEN MARKETS?  
THE EFFECT OF THE EUROPEAN  
COURT OF JUSTICE (ECJ) JUDGMENTS  
ON AVIATION RELATIONS BETWEEN  
THE EUROPEAN UNION (EU) AND THE  
UNITED STATES OF AMERICA (USA)

WITH EVIDENCE

---

*Ordered to be printed 8 April 2003*

---

PUBLISHED BY AUTHORITY OF THE HOUSE OF LORDS  
LONDON – THE STATIONERY OFFICE LIMITED

[price]



## CONTENTS

|  | <i>Paragraph</i> | <i>Page</i> |
|--|------------------|-------------|
| ABSTRACT .....   | 1                | 7           |
| CHAPTER 1: BACKGROUND .....  | 1                | 9           |
| Origin of Air Service Agreements (ASAs) .....  | 1                | 9           |
| Liberalisation of Aviation in the EU .....   | 4                | 9           |
| US Domestic De-regulation.....   | 5                | 10          |
| Current Restrictions on Air Services Between the USA and the EU .....  | 6                | 10          |
| EU Competition Policy and US Anti-Trust Legislation .....  | 9                | 11          |
| Other Aspects of Air Transport Already Covered by European Community<br>Legislation and Where the Community has Extensive External Competence..... | 11               | 12          |
| Slot Allocation at Community Airports.....   | 11               | 12          |
| Ground Handling at Airports.....   | 12               | 12          |
| Safety Issues .....  | 13               | 13          |
| Customs Duties, Taxes and (User) Charges .....   | 14               | 13          |
| Restrictions on Aircraft for Environmental Reasons .....   | 15               | 13          |
| The Application of Community Competition Law to Aviation.....  | 16               | 13          |
| What this Report Addresses .....   | 19               | 13          |
| Wider Economic Background .....  | 22               | 14          |
| Acknowledgements .....   | 25               | 14          |
| CHAPTER 2: DEALING WITH THE EUROPEAN COURT OF JUSTICE  |                  |             |
| JUDGMENTS OF 5 NOVEMBER 2002.....  | 28               | 15          |
| The Commission’s View of the Judgments .....   | 29               | 15          |
| The United States Response .....   | 32               | 16          |
| Position of EU Member States .....   | 33               | 16          |
| Position of the United Kingdom.....  | 35               | 17          |
| Views of the Airlines.....   | 36               | 17          |
| British Airways.....   | 36               | 17          |
| Virgin Atlantic.....   | 38               | 18          |
| BMI British Midland .....  | 40               | 18          |
| KLM Royal Dutch Airlines .....   | 42               | 19          |
| Association of European Airlines .....   | 44               | 19          |
| A Second Communication from the Commission .....   | 45               | 20          |
| The Committee’s Views .....  | 48               | 21          |
| Denouncing Existing ASAs with the USA .....  | 52               | 22          |
| CHAPTER 3: A WIDER MANDATE FOR THE COMMISSION? .....   | 53               | 23          |
| Does the Commission Have the Capacity to Conduct Such Negotiations and<br>what Benefits Would a Successful Negotiation Bring?.....                 | 55               | 23          |
| Advantages in a Community Approach.....  | 58               | 23          |
| State Aid for the Airlines.....  | 60               | 24          |
| Benefits of Liberalisation .....   | 62               | 24          |
| CHAPTER 4: POSITION OF THE UNITED STATES .....   | 67               | 27          |
| Intra-EU Route Pricing and Computer Reservation Systems .....  | 68               | 27          |
| “Nationality” Clause.....  | 69               | 27          |
| EU Denunciation of Bilateral ASAs .....  | 70               | 27          |
| Limits on Foreign Ownership and Control.....   | 72               | 28          |
| Fly America Requirements.....  | 73               | 28          |
| Civil Reserve Air Fleet (CRAF).....  | 74               | 28          |
| Anti-Trust Immunity .....  | 75               | 29          |
| The Brattle Report .....   | 78               | 29          |
| US Attitudes to an EU/US Agreement .....   | 79               | 29          |
| The Committee’s Views .....  | 87               | 30          |
| CHAPTER 5: CARGO AND WET LEASING .....   | 92               | 31          |
| An Uneven Market.....  | 92               | 31          |
| Bermuda 2 and its Effect on the Competitiveness of United Kingdom Exporters ...  | 94               | 31          |
| A “Mini Deal” .....  | 95               | 31          |
| A Mandate for the Commission?.....   | 96               | 31          |
| Wet-Leasing .....  | 97               | 32          |
| The Department for Transport’s Response.....   | 99               | 32          |

|  |     |    |
|--|-----|----|
| CHAPTER 6: CONCLUSIONS OF THE COMMITTEE .....  | 101 | 33 |
| The ECJ Judgments .....  | 101 | 33 |
| A “First” Mandate for the Commission.....  | 102 | 33 |
| A Wider Mandate .....  | 103 | 33 |
| Liberalisation.....  | 104 | 33 |
| Competition .....  | 105 | 33 |
| Denouncing Existing ASAs .....   | 107 | 34 |
| An Opportunity.....  | 108 | 34 |
| <br>   |     |    |
| Appendix 1: Membership of Sub-Committee B.....   |     | 35 |
| Appendix 2: Call for Evidence.....   |     | 36 |
| Appendix 3: List of Witnesses .....  |     | 37 |
| Appendix 4: Glossary of Terms .....  |     | 38 |
| Appendix 5: The “Freedoms” of the Air.....   |     | 45 |
| Appendix 6: The Exclusive External Competence of the Community.....  |     | 46 |
| Appendix 7: US Official Comments on EU “Open Skies” Ruling .....   |     | 48 |
| <br>   |     |    |
| Box 1: Original Standard Designation of the Ownership and Control—“nationality”—clause<br>prior to the ECJ Judgments of 5 November 2002 .....            |     | 9  |
| Box 2: Third EU Aviation Package—Summary .....   |     | 10 |
| Box 3: Salient Features of an “open skies” agreement that distinguish such agreements from<br>Bermuda 2 .....  |     | 11 |
| Box 4: Revised Ownership and Control—“nationality”—Clause to Take Account<br>of the ECJ Judgments of 5 November 2002 .....                               |     | 20 |
| Box 5: Airport Capacity: Heathrow and the Question of Slots .....  |     | 26 |
| <br>   |     |    |
| <b>ORAL EVIDENCE</b>   |     |    |
| <i>Professor Piet Jan Slot, Leiden University</i>  |     |    |
| Oral evidence, 20 January 2003 .....   |     | 1  |
| <br>   |     |    |
| <i>Professor Eileen Denza and Mr Richard Gardiner</i>  |     |    |
| Written evidence .....   |     | 6  |
| Oral evidence, 20 January 2003 .....   |     | 9  |
| <br>   |     |    |
| <i>Association of European Airlines (AEA)</i>  |     |    |
| Written evidence .....   |     | 16 |
| Written evidence from Air France.....  |     | 18 |
| Oral evidence, 27 January 2003 .....   |     | 18 |
| <br>   |     |    |
| <i>Civil Aviation Authority (CAA)</i>  |     |    |
| Written evidence .....   |     | 23 |
| Oral evidence, 27 January 2003 .....   |     | 26 |
| Supplementary evidence .....   |     | 33 |
| <br>   |     |    |
| <i>European Commission, Mr Michel Ayrat, Director of Aviation , DG-Tren, and<br/>    Mr Frank Benyon, Senior Legal Adviser</i>                           |     |    |
| Oral evidence, 3 February 2003 .....   |     | 36 |
| Written evidence from Mme Loyola de Palacio, Vice-president for Relations with the<br>European Parliament and Commissioner for Energy and Transport..... |     | 43 |
| <br>   |     |    |
| <i>BMI British Midland</i>   |     |    |
| Written evidence .....   |     | 44 |
| Oral evidence, 3 February 2003 .....   |     | 47 |
| <br>   |     |    |
| <i>British Airways Plc</i>   |     |    |
| Written evidence .....   |     | 52 |
| Oral evidence, 10 February 2003 .....  |     | 55 |
| Supplementary evidence .....   |     | 61 |
| Additional Supplementary evidence .....  |     | 62 |

|  |     |
|--|-----|
| <i>Virgin Atlantic Airways Limited</i>   |     |
| Written evidence .....   | 63  |
| Oral evidence, 10 February 2003 .....  | 66  |
| <i>British Cargo Airline Alliance (BCAA)</i>   |     |
| Written evidence .....   | 69  |
| Oral evidence, 10 February 2003 .....  | 72  |
| <i>Charter Airline Group of the UK (CAGUK)</i>   |     |
| Written evidence from Air 2000 .....   | 75  |
| Written evidence from Charter Airline Group of the UK .....  | 76  |
| Oral evidence, 10 February 2003 .....  | 76  |
| <i>Department for Transport, Rt Hon John Spellar MP, Minister of State for Transport,<br/>Mr Roy Griffins, Director, Aviation Directorate, Mr Michael Smethers, Head of<br/>Multilateral Division, and Mr Alan Jones, Legal Services</i> |     |
| Written evidence .....   | 81  |
| Oral evidence, 24 February 2003 .....  | 85  |
| Supplementary evidence .....   | 92  |
| Additional Supplementary evidence .....  | 93  |
| <i>Air Transport Users Council</i>   |     |
| Written evidence .....   | 94  |
| Oral evidence, 24 February 2003 .....  | 97  |
| <i>Professor Kenneth Button, George Mason University, USA</i>  |     |
| Written evidence .....   | 102 |
| Oral evidence, 12 March 2003 .....   | 106 |
| <b>WRITTEN EVIDENCE</b>  |     |
| BAA plc .....  | 120 |
| DHL Air Limited.....   | 121 |
| easyJet .....  | 124 |
| FedEx .....  | 126 |
| German Directorate General for Civil Aviation, Aerospace and Shipping .....  | 127 |
| M J Hall.....  | 129 |
| Trevor Soames, Geert Goeteyn, Dr Peter D Camesasca, Howrey Simon Arnold & White LLP  | 132 |
| KLM Royal Dutch Airlines.....  | 135 |
| Ryanair .....  | 137 |
| Brian Simpson MEP.....   | 137 |
| David Starkie.....   | 139 |

NOTE: Pages of the Report and Appendices are numbered in **bold** type; pages of evidence are numbered in ordinary type. References in the text of the Report are as follows:

Q refers to a question in the oral evidence;

page refers to a page in the oral or written evidence;

paragraph(s) refers to a page in the Report (unless otherwise stated).



# SEVENTEENTH REPORT

---

8 APRIL 2003

---

By the Select Committee appointed to consider European Union documents and other matters relating to the European Union.

ORDERED TO REPORT

## “OPEN SKIES” OR OPEN MARKETS?

### THE EFFECT OF THE EUROPEAN COURT OF JUSTICE (ECJ) JUDGMENTS ON AVIATION RELATIONS BETWEEN THE EUROPEAN UNION (EU) AND THE UNITED STATES OF AMERICA (USA)

14663/02      Communication from the Commission on the consequences of the Court Judgments of 5 November 2002 for European air transport policy.

#### ABSTRACT

1. The European Court of Justice (ECJ) handed down a series of judgments on 5 November 2002 against eight EU Member States. These judgments affect the web of bilateral air service agreements (ASAs) between EU Member States and non-EU states. The ECJ judgments deal with two issues:

- the “nationality” clause (see box 1); and
- articles relating to computer reservation systems and intra-EU tariffs in “open skies” ASAs signed by some EU Member States with the United States of America.

2. The “nationality” clause was deemed to have infringed Article 43 of the Treaty establishing the European Community, and the “open skies” infringements offended the principle of exclusive Community competence (see Appendix 6).

3. There is, therefore, a need to bring ASAs into conformity with Community law. The question is, how should this be done? Individually by Member States? Or collectively by the European Commission on behalf of the Community holding a mandate from Member States? Or by Member States in coordination with the Commission?

4. The European Commission, in its Communication dated 19 November 2002, called on Member States to denounce existing bilateral ASAs with the United States, and to agree a mandate for the Commission to negotiate all aspects of ASAs.

5. This position was modified in a second Communication published on 26 February 2003, when the Commission sought to distinguish between the need to address the “infringements” that flowed from the ECJ judgments, and the pursuit of a wider mandate aimed at renegotiating full ASAs with the United States on a *bloc to bloc* basis.

6. This wider mandate’s objective would be the creation of what is known as the Trans-Atlantic Common Aviation Area (TCAA) or the Open Aviation Area (OAA). The aim is to bring about a fully liberalised aviation area comprising the United States and the European Union going further than the existing “open skies” agreements in removing restraints on air services.

7. Supporters of liberalisation claim that considerable benefits will flow from more open markets, but it is often not clear where the benefits will fall. To the airlines or to the consumers? There are also differences between the passenger market, and the air freight and wet leasing markets. (See Appendix 4 which contains a glossary of terms.)

8. This report examines these issues and the US responses, and makes the following recommendations:

- (a) **that Member States should give the European Commission a limited mandate to negotiate with the USA to bring EU Member States’ bilateral ASAs with the United**

**States into conformity with Community law as specified in the ECJ judgments of 5 November 2002;**

- (b) **that Member States should give the Commission a wider mandate to renegotiate ASAs with the United States of America initially, and subsequently with major aviation powers such as Russia and Japan in order to achieve full liberalisation in aviation;**
- (c) **that it would not be in the European Union's interest, or the United Kingdom's national interest, to negotiate for any thing short of a fully liberalised aviation market between the EU and the US. The Committee believes that in current circumstances it may be necessary to deal first with issues under (a) above before moving on to issues under (b) above as a second phase of negotiations;**
- (d) **that HMG resist the Commission's call to denounce existing bilateral ASAs with the USA.**

9. The Committee also concluded that greater liberalisation would bring economic benefit—it had already done so in the case of internal US liberalisation, and intra-EU liberalisation. Although the extent of the long-term benefits for liberalisation for both airlines and passengers has, perhaps, been overstated, such benefits were real and therefore the effect on the wider economy would be advantageous. An agreement to extend full liberalisation to the US, Russia and Japan would effectively open up some 80 per cent of the world aviation market.

10. The Committee held informal talks with the US authorities, and concluded that the US would be prepared to enter negotiations with the European Commission to deal with the changes required by the ECJ decisions, and would, in principle, also be prepared to enter into negotiations with the European Commission in order to achieve greater trans-Atlantic liberalisation.

## CHAPTER 1: BACKGROUND

## ORIGIN OF AIR SERVICE AGREEMENTS (ASAS)

1. Civil aviation is currently supported by a multiplicity of bilateral air service agreements (ASAs), which in themselves derive from the 1944 Chicago Convention that re-affirmed the nation states' sovereignty over air space. EU Member States currently operate some 1,500 ASAs, of which the United Kingdom has 149.

2. Bilateral air service agreements deal with the administrative provisions necessary to facilitate the operation of air services between the two states and with the economic provisions. These include the following elements:

- points and/or routes served;
- number of airlines which can be designated by each state to fly those routes;
- whether there are any capacity and frequency restrictions;
- whether “fifth freedom” rights have been granted, if any (see appendix 5 and glossary at Appendix 4); and
- provisions for setting tariffs.

3. The standard designation article (see box 1) requires, “that substantial ownership and effective control of that airline are vested in the Contracting Party designating the airline or in its nationals”. This is commonly referred to as the nationality or ownership article. This practice—established in 1944—reflected the position of nation states at that time, the concern of such states about the security of their airspace, and the fact that most states operated a national airline.

**Box 1**

*Original Standard Designation of the Ownership and Control—“nationality”—clause prior to the ECJ Judgments of 5 November 2002*

**Article 4****Designation and Authorisation of Airlines**

(1) Each Contracting Party may designate in writing to the other Contracting Party one or more airlines for the purpose of operating the agreed services on the specified routes and to withdraw or alter such designations.

(2) On receipt of such a designation the other Contracting Party shall, subject to the provisions of paragraphs (3) and (4) of this Article, without delay grant to the airline or airlines designated the appropriate operating authorisations.

(3) The aeronautical authority of one Contracting Party may require an airline designated by the other Contracting Party to satisfy that authority that it is qualified to fulfil the conditions prescribed under the laws and regulations normally and reasonably applied to the operation of international air services by that authority in conformity with the provisions of the Chicago Convention.

(4) Each Contracting Party may refuse to grant the operating authorisations referred to in paragraph (2) of this Article, or impose such conditions as it may deem necessary on the exercise by a designated airline of the rights specified in Article 3(2) of this Agreement, in any case where the said Contracting Party is not satisfied that substantial ownership and effective control of that airline are vested in the Contracting Party designating the airline or in its nationals.

(5) When an airline has been so designated and authorised it may begin to operate the agreed services, provided that the airline complies with the applicable provisions of this Agreement.

*Source: Department for Transport*

## LIBERALISATION OF AVIATION IN THE EU

4. Within the European Community, the liberalisation process began in 1987 with the adoption of a first package of measures aimed at opening up the traditionally restrictive bilateral arrangements.<sup>1</sup> A

<sup>1</sup> Council Directive 87/601 and Council Decision 87/602. Official Journal reference L374, 31 December 1987.

second package agreed in June 1990 built on this foundation,<sup>2</sup> and a third package of measures was agreed in June 1992.<sup>3</sup> As a result, a single market in air transport in the European Community came into being on 1 January 1993. Box 2 summarises, using United Kingdom airlines as an example, the new freedoms available under the third aviation package.

### Box 2

#### *Third EU Aviation Package—Summary*

##### **New Freedoms from 1 January 1993**

— United Kingdom airlines able to fly between other Member States without starting or ending at a British airport (so-called “seventh freedom” rights, e.g. Paris–Rome);

— Possible for United Kingdom airline to fly between destinations within another Member State, following or preceding a flight from the United Kingdom (“consecutive cabotage”, e.g. London–Rome–Naples). A capacity limitation applies;

— Free setting of fares: new fares and changes in existing fares come in immediately, and all restrictions on low fares have been swept away;

— Any airline which meets uniform financial, safety and EC ownership and effective control requirements is entitled to an operating licence in any Member State where it is based;

— Charter services are included in the package for the first time. All remaining restrictions, e.g. on “seat only passengers”<sup>\*</sup> have been removed;

— No special status for national flag carriers, in the form of discretionary route licensing or protection from competition on routes, is allowed.

##### **New Freedoms from 1 April 1997**

— Airlines able to fly purely internal routes within other Member States, e.g. United Kingdom airline flying Rome–Naples (“stand alone” cabotage), without restriction: any remaining regulation of national airlines for internal routes will go.

\* Charter seats sold without accompanying accommodation or other services.

*Source: Department for Transport*

#### US DOMESTIC DE-REGULATION

5. In the United States, the Airline Deregulation Act of 1978 ended some 40 years of rigid “public-utility” type regulation of the US domestic aviation market—the world’s largest. Most economists believe that de-regulation has been a resounding success, triggering an explosion of air travel and bringing inexpensive travel within the reach of people of relatively modest means. By providing competition and incentives to innovate, de-regulation has also led to significant improvements in airline operating efficiency.

“Most important, it accelerated the shift from bureaucratically governed linear route structures to network structures based on hub-and-spoke operations. By funnelling traffic through large hub airports network carriers have reaped economies of scope and density and travellers have benefited from more frequent flights to many more destinations. Economists estimate that these and other operational efficiencies have allowed carriers to lower their costs in the United States by 25 per cent since de-regulation.”<sup>4</sup>

#### CURRENT RESTRICTIONS ON AIR SERVICES BETWEEN THE USA AND THE EU

6. Bilateral “open skies” agreements, which govern competition between the United States (US) and 11 European Union (EU) Member States, stop short of complete liberalisation. Most important, they deny foreign entities the ability to own and control an existing (US) domestic air carrier, or to

<sup>2</sup> Council Regulations 2342/90, 2343/90, 2344/90 of 24 July 1990. Official Journal reference L217, 11 August 1990.

<sup>3</sup> Council Regulations 2407/92, 2408/92, 2409/92.

<sup>4</sup> *The Economic Impact of an EU-US Open Aviation Area*—a report by the US Consultancy, the Brattle Group, commissioned by the European Commission and published in December 2002—paragraph 1.2.

establish a new one within the US (“right of establishment”)<sup>5</sup>; restrict important traffic rights such as a foreign (non US) carrier’s right to provide domestic services (“cabotage”) within the US; limit opportunities for EU airlines to wet-lease (see paragraphs 97 and 98) their aircraft into the US and impose restrictions on US government traffic and air traffic related contracts (“fly America”) (see paragraph 73). Trans-Atlantic routes between the United States and the four remaining EU Member States (Greece, Ireland, Spain and the United Kingdom) are governed by bilateral agreements that are more restrictive. (See Box 3 for a summary for the differences between “open skies” and the US/UK Bermuda 2 agreement. See also paragraph 28(b), and Appendix 4 containing the glossary of terms.)

### Box 3

#### *Salient Features of an “open skies” agreement that distinguish such agreements from Bermuda 2*

Under a US so-called “open skies” agreement, there is no restraint on access to the market and no capacity restrictions. There are also no restriction on 5th freedom services, i.e. airlines of both parties have the right to pick up traffic in the other state and carry it to a third country. However, “open skies” agreements do not give rights to the airlines of either party to exercise cabotage rights within the other state.

Under Bermuda 2, access to Heathrow is restricted to two airlines from each country. Routes from Gatwick, while open to all airlines of both countries, are limited in terms of the US gateways that can be served. Service frequencies are capped from both Heathrow and Gatwick and 5th freedom rights from both those two airports are limited to various named points on various named routes. There are no restrictions on services from United Kingdom airports other than Heathrow and Gatwick to anywhere in the US.

(For a summary of the key provisions of Bermuda 2, see Annex A (p97) of the Memorandum by the DETR to the ETRAC Report on Air Service Agreements between the United Kingdom and the US – July 2000.)

*Source: Department for Transport*

7. In general, the following restrictions apply on air services between the USA and the EU:

- EU carriers can fly directly to the United States only from their own country, whereas US airlines can fly generally from any “open skies” EU country to any US point; this distorts competition on trans-Atlantic routes in favour of US airlines and limits competition between European Union airlines;
- EU carriers cannot merge without risking loss of the US traffic rights; this thwarts EU airline consolidation and further limits competition;
- mergers of US and EU carriers have so far proved to be impossible because of US ownership and rights of establishment policies;<sup>6</sup> some EU airlines have settled for a looser relationship based on alliances or partnerships with US airlines; this still puts many of the potential benefits of cross-border consolidation out of reach;
- limits on cross-border investment mean that failing EU and US carriers have restricted options for fresh capitalisation;
- US domestic passengers are denied the benefits of foreign competition.<sup>7</sup>

8. Under the US “open skies” agreements,<sup>8</sup> those EU Member States that have signed these agreements have ceded fifth freedom rights to American carriers, thus giving American airlines an ability to operate between EU points which is effectively a form of cabotage within the European Single Market.

#### EU COMPETITION POLICY AND US ANTI-TRUST LEGISLATION

9. The European Commission would like to negotiate the removal of all commercial restrictions on EU-US aviation competition and investment creating a single open market encompassing the provision of air transport services not only between, but also within, Europe and the United States.

<sup>5</sup> There are also restrictions in the EU—see paragraph 72

<sup>6</sup> There are also restrictions in the EU—see paragraph 72

<sup>7</sup> The Brattle Report, Executive Summary, paragraph I

<sup>8</sup> The US uses a standard ASA which it calls an “open skies” agreement because it is more liberal than the older, restrictive bilateral agreements such as that between the US and the UK (see box 3).

This is referred to as an “open aviation area”. However, according to the Brattle Report, and contrary to general belief, this open aviation area would not create new institutional or regulatory structures, and would not seek to harmonise EU and US competition policy or regulation of aviation safety,<sup>9</sup> security and environmental impact.<sup>10</sup> Nevertheless, recent press<sup>11</sup> reports suggest that the European Commission will be looking into the effect of anti-trust immunity currently enjoyed by certain alliances involving airlines of those EU Member States that have signed “open skies” agreements with the US. Anti-trust immunity by the US transport authorities may be granted when a non-US carrier enters into an alliance with a US carrier. The US Department of Transportation appears to grant this immunity only to alliances involving airlines of countries that sign “open skies” agreements with the US (see paragraph 32).

10. In principle, therefore, the differences between the United States and the European Union stem largely from the fact that the United States aviation market is a single domestic market, whereas the European Union is a multi-state common market, but where the individual Member States have to date retained the privileges of independent nation states negotiating international bilateral agreements with nation states outside the European Union. Thus, whereas the granting of fifth freedom rights by European Member States on international routes within Europe effectively gives US airlines a form of cabotage within the common European market, the US domestic market can be protected by refusing to reach agreement on domestic cabotage (see box 3).

#### OTHER ASPECTS OF AIR TRANSPORT ALREADY COVERED BY EUROPEAN COMMUNITY LEGISLATION AND WHERE THE COMMUNITY HAS EXTENSIVE EXTERNAL COMPETENCE

##### *Slot Allocation at Community Airports*

11. On 7 December 1992, the Council agreed a Regulation<sup>12</sup> to standardise slot allocation procedures at Community airports. The Regulation is now due for revision in a two-stage process: the first stage, a limited “technical” revision, the second, a more radical revision. Proposals for the first stage were published in June 2001<sup>13</sup> and were part of a Commission strategy designed to:

- clarify the legal nature of slots;
- promote efficient slot allocation;
- encourage the efficient use of slots;
- enhance competition between incumbent carriers and new entrants; and
- provide a stable environment for hub and spoke networks.

The first phase is limited to defining the existing situation pending the completion of a study from consultants who are due to report later this year (2003). Phase 2 will propose, as yet unidentified, changes to the existing structure. United Kingdom airlines, the United Kingdom Slots Regulator and the Government will be keen to preserve the United Kingdom’s secondary market system for slot allocation. In oral evidence, the Minister expressed support for a transparent secondary market in slots e.g. at Heathrow.<sup>14</sup>

##### *Ground Handling at Airports*

12. This covers a variety of airport activities including passenger check-ins, loading and unloading of luggage, operation of luggage carousels, positioning of ramps and steps, fuelling of aircraft and handling of freight and mail. The Council adopted a Directive in 1996 to liberalise ground handling services.<sup>15</sup>

<sup>9</sup> While the US is content to accept countries that have similar levels of aviation safety, not all current EU Member States meet the US’s “Level 1” rating. For example, Greece has a “Level 2” rating and the US might seek to put restrictions on Greek-registered airlines using the traffic routes to the US of “Level 1” EU Member States.

<sup>10</sup> The Brattle Report, Section 1, 1.1.

<sup>11</sup> *European Voice*, Vol XXX 27 February–5 March 2003.

<sup>12</sup> Official Journal reference L14, 22 January 1993.

<sup>13</sup> EM 10288/01 (now EM 14205/02) COM(2002) 623 final – amended proposal for a Regulation of the European Parliament and of the Council amending Council Regulation (EEC) No 95/93 of 18 January 1993 on common rules for the allocation of slots at Community airports.

<sup>14</sup> Q 367

<sup>15</sup> Official Journal reference L272, 25 October 1996.

*Safety Issues*

13. Regulation EC No1593/2002 of 15 July 2002 sets out common rules in the field of civil aviation and establishes a European Aviation Safety Agency.<sup>16</sup>

*Customs Duties, Taxes and (User) Charges*

14. Council Directive 92/12/EEC of 25 February 1992 deals with the general arrangements for products subject to excise duty and the holding, moving and monitoring of such products and the exemption of aviation fuel from excise duties covered by Council Directive 92/81/EEC of 19 October 1992.

*Restrictions on Aircraft for Environmental Reasons*

15. There are several restrictions which limit the operation of aircraft including rules and procedures with regard to noise-related operating restrictions at Community airports.

## THE APPLICATION OF COMMUNITY COMPETITION LAW TO AVIATION

16. The European Community's competition law is set out in:

- Article 81, which outlaws agreements between firms which may affect trade between Member States, and which prevent, restrict or distort competition in the single market;
- Article 82 which bans the abuse of a dominant position in the market; and
- the Merger Control Regulation: Council Regulation 4064/89 which gives the Commission jurisdiction over mergers with a Community dimension.<sup>17</sup> This was subsequently modified in 1997 (Regulation 1310/97).<sup>18</sup>

17. The application of Articles 81 and 82 to air transport services within the Unions is governed by Council Regulation 3975/87<sup>19</sup> and Regulation 3976/87.<sup>20</sup> This Regulation does not, however, apply to external aviation services, which remain subject to the rudimentary procedural regime set out in Articles 84 and 85 TEC.

18. In June 1997, the Commission submitted a proposal<sup>21</sup> to extend Regulation 3975/87 to cover air services outside the Union. This proposal made no progress, but has most recently been revived.<sup>22</sup>

## WHAT THIS REPORT ADDRESSES

19. The Committee considered the Community's external aviation relations in 1991<sup>23</sup> and airline competition in 1998.<sup>24</sup> In this report we examine the effect of the judgments handed down by the European Court of Justice on 5 November 2002.

20. The Court made judgments on eight cases brought by the European Commission against Austria, Belgium, Denmark, Finland, Germany, Luxembourg, Sweden and the United Kingdom.<sup>25</sup> There are two cases outstanding against France and the Netherlands. All Member States listed above, except the United Kingdom, have signed "open skies" bilateral air service agreements (ASAs) with the United States of America (see box 3).

21. The Court found that:

<sup>16</sup> Official Journal reference L240/1 of 7 September 2002.

<sup>17</sup> Official Journal reference L395, 30 December 1989.

<sup>18</sup> Official Journal reference L180, 9 September 1997 and L40 13 February 1998.

<sup>19</sup> Official Journal reference L374, 31 December 1987. The Regulation will be replaced, as from 1 May 2004, by Regulation 1/2003.

<sup>20</sup> Official Journal reference L374, 31 December 1987.

<sup>21</sup> COM(1997) 218 final.

<sup>22</sup> Proposal for a Council Regulation repealing Regulation (EEC) No 3975/87 and amending Regulation (EEC) No 3976/87 and Regulation (EC) No 1/2003, in connection with air transport between Community and third countries. COM(2003) 91 final.

<sup>23</sup> *Conduct of the Community's External Aviation Relations*, 9th Report Session 1990-91, HL Paper 39

<sup>24</sup> *Airline Competition*, 32nd Report, Session 1997-98, HL Paper 156.

<sup>25</sup> As above (1) minus the United Kingdom. The US uses a standard ASA which it calls an "open skies" agreement because it is more liberal than the older, restrictive bilateral agreements such as that between the US and the UK (see box 3).

- (a) the eight Member States had infringed Article 43 of the TEC through the ownership and control clause in their existing ASAs with the USA—the so called “nationality” clause; and
- (b) in addition, articles dealing with certain issues—such as intra-EU pricing and computer reservation systems—in the seven “open skies” ASAs were also in breach of Community law because these areas were within the exclusive competence of the Commission (see Appendix 6).

#### WIDER ECONOMIC BACKGROUND

22. Aviation is not immune to the world downturn in economic activity, but is particularly susceptible to it. The attack on the twin towers in New York on 11 September 2001 brought about a sudden drop in passenger traffic, but this was against a background of increasing weakness in both the US airline industry and in the European airline industry. The current war in Iraq will not make it easier for the airlines to survive. IATA fears that passenger travel could drop some 15–20 per cent during this period. The past three years have been characterised as the worst crisis in the history of aviation.<sup>26</sup> The continued rapid rise of the low-cost carriers such as easyJet and Ryanair even in the aftermath of the terrorist attack on 11 September 2001, has only served to highlight the structural flaws in the aviation industry. There are too many airlines, particularly over the North Atlantic. A number of US airlines are in severe financial difficulty. There have been recent reports of cuts in capacity by BA, Air France and Lufthansa—the latter affected by losses made by BMI where Lufthansa has a substantial share-holding—reflecting a combination of short-term retrenchment against a longer-term weakening of the aviation market.

23. Against this background, it could be argued that an attempt to use the ECJ judgments as a lever to bring about fuller liberalisation between the US and EU aviation markets demonstrates a poor sense of timing. However, a liberalised market is essential to bring about the restructuring of the airline industry on both sides of the Atlantic. Conversely, opting for a semi-liberalised aviation market based on the US “open skies” model will simply postpone the restructuring that the Committee believes will ultimately be necessary in order to ensure a financially stronger aviation industry in North America and in Europe. But the economic downturn, and in particular the parlous financial position of many of the airlines, will not make a negotiation between the EU and the US any easier.

24. This report is divided into six chapters. In Chapter 2, we examine how to put right the specific breaches in Community law identified by the ECJ judgments. In Chapter 3, we consider whether or not Member States should give the European Commission a mandate to negotiate an “Open Aviation Area” with the United States. In Chapter 4, we look at the possible responses of the United States; in Chapter 5, at the problems faced by EU all-cargo operators. Finally, in Chapter 6, we give the Committee’s conclusions.

#### ACKNOWLEDGEMENTS

25. This report is based on an inquiry carried out by Sub-Committee B (Energy, Industry and Transport). The Membership of Sub-Committee B is given in Appendix 1 below. The witnesses are listed in Appendix 2; the Call for Evidence can be found in Appendix 3. We are grateful to all the witnesses for their evidence and particularly to those who travelled to the United Kingdom in order to give oral evidence.

26. During the course of this inquiry the Committee made a short visit to Washington to hold informal discussions with the United States Department of Transportation, the United States Department of Justice, American Airlines, Northwest Airlines, Delta Airlines, the Air Transport Association of America and the Brattle Group. We also took evidence from Professor Button of George Mason University, Washington. We are grateful for the willingness of our American interlocutors to share their views with us. We are particularly grateful to the staff of the British Embassy, Washington, for arranging this visit and for their advice and hospitality.

27. Finally, we should like to thank the Specialist Adviser, Professor Rigas Doganis, for his assistance during the inquiry and in the preparation of this report.

---

<sup>26</sup> Comment and Analysis, *Financial Times*, Wednesday March 26 2003.

---

CHAPTER 2: DEALING WITH THE EUROPEAN COURT OF JUSTICE JUDGMENTS OF 5 NOVEMBER 2002

28. The European Court of Justice decisions deal only with two specific areas covered by existing ASAs. The Court concluded that:

- (a) “nationality” restrictions infringe Article 43 of the TEC; and
- (b) “open skies” agreements with the US (but not the UK/US ASA known as “Bermuda 2”) cover issues within the exclusive competence of the Commission, such as fares on intra-EU routes and provisions relating to computer reservation systems.

THE COMMISSION’S VIEW OF THE JUDGMENTS

29. The Conclusions of the Commission’s Communication of 9 November 2002 read as follows:

“The judgments of the European Court of Justice of 5 November 2002 on the so-called “open skies” cases against eight Member States, not only have implications for the eight specific agreements with the United States but also for existing bilateral aviation agreements between Member States and other third countries and for any future negotiation of bilateral air service issues.”

“According to Article 10 of the Treaty, Member States shall take all appropriate measures, whether general or particular, to ensure fulfilment of the obligations arising out of the treaty or resulting from action taken by the institutions of the Community.”

“Moreover, as the Court found in the judgments of 5 November 2002, in the case of an infringement stemming from an international agreement Member States are prevented not only from contracting new international commitments, but also from maintaining such commitments in force...”

“...in the light of the foregoing considerations, the Commission has requested the eight governments directly concerned by the judgments to activate the provisions for denunciation contained in their agreements with the United States in order to ensure at the earliest possible date compliance with the judgments of the Court of Justice.”

“The Commission has also requested the remaining seven Member States to activate the provisions for denunciation contained in their agreements with the United States in order to ensure compliance of their agreements with Community law and to avoid the necessity to pursue further infringement procedures.”

“More generally, the Commission has asked all Member States to refrain from making international commitments of any kind in the field of aviation before having clarified their compatibility with Community law.”

“Finally, in order to take the first step forward in this area, the Commission has urged the Council of the European Union to agree a mandate as soon as possible for negotiations to replace the existing bilaterals with the United States with an agreement at Community level.”<sup>27</sup>

30. The European Commission argues that only it has the competence to remedy the infringements in existing ASAs. When the Community has or acquires an internal competence, the application of that competence externally is for the Community alone (see Appendix 6). This is a view supported by many witnesses.<sup>28</sup> Subsequently, the Commission, in its first Communication on the judgments, asked Member States:

- (a) to denounce their ASAs with the US—that is to say, to give the requisite notice of termination; and
- (b) to give the Commission a negotiating mandate in all areas including some where it has no current competence, for example traffic rights.

31. These were ambitious demands. There is no doubt that the infringements identified by the ECJ in existing ASAs have to be removed. Some witnesses stated that Member States were obliged to do this themselves and had the right to do so bilaterally. The argument in this instance between Member

---

<sup>27</sup> EM 14663/02 COM(2002) 649 final: Communication from the Commission on the consequences of the Court Judgments of 5 November 2002 for European air transport policy.

<sup>28</sup> DTI written evidence page 82, paragraph 10; written evidence from Professor E Denza and Mr R Gardiner, page 8.

States and the Commission is: who should make the changes?—the Commission (on a mandate), the Member States themselves, or both.

#### THE UNITED STATES RESPONSE

32. The United States government has expressed a willingness to modify its ASAs bilaterally with EU Member States.<sup>29</sup> (For a fuller account of the US position, see Chapter 4 and Appendix 7.) However, it should be noted that in the first instance the United States government made this offer specifically to those EU Member States that have signed “open skies” agreements with the United States, and circulated a new text to replace the existing ownership article. This would allow designation of any airline having its “principle place of business” in the designating state. However, this proposal has not been made formally to the United Kingdom.<sup>30</sup> It was also pointed out to the Committee while it was in Washington that EU airlines from Member States that have signed “open skies” ASAs with the US already have rights granted by the US (fifth freedom) to fly from other EU states to the US. It is EU Member States that are currently preventing airlines from doing this by not granting fifth freedom rights to the USA to other EU States.

#### POSITION OF EU MEMBER STATES

33. Although all EU Member States’ Civil Aviation Authorities were invited to submit evidence to the Committee, only the German authorities gave evidence (see paragraph 34 below). Member States have been considering collectively how to respond to the Commission’s two Communications. According to the Government,<sup>31</sup> there appears to be a general reluctance on the part of Member States to accept that the Commission’s interpretation of the judgments necessarily excludes Member States from remedying the breaches of Community law themselves. The Council has still to adopt a common position on the matter. The subject was discussed at the 27 March Transport Council when it emerged that “most Member States were willing to give the Commission a mandate but only in return for greater certainty over future arrangements for the negotiation and implementation of bilateral agreements in the light of the recent judgment of the European Court of Justice. The Presidency concluded that work would continue with a view to reaching agreement in June”.<sup>32</sup>

34. The Committee received evidence from the German Civil Aviation Authority (Bundesministerium Für Verkehr, Bau, und Wohnungswesen (BMVBW)). In a covering letter, Dr Thilo Schmidt, Deputy Director General, wrote:

“in my view, the ECJ’s judgments form a solid basis to shape the external aviation relations with non-EU countries in the spirit of close co-operation of the Community institutions involved in the field of international civil aviation”<sup>33</sup>

And in the body of the evidence, the BMVBW states:

“as regards infringements which are founded in commitments affecting the Treaty (article 43) it appears to be difficult, although not impossible, to bilaterally agree with the other contracting party on adequate remedial action. In this respect a common approach by all Member States concerned appears to be indispensable in order to ensure conformity with the Treaty. In our view, consent by the European Commission is also required in addition to agreement by the other contracting party.”

This careful wording introduces a nuance and seems to suggest that while Member States will have to address the specific requirements of the Court, they should do so jointly and in association with the Commission. However those who would wish to deny the Commission a role in dealing with the ECJ judgments stress that those States that have been found wanting are “obliged” to amend their ASAs. In other words, they argue that the Court effectively placed the onus on the Member State.<sup>34</sup> According to some witnesses, alliances between EU and US airlines might lose their US anti-trust immunity if “open skies” agreements were denounced.<sup>35</sup> However, this view of possible US reaction was not supported by the US authorities during the Committee’s visit to Washington.

<sup>29</sup> US State Department taken questions 20 November 2002 and speech by Assistant Deputy Secretary of Transportation, Jeffrey Shane, at an American Bar association forum in Florida, 8 November 2002.

<sup>30</sup> Q 327.

<sup>31</sup> Q 325.

<sup>32</sup> PQ, House of Commons Official Report (Hansard), 2 April 2003, Vol 402 No 76, Col 703W.

<sup>33</sup> Covering letter to BMVBW written evidence (not printed).

<sup>34</sup> CAA written evidence, page 23, paragraph 2; Memorandum by T Soames, G Goeteyn and Dr P D Camesasca, page 132, paragraph 4.

<sup>35</sup> Memorandum by T Soames, G Goeteyn and Dr P D Camesasca, page 132, paragraph 4.

## POSITION OF THE UNITED KINGDOM

35. The position of the United Kingdom Government is notably cautious and for good reason:

“The UK Government is clear, however, that the judgment does not go so far as to preclude Member States from negotiating bilateral agreements, provided these comply with relevant provisions of Community law.”<sup>36</sup>

And,

“we recognise that we should secure agreement from our aviation partners to effect appropriate changes to nationality-based designation clauses in existing aviation bilateral agreements.”

“There are many issues...on which Member States will want to reach an understanding with the Commission in the light of the Court verdict. These include the question of to what extent existing bilaterals with the US may remain in force pending the conclusion of Community level negotiations and also to what extent Member States may continue to negotiate, or at least update, bilaterals with the US during the period of Community-level negotiations.”

The United Kingdom Government is currently attempting to persuade bilateral partners to accept a clause of its own devised to take heed of the ECJ judgments (see box 4).<sup>37</sup>

## VIEWS OF THE AIRLINES

*British Airways*

“I believe last November’s judgment of the European Court of Justice offers a great opportunity to modernise the arcane, indeed the archaic, regulation of the aviation industry...I hope, therefore, that this Committee’s report will be able to provide clear guidance to the British Government and the European Commission on how to use this opportunity to normalise our industry.”<sup>38</sup>

36. So said Mr Andrew Cahn, Director of Government and Industry Affairs, British Airways, when presenting oral evidence to this Committee on 10 February 2003. The Committee found this position surprising. British Airways has a commanding position at Heathrow; in any negotiation led by the Commission, it might well find this position threatened. BA’s response is that having survived in an intensely competitive United Kingdom domestic market, the airline was confident that it could survive in a liberalised environment, particularly when the block on ownership and control was removed.<sup>39</sup> In supplementary written evidence, British Airways proposed that Member States give a mandate to the Commission to negotiate on behalf of the Community, and that negotiations be phased. Its reasons for agreeing a mandate are that:

“since the Community has more power as a negotiating bloc than individual states and has the competence to propose changes to some of the existing restrictive European Regulations, an EU-led US negotiation is more likely to achieve the whole package than Member States on their own.”

Turning to how the negotiation might proceed, BA argues that:

“the body of the negotiation including the hard rights inherent in an open skies<sup>40</sup> deal must necessarily remain as a coherent whole in order to exercise the requisite leverage on the US to provide for access to the hinterland. However, there are shorter and longer-term issues which can be discussed in separate phases in order to facilitate the progress of the overall negotiation. Our suggested phasing model is as follows:

- initial phase: right of establishment; issues of Community competence; overall shape of deal; and timetable;

<sup>36</sup> DTI written evidence, page 82, paragraph 4.

<sup>37</sup> States which have accepted a designation article on the model of that in Box 5/XXX: Macao SAR, Albania, Serbia and Montenegro, Slovakia, and Algeria. States that have declined to accept this proposed change to ASAs: China, South Korea, Brazil, Ukraine, and Egypt. Georgia is still considering whether or not to accept or decline.

<sup>38</sup> Q 230.

<sup>39</sup> Q 232.

<sup>40</sup> BA presumably means an “Open Aviation Area” or “Trans-Atlantic Common Aviation Area”. The term “open skies” applies only to the restricted US model for ASAs.

- main phase: open skies<sup>41</sup> including liberalisation of routing and traffic rights; pricing freedom; code-sharing, “Fly America” restrictions removed; wet leasing restrictions eased; foreign ownership limit raised to 49 per cent and then to 100 per cent (legislative changes needed); consecutive and free standing cabotage (legislative changes needed).”

37. This division into two phases and, in effect, two mandates, coincides with the views of the Committee, namely that the first mandate should be to put right the issues that have appeared as a result of the ECJ judgments of 5 November 2003 and a second mandate would cover the restrictions that currently impede the operation of a fully liberalised Trans-Atlantic Aviation Area recognising that this will require legislative changes in the United States.

#### *Virgin Atlantic*

38. Virgin Atlantic, too, foresee a phased agreement, but recognise the ECJ Judgments of 5 November 2002 as the lever to bring about a fully liberalised aviation market, and to expand a Trans-Atlantic Common Aviation Area to embrace countries such as Australia, Singapore and Canada.<sup>42</sup>

“Virgin Atlantic has consistently over many years campaigned for the removal of...the archaic rules which still apply to international aviation...the current rules which we are forced to operate under have resulted in an artificial industrial structure which is not in the interests of the industry anymore than it is in the interests of the consumer. The decision of the European Court of Justice in our view provides a real opportunity to achieve the goal we have been seeking for a long time.”<sup>43</sup>

39. Contrary to British Airways’ concept of phased negotiation, Virgin Atlantic envisage tackling the “hard rights”—“to include liberal ownership control and cabotage rights”—in the first phase, and is remarkably optimistic about the time required to achieve it. But Virgin Atlantic also recognise that full liberalisation will require legislative changes both in Europe and in the United States which would take time. It therefore regards such issues as falling into a second phase. The third phase, which British Airways describe as “ongoing”, would deal with “soft rights” e.g. competition policy, environmental issues etc.<sup>44</sup> Virgin Atlantic’s interest in dealing with ownership and control and cabotage issues in a first phase reflects its global strategy. For example, Virgin set up an airline in Australia when the Australian domestic market was de-regulated, and told the Committee that it would wish to do so in the United States.<sup>45</sup> Virgin Atlantic subsequently announced plans to set up a US company even though it will be limited to 25 per cent of the voting shares.<sup>46</sup>

#### *BMI British Midland*

40. The position of the third major United Kingdom carrier, BMI British Midland, was at odds with that of BA and Virgin Atlantic. BMI British Midland argued that the willingness of those two airlines to support a mandate for the European Commission was based on a cynical awareness that this would take considerable time, during which the existing UK/US ASA would preserve their status at Heathrow. BMI British Midland argue, however, that multilateral liberalisation “should result in the opening up of competition in all Member States” in the long-term, “but in the short-term it is clear that the difficulties and the complexities of the EU negotiating with the US mean that it is likely to take significantly longer to achieve that liberalisation than if, for example, the United Kingdom Government was encouraged in the next few months to attempt to negotiate a deal with the Americans that would allow us all—indeed it would not be us, it would be a third national carrier of EU nationality—to fly from Heathrow to the US”.

41. BMI British Midland’s position may well be coloured by its relationship with Lufthansa (which owns 30 per cent of BMI British Midland and already enjoys the benefits of a US “open skies” ASA) and because BMI British Midland is also seeking to persuade the Government to obtain a Heathrow/US route in exchange for concessions for the US cargo carrier FedEx on services from the United Kingdom to Europe (see paragraph 95).

<sup>41</sup> BA presumably means by this term an “Open Aviation Area” or “Trans-Atlantic Common Aviation Area”. The term “open skies” applies only to the restricted US model for ASAs.

<sup>42</sup> Q 258.

<sup>43</sup> Q 258.

<sup>44</sup> Q 259.

<sup>45</sup> Q 263.

<sup>46</sup> *The Financial Times*, 24 March 2003, page 26.

*KLM Royal Dutch Airlines*

42. In its written evidence to the Committee, KLM Royal Dutch Airlines argued that in those areas affected by the ECJ judgments, changes could only be made by the Commission which had sole competence. On the issue of Article 43 of the Treaty—the “nationality” clause—KLM stated that

“in order to enable the Member States to rectify this inconsistency, the Commission must supply to the Member States language which provides for conformity with Article 43 of the Treaty”.

This is a subtle point: it does not specify whether Member States should negotiate bilaterally to a Commission text or whether Member States act in coordination with the Commission.

43. On the question of a general mandate, KLM Royal Dutch Airlines argues that the present bilateral system is both inefficient and outdated, and that, “the development of the European air transport industry (including the United Kingdom air transport industry) would be best helped along by a coordinated EU-broad approach.” This formulation, however, falls short of recommending that Member States grant the Commission a negotiating mandate.

*Association of European Airlines*

44. In written evidence to the Committee the Association argues that,

“we believe the Member States are entitled to renegotiate in such a manner as that there will be clauses that satisfy the requirements of legal experts both of the Commission and of the Member States involved”.

In other words, AEA did not consider it necessary to grant the Commission a specific mandate to negotiate the remedies to the problems identified in the ECJ Judgments. The AEA’s concern appeared to be that whatever was required of the eight Member States to bring them into compliance with the requirements of the Court, the Council should decide at a political level whether a mandate should be granted to the Commission to negotiate on behalf of all Member States. The AEA seemed particularly anxious to break any implicit link between the ECJ decisions and the requirement to change the existing pattern of ASAs.<sup>47</sup>

---

<sup>47</sup> Q 95 and Q 87.

**Box 4**

*Revised Ownership and Control—“nationality”—Clause to Take Account of the ECJ Judgments of 5 November 2002*

**Article 4****Designation and Authorisation of Airlines - Principal place of business version**

(1) Each Contracting Party may designate in writing to the other Contracting Party one or more airlines for the purpose of operating the agreed services on the specified routes and may withdraw or alter such designations.

(2) On receipt of such a designation the other Contracting Party shall, subject to the provisions of paragraphs (3) and (4) of this Article, without delay grant to the airline or airlines designated the appropriate operating authorisations.

(3) The aeronautical authority of one Contracting Party may require an airline designated by the other Contracting Party to satisfy that authority that it is qualified to fulfil the conditions prescribed under the laws and regulations normally and reasonably applied to the operation of international air services by that authority in conformity with the provisions of the Chicago Convention.

(4) Each Contracting Party shall have the right to refuse to grant the operating authorisations referred to in paragraph (2) of this Article, or impose such conditions as it may deem necessary on the exercise by a designated airline of the rights specified in Article 3(2) of this Agreement, in any case where:

(a) Country X is not satisfied that the said airline:

i) is incorporated and has its principal place of business in the territory of a Member State of the European Union or of an European Free Trade Association State party to the Agreement on the European Economic Area; and

ii) holds a current Air Operator's Certificate issued by the aeronautical authority of a Member State of the European Union or of an European Free Trade Association State party to the Agreement on the European Economic Area; or

(b) the United Kingdom of Great Britain and Northern Ireland is not satisfied that the said airline:

i) is incorporated and has its principal place of business in the territory of Country X; and

ii) holds a current Air Operator's Certificate issued by the aeronautical authority of Country X.

(5) When an airline has been so designated and authorised it may begin to operate the agreed services, provided that the airline complies with the applicable provisions of this Agreement.

*Source: Department for Transport*

**A SECOND COMMUNICATION FROM THE COMMISSION**

45. On 26 February, the Commission submitted a recommendation to the Council for authority to open Community negotiations with all bilateral partners on the ownership and control i.e. “nationality” issue.<sup>48</sup> The mandate would be following “the procedures set out in Article 300 of the Treaty creating a special Committee of Member States representatives to assist and support the Commission”. The Commission added, however, that it “would also be mandated to address other issues of Community exclusive competence with a view to incorporating these into the Community agreement.

“The Commission envisages that the outcome of the negotiations could take several forms. The simplest would be a short stand-alone agreement in which the parties agreed to a revised definition of the beneficiaries that would override the relevant clauses in the existing bilateral agreements. Such an agreement should also contain new provisions covering other matters of Community competence as identified by the Commission in its previous Communication of 19 November 2002. This agreement would be the subject of Community signature and conclusion. Member States would maintain their own agreement with the country concerned dealing with matters of national competence. This situation would be maintained until such time as a

<sup>48</sup> 2003/0044 (COD) – COM(2003) 94 final: Communication from the Commission on relations between the Community and third countries in the field of air transport – Proposal for a European Parliament and Council Regulation on the negotiation and implementation of air service agreements between Member States and third countries.

mandate is granted for a full negotiation on a Community agreement. For most countries, this is likely to remain some time in the future.”

46. On the face of it, this would appear to offer a sensible solution to the general difficulties that have arisen from the ECJ judgments. A Community mandate would ensure that any changes were made uniformly and at the same time. Unfortunately, this Communication came too late for the Committee to put to the Minister in the oral evidence session on 24 February 2003. The Communication has since been submitted to the Committee, and the Government’s view is covered by Explanatory Memorandum 7047/03 COM(2003) 94 final. The EM argues that the effect of the Commission’s Communication of 26 February is to recognise that Member States will continue to negotiate with their bilateral partners, though the Commission will wish to ensure non-discrimination among Community carriers in the allocation of traffic rights agreed in such negotiations. The proposed Regulation aims to ensure that bilateral negotiations would be conducted in such a way as to produce results compatible with Community law, and that there would be a proper information exchange within the Community and non-discriminatory treatment of European airlines by Member States. In addition, in implementing the results of any negotiations, the Commission would want to be sure that all eligible EU airlines had an equal chance to apply for, and to take up, the traffic rights negotiated by Member States.

47. In his Explanatory Memorandum, the Minister says that,

“In principle, the UK Government is open to giving the Commission a mandate to negotiate an Open Aviation Area with the US, provided it would not preclude Member States acting bilaterally if Community-level talks failed to progress. But the UK, along with other Member States, has indicated that a mandate must be part of a package agreement encompassing a number of issues on which Member States need to reach an understanding with the Commission in the light of the Court verdict.”

“By addressing the need of Member States to be able to negotiate new bilateral agreements, or to re-negotiate existing ones, in conformity with Community law, the latest proposal by the Commission contains the seeds of a compromise agreement. The proposed Regulation is in principle acceptable to the UK Government, although we will need to consider carefully a number of areas where the procedures appear unduly cumbersome or impose limitations on Member States’ future freedom of action. Areas for discussion include the requirement in Article 1 for Member States to communicate to the Commission their intention to negotiate with a bilateral partner at least one month before making contact with that country. I consider that this provision could disrupt normal business contact with bilateral partners to an unacceptable degree. I am also concerned about Article 4(2), which would give the Commission wide powers to object to the conclusion of a bilateral agreement if it considered it incompatible with Community law, and about Article 3, which would preclude Member States agreeing limited designations.”

“I also consider that it would be helpful if the Commission offered up a standard Community designation clause which Member States could use in their negotiations with their bilateral partners, but the Commission has so far refused to do so. We will pursue this point when negotiations in Working Group resume.”

#### THE COMMITTEE’S VIEWS

48. The Committee considered whether the changes occasioned by the ECJ judgments should be made by Member States bilaterally or by giving the Commission a restricted mandate to do so with and on behalf of Member States. The chief arguments that favour a mandate are that any amendments to the existing ASAs ought to be uniform and to take place at the same time. If individual Member States were to renegotiate, even with the agreement of the Commission, it is unlikely that they would be able to meet these two *desiderata*.

49. Other EU Member States that were not directly mentioned in the ECJ judgment because there were no cases in the Court against them are not specifically obliged by the Court to renegotiate their ASAs. They are bound implicitly, however, by the consequences of these judgments. But, if eight Member States were to amend their ASAs, and seven did not do so at the same time as the other eight, then there would be an imbalance, if only temporarily, in the rights available to airlines of different Member States that could affect competition issues.

50. Response from witnesses shows a clear predominance in favour of the Commission remedying the flaws in current ASAs identified by the ECJ judgments.<sup>49</sup> In particular, the two largest United Kingdom airlines have demonstrated powerful support in favour of a mandate for the Commission even though their current positions, for example, at Heathrow could be threatened by a more liberal regime. Indeed, the Committee was struck by the robust attitude adopted by the airlines which contrasted with the caution expressed by the Government.<sup>50</sup> Most witnesses regarded the ECJ judgments as a moment for historic change to move beyond the current restrictions on the market imposed by the web of bilateral national state agreements.

51. While the Committee can understand the reluctance of Member States to cede greater competence to the Commission, the effect of the judgments of the European Court of Justice on 5 November 2002 is to recognise the Community's exclusive competence on these specific points. The Commission's right to negotiate these issues in place of the Member States is a matter of principle and can no longer be questioned. **The Committee therefore recommends that the Government accede to the approach proposed by the Commission, namely that the Commission, assisted by Member States, negotiate in the first instance with the United States, to remedy those breaches of Community law identified by the ECJ judgments in existing ASAs with the United States.** However, such a mandate should be restricted to the specific issues raised by the ECJ judgments.

#### DENOUNCING EXISTING ASAS WITH THE USA

52. In its Communication dated 19 November 2002 and again in its second Communication dated 26 February 2003 and in the Commissioner's written evidence dated 6 February 2003, the Commission calls on Member States to denounce existing bilateral ASAs with the USA as a necessary prelude to negotiating changes to these agreements. The Minister told the Committee that no Member State wished to denounce their ASA with the USA.<sup>51</sup> Given that the United States Government has already indicated its willingness to negotiate changes to the ASAs to bring them into line with Community law,<sup>52</sup> the Commission's insistence of formal denunciation seems unnecessarily confrontational. We agree with those witnesses<sup>53</sup> who saw little value and possibly much harm in denouncing the ASAs. **We recommend that HMG resist the Commission's call for denunciation of existing bilateral ASAs with the USA.** This is a matter that should be dealt with in a co-ordinated manner across the EU States as part of negotiations between the EU and the US.

<sup>49</sup> Evidence from: KLM, page 135; German Directorate-General for Civil Aviation, Aerospace and Shipping, page 128, paragraph 9; BA, page 52, paragraph 2.2; and Virgin Atlantic, page 63, paragraph 6. But see contra opinion from: BMI, page 44; Air 2000, page 75, paragraph 1; and AEA, page 16, paragraph 6.

<sup>50</sup> Q 352.

<sup>51</sup> Q 333.

<sup>52</sup> But see Mr M J Hall's written evidence, page 129, paragraph 2.2.

<sup>53</sup> AUC, page 96, paragraph 16; BMI, Q 209; CAA, page 25, paragraph 12; and Soames, Goeteyn and Camesasca, page 132, paragraph 4.

## CHAPTER 3: A WIDER MANDATE FOR THE COMMISSION?

53. Assuming that it is possible for the Commission to secure a separate mandate to address, on behalf of all EU Member States, the existing infringements identified by the ECJ judgments on 5 November 2002, there is a wider, and ultimately more important question, of whether or not Member States should mandate the Commission to negotiate on behalf of all Member States in matters of aviation policy that have hitherto been within the competence of Member States. In other words, is it now time effectively to dismantle the system of bilateral ASAs that has grown up since the 1944 Chicago Convention, and to replace it with *bloc to bloc* common aviation areas starting first with the United States, but moving thereafter to include Russia, Japan and other states?

54. The evidence from witnesses is almost unanimous in support of a mandate for the Commission. Here, again, the United Kingdom Government is cautious. It argues that it does not object in principle, but that negotiation by the Commission on behalf of Member States would have to “add value” to the existing ASAs. The Government is right to be cautious in that the United Kingdom, as one of the major aviation countries, might have to make considerably greater concessions to a common policy than other Member States. Access to Heathrow has long been recognised as a highly desirable negotiating objective for the United States: in our discussions in Washington demands for Heathrow landing-slots were made by representatives of all airlines which presently do not have them. HMG was also insistent that if the Commission was to negotiate with the US its negotiating objective should be to go beyond existing “open skies” agreements and aim for full liberalisation.

## DOES THE COMMISSION HAVE THE CAPACITY TO CONDUCT SUCH NEGOTIATIONS AND WHAT BENEFITS WOULD A SUCCESSFUL NEGOTIATION BRING?

55. Two questions arise:

- (i) has the Commission the capacity to conduct negotiations satisfactorily?
- (ii) what additional benefits would flow from a successful EU *bloc* negotiation?

56. So far as the first of these two questions is concerned, the Committee has received mixed evidence, but on balance most witnesses agree that the Commission is capable of conducting this type of negotiation satisfactorily. It has done so before, for example, in negotiating an air services package with the ten Accession States; with Norway and Switzerland; and in analogous Law of the Sea negotiations. The Commission will, inevitably, want to use the expertise of Member States, and it has made this explicit in its second Communication of 26 February 2003.

57. However, the Commission has recognised that there are problems inherent in a joint EU negotiation. How to distribute traffic rights between EU carriers when rights are limited in agreements signed with particular third countries. There is the added problem of slot constraints at certain airports—in particular Heathrow. (See box 5 and Appendix 7 for a fuller account of the importance of slots at Heathrow in any negotiation with the US, for the US, the other EU Member States and the United Kingdom.) The Commission already has competence for certain aspects, for example, slots and ground handling. Difficult as it may seem, the fair allocation of traffic rights at EU airports is not an insoluble problem. Increasingly, the Commission is being drawn into all aspects of ASAs and aviation policy. This seems an ineluctable process which means that Member States and the Commission will have to work together until eventually ASAs and aviation policy become, in effect, a full Community competence. In her written evidence to the Committee, the Commissioner and Vice-President of the European Commission, Mme Loyola de Palacio, gave a hint of this:

“the ECJ already identified [as falling within Community competence] airport slots, computer reservation systems, and intra-Community fares and rates, but an analysis of existing Community law reveals that there are many further areas where the AETR principle creates exclusive Community competence since the Court’s analysis concerned only those measures of Community law in force at the time of concluding the agreements.”

## ADVANTAGES IN A COMMUNITY APPROACH

58. The argument is, therefore, that the process is moving in favour of a Community approach, and that it might be advantageous to hasten this process by means of a mandate. But, it is also important to try to estimate what added value Member States might expect to achieve. The first argument is surely one of negotiating weight. The European Commission, supported by Member States, must, by any definition, carry more weight in a negotiation with the US than the individual Member States by themselves. This leverage is likely to increase as the range of subjects that have hitherto fallen to Member States passes gradually to the Commission under the application of the AETR principle (see Appendix 6). The two main objectives must, therefore, be parity and comprehensiveness—that is to

say, on the one hand, balancing the advantages which US airlines currently enjoy in being able to operate from their own large home market into the single Community market with the disadvantages the EU Member States currently face in being excluded from the US domestic market, and on the other, going for full rather than partial liberalisation. As the Brattle Report points out, the US currently protects its domestic market through a series of legal measures, e.g. “Fly America”, the Civil Reserve Air Fleet (CRAF), and not least the restrictions on foreign ownership of capital in American airlines.<sup>54</sup> It is therefore important that any mandate that Member States give to the Commission should be firmly anchored in a negotiating programme that will lead to full liberalisation beyond the current US “open skies” model. However, it became clear from our Washington meetings that the opposition of labour unions in the US to liberalisation is likely to be extensive.

59. An additional benefit that might accrue from a successful negotiation with the US is that other non-EU States might be persuaded to liberalise their own agreements with the EU. A more direct benefit would be airline consolidation, particularly among EU carriers, and a widening of the alliance system that would lead to lower costs through rationalisation, thus enabling surviving EU airlines to become more competitive in comparison with US or other major carriers. But there are other regulatory benefits that can only come from a common approach as the German Civil Aviation Directorate notes:

- opening up US air carriers to greater foreign investment;
- full access to the US aviation market with comprehensive traffic rights;
- convergence in the application of competition rules both of the EU and the USA;
- measures to prevent state aids which distort effective competition;
- harmonised security measures to combat terrorism in civil aviation.

#### STATE AID FOR THE AIRLINES

60. State support for airlines arising from the terrorist attack in New York on 11 September 2001 continues in the US—indeed, we heard in Washington that Congress would be approached for further financial support this year, possibly as much as US\$9 billion primarily in the form of relief from federal aviation-related taxes, help in extending terrorism insurance, and paying for extra security measures at airports. Further direct cash payments and further loan guarantees for struggling airlines were also being canvassed. However, Congress is split on whether or not to bolster the airlines.<sup>55</sup> In the EU, the Commission is reported to be considering allowing EU governments to meet costs of extra security measures without this being classed technically as a subsidy, as well as costs of extra war-inflated insurance. The Commission may also relax the “use it or lose it” rule on slots to allow airlines to reduce flights temporarily without losing their slot rights.<sup>56</sup> The size of any implied financial support to EU airlines is expected to be substantially less than such support to US airlines in the US.

61. The Commission has proposed a Regulation on unfair pricing practices by third countries that would allow Community measures to be applied to non-EU airlines found to be using state aid to price unfairly. This was the subject of discussion at the Transport Council held on 27/28 March 2003.<sup>57</sup>

#### BENEFITS OF LIBERALISATION

62. There is an argument that increased competition on major US/Europe routes, and more trans-Atlantic services from a larger number of secondary points in Europe would mean increased consumer benefits through a wider-range of services to chose from and lower prices. It would also create benefits for Europe’s tourism industries by encouraging more incoming tourism. However, at least one witness cautions against accepting the obvious.<sup>58</sup>

63. Perhaps the most persuasive argument in favour of the mandate is that this would ensure that all EU Member States were treated equally. The Commission has already identified this as an important requirement, and, in its second Communication of 26 February 2003, has proposed a new draft Regulation that would require all Member States to inform the Commission about existing or future activities in connection with ASAs. The Commission’s design of a single aviation market bringing together the EU and US aviation market is visionary. But, preparations for such a mandate would have

<sup>54</sup> The Brattle Report, paragraph 1.3, pages 1-6 and 1-7.

<sup>55</sup> *The Times*, March 27 2003, page 29.

<sup>56</sup> *The Times*, March 27 2003, page 29.

<sup>57</sup> Hansard, 2 April 2003, Col 705W

<sup>58</sup> Written evidence by Professor Button, page 104, paragraphs 9 and 10.

to be careful. Member States would have to identify and agree negotiating positions, and there would have to be a mechanism for the Commission to report back regularly to the Council if Member States are to be carried collectively with the Commission.

64. The Commission's vision of an open aviation area carries with it the implicit assumption that a degree of harmonisation will have to be established between the United States' anti-trust legislation, and the European Community's competition regulatory system.

65. The Committee concludes that, on the basis of the evidence it has received, the balance of opinion lies in supporting the proposal that the Council should give the Commission a mandate to negotiate a wider Open Aviation Area and **recommends that the Government should agree to a full negotiating mandate for the Commission on the basis that the objective of such a mandate would be the full liberalisation of the aviation industry in the EU and the US.** However, much preparatory work will have to be done between Member States and the Commission to ensure that the negotiating objectives are fair to all Members, that agreed fall back positions will be strictly observed, that there will be a mechanism for rapid reference to the Council during the course of negotiations, and that the Commission and Member States consult about the establishment of an impartial mechanism to deal with the award of traffic rights whenever these are constrained or limited in any way. In addition, the Government will wish to be reassured that the United Kingdom's major international aviation asset—access to London Heathrow—will not be included in a settlement that might prove damaging to United Kingdom national interests. Increased access to Heathrow without the total package of opportunities provided by full liberalisation would simply disadvantage United Kingdom carriers. **The Committee further recommends that progress be made in ensuring that the objectives and application of Community competition law and United States anti-trust legislation with respect to international aviation are in tandem and harmonised.**

66. **The Committee recommends that it would not be in the European Union's interest, or the United Kingdom's national interest, to negotiate for anything short of a fully liberalised aviation market between the EU and the US. The Committee believes that in current circumstances it may be necessary to deal first with the need to bring EU Member States' bilateral ASAs with the United States into conformity with Community law as specified in the ECJ Judgments of 5 November 2002 before moving on to the wider negotiation of a EU/US Open Aviation Area. It will be of paramount importance to the United Kingdom to ensure that a robust and acceptable mechanism links all intermediate steps in the negotiation to the final agreement.**

#### Box 5

##### *Airport Capacity: Heathrow and the Question of Slots*

One difficulty in the way of a negotiation between the EU and the US on a fully liberalised trans-Atlantic aviation market is that of airport capacity, particularly at London Heathrow. The United Kingdom has, by a considerable margin, the highest volume of passengers of any European country travelling to and from the US. As BAA notes, "experience has shown that the process of liberalisation typically stimulates additional demand". Capacity utilisation is currently so tight at Heathrow that there is a thriving (grey) secondary market in the allocation of landing and take off slots. If liberalisation leads to increased trans-Atlantic access to Heathrow, then, necessarily, as capacity stands at present, other routes using Heathrow will be displaced.

The allocation of slots applies at several European airports, but the pressure is acute only at Heathrow. Access to Heathrow is the main objective of US airlines. Heathrow, alone among European airports, operates an independent slot regulator because the United Kingdom, again unique among EU Member States, has more than one major trans-Atlantic airline operating under the ASA with the United States.

By way of example, British Airways currently has some 39 per cent of slots at Heathrow, whereas Air France has 58 per cent of the slots at Charles de Gaulle Paris, KLM has 59 per cent at Amsterdam, Lufthansa has 63 per cent at Frankfurt, and in the US, Delta has 75 per cent at Atlanta, and Continental 83 per cent at Houston.

Because more airlines currently want to fly the Atlantic via Heathrow, a partial liberalisation of the aviation market might require United Kingdom carriers currently using Heathrow to surrender slots to competitors, while being unable to obtain the benefits of full liberalisation such as the ability to buy into or take over other airlines, particularly in the United States. This, therefore, will be an important concern for the Government in any negotiation of the current ASAs with the United States.

A fuller account of runway capacity, aircraft movements, passenger and cargo throughput at major European airports is provided in the CAA's supplementary evidence on pages 34 and 35.

## CHAPTER 4: POSITION OF THE UNITED STATES

67. It is the practice of the United States Government to give evidence only to the US Congress. The Committee regrets that US airlines felt unable to respond to the Call for Evidence. We understand current financial pressures on the US airlines may have pre-occupied senior management and that, in any case, the ECJ judgments are primarily an EU problem, not an US one. However, a United States government's view of the ECJ judgments was sketched out on 8 November 2002 by the Assistant Deputy Secretary of Transportation, Mr Jeffrey Shane, at an American Bar Association forum in Florida.<sup>59</sup> He described his remarks as “a first reaction and largely a personal one”, and then proceeded to analyse what he thought the ECJ judgments amounted to. In his view,:

“the European Court of Justice rendered what American callers would call a “surgical” decision...it did not strike down the bilateral agreements that were the subject of the Commission's complaint. Nor did the Court prohibit EU Member States from continuing to discuss negotiations with the US in their own right. The Court certainly did not—and indeed could not—confer competence on the Commission to conduct negotiations with the US, a political decision that can only be taken by the EU Council of Ministers.”

Mr Shane pointed out that the only areas which the ECJ judgments dealt with were those described earlier in this report, namely, the “nationality” or control and ownership clause and the intra-European pricing provisions and computer reservations systems. Mr Shane drew a parallel between the EU concept of relevant competence and the US doctrine of pre-emption: the well established principle that state governments are prohibited from legislating with effect to any general subject area “occupied”—and thus pre-empted—by the Federal Government.

## INTRA-EU ROUTE PRICING AND COMPUTER RESERVATION SYSTEMS

68. In dealing with the Court's objections to intra-European pricing provisions and computer reservation systems, Mr Shane argued that US airlines do not “price lead” on the fifth freedom aspect of their bilateral alliances with EU airline partners. He added that “no US airline owns a computer reservation system solely in its own right”. More importantly, however, in the course of his speech he said that “some of our “open skies” agreements even include an explicit statement acknowledging that in the event of a conflict between EU rules and the rules set forth in the agreement, our EU partners will have to abide by the EU rules.”

## “NATIONALITY” CLAUSE

69. On the issue of the “nationality” clause, Mr Shane said that, “the offending nationality provisions are permissive. In other words they do not require the US to reject a carrier originating flights to the US from a country on the ground that it isn't owned and controlled by citizens of that country though that right does exist. Indeed, the US from time to time has waived its objection under such clauses in the interests of ensuring fuller participation in the aviation market by certain trading partners and to encourage competition.” Then, as if to underline that the US was not overly concerned by the EU requirement to amend the “nationality” clause, Mr Shane pointed out that the United States had already entered into a multi-lateral “open skies” agreement with four partners in the Asia/Pacific economic cooperation forum—Brunei, Chile, New Zealand and Singapore. Peru acceded to the agreement earlier this year.

“That agreement is notable for its departure from the conventional approach to airline nationality. The agreement expressly prohibits any signatory country from objecting to operations by *any airline that has its principle place of business* in the country from which its flights originate on the grounds that it is not owned by citizens of that country.”

The phrase in italics above is significantly more restrictive than the Commission's view which only requires EU carriers should be “established” in another Member State in order to be designated.<sup>60</sup>

## EU DENUNCIATION OF BILATERAL ASAS

70. The US State Department on 20 November 2002 said:

“the European Court of Justice's decisions do not call for European Union Member States to denounce these agreements. The Court also ruled against the Commission's assertion that Member States lacked competence to negotiate agreements. Instead, the Court found that our agreements are consistent with EU law, except in three areas. We see no utility in denunciation

<sup>59</sup> Appendix 7.

<sup>60</sup> Q 183.

of our aviation agreements. The United States is prepared to discuss with the European Union Member States on a bilateral basis how to accommodate the European Court of Justice's specific legal findings. Such discussions can occur without denunciation."

71. What comes across clearly here is that the United States appears to believe that its "open skies" model of partial liberalisation effectively serves its interests and it would not wish to see these denounced by the 11 EU Member States<sup>61</sup> who have "open skies" ASAs with the United States. In the course of oral evidence, the Committee became aware that the United States authorities had already written to the seven "open skies" EU Member States who were found in default by the ECJ offering revised articles for their ASAs with a form of words to take account of the requirement to bring the "nationality" clause into conformity with the TEC. It is significant that the United States Government did not seek to initiate such negotiations with the United Kingdom. The inference that the Committee draws is that the United States sees the existing network of "open skies" ASAs (of which it has 59 world-wide) as very much in its interests and will wish to preserve the model.<sup>62</sup> On the other hand the European Commission sees this US concern to preserve the "open skies" ASAs as an effective pressure point to force the United States into substantial negotiations with the European Community acting as a *bloc*.

#### LIMITS ON FOREIGN OWNERSHIP AND CONTROL

72. Under US law, at least 75 per cent of the voting stock of a US airline must be owned or controlled by US citizens, and the president and two thirds of the board of directors of the carrier must be citizens. Administrative decisions by the Civil Aeronautics Board of the United States, and later by the Department of Transportation, have interpreted this law to require that the airline must be under the actual control of US citizens (i.e. the airline must have US ownership and control).<sup>63</sup> (It should be noted that similar constraints on ownership and control apply in the EU: EC rules require carriers obtaining their operating licences in Community States to be majority-owned and substantially controlled by those (i.e. Community) States or their nationals).

#### FLY AMERICA REQUIREMENTS

73. Most US Government commercial air transport requirements, domestic as well as international, must take place on US airlines. This includes the transport of US Government personnel and cargo as well as most items handled by the US postal service (the latter is covered by a separate statute). On international flights, foreign code-share partners of US flag carriers can transport US Government personnel, cargo and mail under the US carriers code on routes covered by their code-sharing agreement. In practice, any movement of passengers or cargo, including that of contractors, that is in anyway connected with US Government affairs has to take place on US airlines or on non-US airlines that have code-sharing agreements with US airlines. The cumulative impact of the "Fly America" policy is to reserve for US airlines a significant share of trans-Atlantic traffic.<sup>64</sup>

#### CIVIL RESERVE AIR FLEET (CRAF)

74. The Civil Reserve Air Fleet (CRAF) is a critical component of America's military readiness. Under the CRAF programme, US commercial air carriers pledge to provide military air lift in a defence emergency in exchange for exclusive access to US Government peacetime business. Department of Defence officials fear that allowing foreign investors to acquire US air carriers would jeopardise the military's dependable access to this emergency capability. The Department of Defence's concerns rest on three assumptions:

- US air carriers are more dependable than foreign air carriers;
- if a foreign entity bought a US air carrier it would operate as a foreign carrier;
- if the US Government changed its statutory policy to allow foreign ownership of US carriers it would open itself up to problematic transactions.<sup>65</sup>

<sup>61</sup> All EU Member States except Greece, Ireland, Spain and the UK (but the US has also concluded "open skies" ASAs with non-EU States—Iceland, Norway and Switzerland).

<sup>62</sup> Q 336.

<sup>63</sup> The Brattle Report 1.3 pages 1-7

<sup>64</sup> Supplementary written evidence from BA, page 62.

<sup>65</sup> The Brattle Report, Executive Summary part iv, page x

## ANTI-TRUST IMMUNITY

75. Under US anti-trust legislation, any agreements between major suppliers/producers of goods or services relating to price levels or to output or production levels may be considered anti-competitive and in breach of the anti-trust rules. Code-share and related agreements which involve joint control of frequencies or capacity offered between the airlines in an alliance would fall foul of the anti-trust rules unless given explicit exemption by the relevant US Government Department.

76. The rationale for granting exemption is that because of the “open skies” agreement, there is freedom for other airlines to enter the markets on which the alliance partners code-share, and possibly agree frequencies. In practice, the US Department for Transportation has recommended anti-trust immunity to airlines of those states that have agreed to sign “open skies” ASAs with the United States.

77. Some witnesses have pointed out that denunciation of “open skies” bilaterals by Member States, as demanded by the Commission, would lead to loss of anti-trust immunity for major alliances, notably those between Lufthansa/SAS and United, KLM and North West, Air France/Alitalia and Delta. However, from its discussions in Washington, the Committee concluded that this is not necessarily so. Following investigation of an alliance by the Department of Justice and the Department of Transportation, immunity is granted through a Federal Government Order. Such Orders have no provision for automatic cancellation. The Department of Transportation would have to take positive action to cancel existing anti-trust immunities.

## THE BRATTLE REPORT

78. The European Commission asked the Brattle Group, a respected US consultancy,<sup>66</sup> to examine the economic impacts of an EU/US open aviation area. The Brattle Group produced its report in December 2002. The report comes to the conclusion that full liberalisation would benefit both the United States and the European Union. It analysed the restrictions mentioned above, but concluded that none of the fears expressed either by the industry, the US Department of Defence, or the labour unions, provided a sufficient reason for resisting liberalisation. One critic questioned the extent to which benefits would necessarily follow from liberalisation on the grounds that the methodology used was perhaps more appropriate to smaller organisations. But he did not contest the assumptions arising from the report that liberalisation would bring economic benefit to all parties. However, it appears from the report that a significant part of the benefits of full liberalisation could be achieved through extending US “open skies” agreements in Europe to include the four EU Member States with which US “open skies” agreements do not exist, and particularly the United Kingdom.

## US ATTITUDES TO AN EU/US AGREEMENT

79. The main constraints were deemed by the authors of the Brattle Report not to be economic or security, but rather political. There has been, hitherto, resistance from the labour unions, as well as from the Department of Defence, and it was in order to assess how immutable these obstacles might be that the Committee travelled to Washington between 12 and 13 March 2003. The Committee held informal talks with officials in the Department of Transportation and the Department of Justice, and with senior management in American Airlines, Northwest Airlines, Delta Airlines, the Air Transport Association of America, and the authors of the Brattle Report.

80. The US aviation authorities as was evident from the speech by Mr Shane quoted earlier (para 67) would welcome the opening of discussion with the European Commission on liberalising air services between the EU and the US. While it may be difficult to reach agreement on some of the issues, the launch of discussions would compel the US government, the airlines and the labour unions to face up to the issues that have to be resolved.

81. US international airlines appear in general to welcome EU/US discussions. Some to whom the Committee talked in Washington felt that US airlines had much to gain from further liberalisation through the free flow of capital, the creation of more stable market-based alliances, increased access to Heathrow and so on.

82. A major obstacle to full liberalisation is the opposition of the organised labour and some members of both sides of Congress. Labour opposition could be reduced, if airlines made a concerted effort to explain and argue for the potential benefits of liberalisation as had been done when the first “open skies” agreements were signed. But in the present crisis, when airline executives are preoccupied in trying to win wage and productivity concessions from their unions, they do not want to use up political capital in arguing a case for further liberalisation.

---

<sup>66</sup> *The Economic Impact of an EU-US Open Aviation Area*—a report by the Brattle Group, commissioned by the European Commission and published December 2002 (office@brattle.com).

83. The US view in general was that a staged approach was more likely to succeed than trying to reach agreement on all issues at once.

84. On foreign ownership of existing US carriers, moving from 25 per cent to 49 per cent was seen as possible, but majority ownership would meet stiff opposition. Conversely, several people the Committee talked to felt that the “right of establishment” might be conceded in future negotiations. This would enable non-US airlines or companies to set up US based airlines operating under US safety regulations and employment laws. It was suggested to the Committee that this might be more readily accepted by the unions since it would generate local employment, than would opening up domestic cabotage to foreign carriers.

85. The Committee found little support for the continuation of the ban on inward wet-leasing of aircraft, particularly if those aircraft were EU-registered since safety standards within the EU were mutually accepted by the US and increasingly harmonised.

86. The Committee found a positive response to the concept of harmonising the objectives of competition rules on both sides of the Atlantic. The Department of Transportation (in the case of aviation policy), and the Department of Justice and the European Commission have worked closely on many mergers and, with a few exceptions, have usually come to similar conclusions. They have already been working closely to try and harmonise both the objectives of US anti-trust and EU competition policies and the criteria used to assess anti-competitive actions or mergers.

#### THE COMMITTEE’S VIEWS

87. The Committee felt that it was important to seek as wide a reading of the United States’ position as possible, because although the ECJ judgments require EU Member States to bring their ASAs into conformity with Community law on those issues referred to in the judgments, the ASAs also involve the agreement of the bilateral partner, namely the United States. The United States’ first reaction was to argue that denunciation of existing ASAs was unnecessary, and that the United States was prepared to negotiate bilaterally in order to amend existing ASAs where necessary to conform to the ECJ judgments. The US willingness to open negotiations on these points is understandable: the “open skies” agreements which create some international liberalisation, but which in effect protect the huge US domestic market in a number of ways, are valuable to the United States. They enable the US airlines to exploit the fragmentation between EU Member States, and thus maintain their dominance in the world aviation market.

88. While in Washington, the Committee heard an American willingness to look at a negotiation that would aim to deal with more substantial restraints such as cabotage, ownership and control, the “Fly America” policy and the CRAF. The Committee was also told that the United States government and airlines could see advantage in a fully liberalised Trans-Atlantic Civil Aviation Area. A number of our interlocutors suggested that all the issues listed above could form part of an EU/US *bloc to bloc* negotiation.

89. However, a number of issues would require legislative action in the United States: the “Fly America” policy, possibly cabotage, but particularly, ownership and control of US airlines. While the airlines themselves might see benefit in seeking new sources of finance, the truth is that at present it is unlikely that Congress would wish to take appropriate legislative action. US concerns are focused on the economic downturn and on the difficult financial position of US airlines, notably United, which has already filed for bankruptcy, and according to press reports, American Airlines appears to be close to doing so.<sup>67</sup>

90. There is also a question of whether the objections that have been hitherto voiced by the American labour unions, in particular, the American Pilots’ Association, could be overcome as easily as many commentators, including BA and Virgin Atlantic, think. The US airlines are themselves engaged in difficult negotiations with the unions over staff reductions and various other retrenchments, and are unlikely to want to spend negotiating capital on an issue which is not a matter of overwhelming priority to them.

**91. The Committee, therefore, came to the conclusion that while the United States government would not object to entering full negotiations for an open aviation area, the difficulties in the way of a successful negotiation within the next two to three years will be considerable and should not be underestimated.**

<sup>67</sup> *The Financial Times*, Comment and Analysis, March 26 2003.

## CHAPTER 5: CARGO AND WET LEASING

## AN UNEVEN MARKET

92. In dealing with ASAs between EU Member States and the United States, it is often easy to overlook the role that all-cargo airlines play in contributing to the economies of both areas. However, for the cargo operators, the market is even more skewed in favour of the Americans than is the case with passenger airlines. The reason is that the US refusal to cede cabotage rights means that non-US cargo airlines are virtually locked out of the US market which represents over 40 per cent of the world's cargo traffic. Through their "open skies" agreements, the Americans are able to utilise the fifth freedom rights obtained from European States to establish global cargo services.

93. In the case of passenger airlines, access to the internal American market can, subject to granting of anti-trust immunity, be reached indirectly through an alliance with an American passenger airline. This has had the effect of making US cabotage rights a less important objective for passenger airlines: few want to establish themselves in the United States to compete with the US domestic operators, and the advantages of the alliance system enables them to reach destinations from which they would normally be debarred.

## BERMUDA 2 AND ITS EFFECT ON THE COMPETITIVENESS OF UNITED KINGDOM EXPORTERS

94. The Committee also received evidence from an American freight operator urging the United Kingdom to abandon the current restricted agreement (Bermuda 2) and to go for an "open skies" agreement similar to those between the United States and France and Germany. The advantage for the US company is that the acquisition of the fifth freedom rights from an "open skies" US/UK ASA would enable the company to expand its global network. The argument it uses to bring pressure upon HMG is that "we cannot serve UK companies that want to export as efficiently as we serve those in "open skies" countries such as France and Germany. We believe that this impairs the competitiveness of British exporters, particularly to fast-growing markets such as Asia". The company argues that, by moving to an "open skies" agreement, air express and freight markets between the United Kingdom and Asia would receive a boost of 6 per cent. The company claims that by concluding an "open skies" agreement with the US, "the UK would add 108,000 jobs in the general UK economy by 2005." The company implies that if decisions "over the US/UK aviation relationship are left to the European Commission, the timeline for the UK to benefit from better access to cargo/express services will be delayed by many years".<sup>68</sup>

## A "MINI DEAL"

95. A major European company which operates a cargo/express service from the United Kingdom is seeking the help of the Department for Transport to obtain cabotage rights for the carriage of domestic intra-US material from various US airports to support a new trans-Atlantic scheduled all-cargo service from a number of European airports, including some in the United Kingdom, to various US airports. This company expresses concern that the Department for Transport is contemplating a "mini deal" whereby passenger traffic rights for an additional British carrier to fly to the US would be exchanged for fifth freedom rights for FedEx to Europe from the United Kingdom. If such a deal were agreed, it would have seriously harmful effects for a European express cargo carrier unless balancing cabotage rights in the US were guaranteed. This company, therefore, argues that Member States should denounce existing ASAs with the United States and give the EU Commission a mandate to negotiate a trans-Atlantic common aviation area.

## A MANDATE FOR THE COMMISSION?

96. The Civil Aviation Authority (CAA) confirm this judgment, arguing that the United Kingdom all-cargo airline industry is small in comparison to that of the United States. US cargo carriers already have extensive operations, not only across the Atlantic, but also within Europe. Therefore, a bilateral liberalisation of all-cargo services between the United Kingdom and the US along the lines of the US "open skies" model would give US cargo airlines further flexibility to mount operations within Europe, but would yield little or no practical benefit to United Kingdom all-cargo carriers.

"The EU acting as a whole seems more likely to be able to secure a broader liberalisation that would establish a more level playing field for UK all-cargo carriers than would any individual Member State."<sup>69</sup>

<sup>68</sup> Written evidence from Fedex.

<sup>69</sup> Supplementary written evidence from the CAA, page 33, paragraph 4.

#### WET-LEASING

97. Wet-leasing is the hiring of an aircraft complete with crew, maintenance and insurance by one airline (the lessor) to fly on the routes of another airline (the lessee). The US is the world's biggest lessor of wet-lease aircraft (many for all-cargo operations), generating more than \$1 billion a year from wet lease contracts in Europe. Under US regulations European airlines are denied access to wet-lease to the US market.

98. There are differences between the EU and the US in the policy they adopt towards wet-leasing of aircraft. Under EU legislation, EU carriers are permitted to wet-lease aircraft from non-EU airlines, either on a short-term basis to meet temporary needs, or otherwise in exceptional circumstances. US airlines are therefore able to wet-lease their aircraft to EU carriers albeit within certain restrictions. The US, on the other hand, places a blanket prohibition on US carriers wet-leasing aircraft from non-US carriers. The aim originally was to protect US consumers from foreign registered aircraft that might not meet US safety standards. Wet-leasing is of interest to both passenger and cargo carriers, but United Kingdom all-cargo airlines are particularly active in this area. The United Kingdom has long sought to persuade the US to relax its restrictions on wet-leasing in bilateral negotiations, but without success. As the CAA notes, "a bilateral "open skies" agreement between the US and the United Kingdom seems unlikely to achieve any change in the US restrictions" on wet leasing.<sup>70</sup>

#### THE DEPARTMENT FOR TRANSPORT'S RESPONSE

99. When the Minister gave oral evidence to the Committee on 24 February 2003, the Committee raised the allegation that the Department for Transport might be involved in a "mini deal" offering increased traffic rates for United Kingdom airlines from Heathrow to the US in return for fifth freedom rights for FedEx. The Minister agreed that discussions had taken place. Asked if this deal would not unreasonably increase FedEx's market dominance, the Minister argued that he had a duty to look at the interests of the United Kingdom economy as a whole—"whether having a wider range of freight flights in and out of the UK would be to the benefit of the competitiveness of the UK economy and UK industry".

100. The Committee was left with the distinct impression that the strength of European air cargo operators did not rate the same measure of importance for HMG as passenger airlines.<sup>71</sup> The Minister was quick to remind the Committee that passenger-carrying aircraft also carried cargos. The Committee is unable to assess the wider economic interest to the United Kingdom involved in balancing passenger airline and air cargo routes, but was sufficiently concerned by the evidence presented to urge the Government to bear carefully in mind the interests of all-cargo services and the separate issue of wet-leasing. Given that a bilateral negotiation has so far been unable to achieve any advances in these areas, the Committee concludes that the all-cargo airlines and the leasing industry would benefit only from a full liberalisation of aviation between the US and EU. **We therefore recommend that the Government bear these interests specifically in mind for any mandate to the Commission to negotiate the wider open aviation area.**

---

<sup>70</sup> Supplementary written evidence from the CAA, page 33, paragraph 6.

<sup>71</sup> See also House of Lords Hansard, 25 November 2002, Cols 560–561.

## CHAPTER 6: CONCLUSIONS OF THE COMMITTEE

## THE ECJ JUDGMENTS

101. The declared reason why the Commission took Member States to the Court was to ensure that ASAs were consistent with the single market rules and to address matters of Community competence. However, it may well have been, in part, to put pressure on Member States to grant the Commission a mandate and a *locus standi* in what had hitherto been an almost exclusive preserve of Member States.<sup>72</sup> The Commission has pointed out that the growth of competition policy and commercial policy has inevitably leaked into aviation. It is no longer feasible to exclude aviation as was once thought possible. However, whatever the Commission's intentions, the outcome has been claimed as a victory by both sides. The Court has found Member States in default on specific clauses in their existing ASAs, but, at the same time, has reiterated the competence of Member States to conclude bilateral ASAs.

## A "FIRST" MANDATE FOR THE COMMISSION

102. In our view, this now requires a fresh look at the way in which ASAs are handled. There is clearly mixed competence, and the balance between Member States' competence and the areas of Community competence is likely, over time, to move in the direction of the latter. However, in the short term, our concern has been to address the specific issues on which the Court found the eight Member States wanting. Should Member States try to bring their ASAs to conformity with the Court's judgments, or should the Commission be given a mandate as it has proposed in its Communication of 26 February 2002? We have concluded that it makes more sense for Member States to concede a mandate to the Commission to deal with the amendments to ASAs to take account of the ECJ judgments. The most persuasive argument in favour of a mandate for the Commission is that this is the only way, in our view, that changes can be brought about uniformly and at the same time.

## A WIDER MANDATE

103. We have also looked at the wider issue of a second mandate for the Commission to conduct a renegotiation of all EU Member State ASAs with the United States in the first instance, and later perhaps with Russia, Japan and others. Here again, we have concluded that the arguments in favour of a Commission mandate outweigh the case made by those who would prefer to stick to a mixed bag of bilateral ASAs. The Commission can deploy more weight, and might well achieve concessions in areas where the Member States individually have so far been unsuccessful. But we recognise that even armed with a mandate, a full negotiation on these issues, which include cabotage, cargo, wet-leasing, ownership and control, and the right of establishment will take time. We think it important, therefore, that the first mandate mentioned above should be granted as soon as possible provided that the conditions set out in paragraph 51 are adhered to—and certainly no later than the June 2003 Transport Council.

## LIBERALISATION

104. Whilst superficially it may appear that the benefits from greater liberalisation that the Brattle Report examined could be to a significant degree achieved by an EU/US "open skies" type of agreement, and that such an agreement could be achieved more quickly because it was manifestly in the interests of the United States, it would not remove other distortions in market opportunities which currently favour US airlines. Nor would it address key issues of ownership and access to international capital. In our opinion, therefore, HMG should ensure that a wider mandate is designed to bring about a fully liberalised Trans-Atlantic Common Aviation Area, and to include those areas currently subject to United States and EU legal restrictions. This would include the ability to buy into American airlines, to wet-lease to American clients for all-cargo operations to obtain internal US cabotage rights. We recognise that this wider requirement will inevitably take time, but we think it is worth waiting for.

## COMPETITION

105. Liberalisation will not, in itself, necessarily bring economic benefit either to the economy or to the airlines. There is currently excess capacity in global aviation and many airlines survive because the bilateral ASAs support the existing international route system. But many also survive on subsidies, hidden or overt. We have indicated some of the latter, especially in the USA, in paragraphs 72–74, but

---

<sup>72</sup> See M. Ayrál's oral evidence, Q 178.

there is also believed to be a range of practices in some EU Member States, which are tantamount to hidden subsidies, often in defence of national airlines. Until such practices are rooted out, many of the benefits of an open market through transparent competition on a level playing field will fail to come through.

106. There is widespread agreement that the airline industry requires a degree of consolidation in both the USA and the EU, while at the same time enabling new airlines to emerge in a competitive environment. If airline consolidation and restructuring is to take place within and between the USA and the EU, the relevant competition authorities on both sides of the Atlantic will need to reflect further upon the application of competition policies to the aviation industry, especially in the international context.

#### DENOUNCING EXISTING ASAS

107. The Commission has demanded that Member States denounce existing ASAs with the United States as a necessary prelude to any negotiation with the United States, both on the infringements identified by the ECJ, and on negotiation to a wider liberalised EU/US aviation market. Given that the United States has already indicated that it is willing to negotiate in both areas, it seems to the Committee unnecessarily confrontational at this stage to denounce ASAs in the way proposed by the Commission.

#### AN OPPORTUNITY

108. The Committee concludes that the Government and other Member States should give two mandates to the Commission: the first, to remedy the specific breaches of Community law identified by the ECJ in its judgments of 5 November 2002; the second, to address the imbalance in the existing ASA system between the United States on the one hand and the European Union on the other. The Government is right to be cautious. Heathrow is the priority target for the Americans, and we cannot expect our European competitors to make our position any easier. The main constraint is the limited capacity at Heathrow, and the intense competition that this generates for slots. These are matters of considerable importance for the Government, the aviation industry and the United Kingdom economy. Nevertheless, we think that the ultimate benefits that would flow from a fully liberalised Trans-Atlantic Common Aviation Area could outweigh the potential disadvantages of widening access to Heathrow (see box 6). The Government has argued that any mandate to the Commission should not be exclusive, and that Member States should have the right to negotiate bilaterally if they think the mandated negotiations are unlikely to succeed. We are not convinced that this is a sustainable argument: there are areas of Community competence where the Member States no longer have the right to take action, and even on the matter of the “nationality” clause, there are divided opinions about whether or not Member States could act separately from the Commission.

109. Having said this, it is, in the view of the Committee, important that this opportunity be seized. We sense that witnesses such as Virgin Atlantic are right when they describe this as an historic opportunity to change the nature of civil aviation away from a highly regulated market to an open and liberalised one. We recognise it cannot happen quickly, but we note that action to deal with the matters raised by the ECJ Judgments has to be taken quickly. **We urge the Government, therefore, to attempt to achieve agreement at the June Transport Council so that negotiations can be opened quickly thereafter with the Americans on these specific issues.**

110. We also see benefit in Member States granting the Commission a wider mandate to negotiate an EU/US open aviation area. We agree strongly with the Government that this negotiation must not settle for anything less than full liberalisation—an extension of the US “open skies” system will not lead to the type of consolidation in the airline industry and restructuring of that industry that will ultimately bring the fullest economic benefit. However, **we urge the Government to keep the objective of a fully liberalised aviation market firmly in its sights. We think that the economic benefits to the United Kingdom economy will justify risks taken in negotiation to achieve them.**

111. The Committee considers that the European Court of Justice judgments and their effect on existing bilateral air service agreements between EU Member States and the United States of America raise important questions to which the attention of the House should be drawn and makes this Report to the House for debate.

## APPENDIX 1

**Membership of Sub-Committee B**

The Members of Sub-Committee B who conducted this inquiry were:

Lord Cavendish of Furness

Lord Chadlington

Baroness Cohen of Pimlico

Lord Cooke of Islandreagh

Lord Faulkner of Worcester

Lord Fearn

Lord Howie of Troon

Lord Shutt of Greetland

Lord Skelmersdale

Lord Woolmer of Leeds (Chairman)

## APPENDIX 2

**Call for Evidence**

Sub-Committee B (Energy, Industry and Transport) of the House of Lords Select Committee on the European Union is undertaking an inquiry into the Future of European Aviation Relations with the United States of America (US) and Other States.

On November 5th the European Court of Justice (ECJ) issued its long-awaited judgments in the so-called “open skies” cases. These concerned two separate legal issues. First, whether it is the Community or individual member states which have competence to negotiate air services agreements with other states. Second, whether existing “nationality” clauses in air services agreements infringe Community law on the right of establishment.

On the competence issue, the Court held that states do have the right to conclude bilateral air services agreements, except when they deal with certain areas such as air fares within the European Union (EU), which are the preserve of the Commission.

On the second issue, the Court held that nationality clauses in the bilaterals with the US, which limit designation to airlines “substantially owned and effectively controlled” by nationals of the two signatory states infringe Article 43 of the EC Treaty on the right of establishment.

In response, the European Commission (EC) has called on EU member states to revoke their aviation agreements with the US and to give it (the Commission) a negotiating mandate to conclude an EU-US air services agreement.

Evidence is invited on the issues raised by the Court’s decision and the Commission’s response to it.

In particular, the inquiry will be seeking answers to the following questions:

- (1) What action should EU Member States take to ensure that existing Bilateral Air Transport Agreements conform to the ECJ judgments?
- (2) Should the United Kingdom (UK) Government and the other EU Member States be encouraged to give a mandate to the European Commission to negotiate an EU-US air services agreement?
- (3) What practical difficulties would the Commission face in undertaking such a mandate? How could they be overcome?
- (4) Would an EU-US agreement lead to improved air services and wider choice for UK, EU and US travellers?
- (5) What are the longer-term implications of the Court’s decision (on nationality clauses) and a possible EU negotiating mandate on the UK’s air services agreements with states other than the US?
- (6) Will the relaxation of the nationality rule facilitate airline consolidation in Europe through cross-border acquisitions and mergers? Would such consolidation be in the interest of UK and EU air transport industry?

## APPENDIX 3

**List of Witnesses**

The following witnesses gave evidence. Those marked \* gave oral evidence.

- \* Air 2000
- \* Air France
- \* Air Transport Users Council (AUC)
- \* Association of European Airlines (AEA)
- \* Michel Ayral, Director of Aviation, European Commission
- BAA plc
- \* BMI British Midland
- \* British Airways Plc (BA)
- \* British Cargo Airline Alliance (BCAA)
- \* Professor Kenneth Button
- \* Charter Airline Group of the UK (CAGUK)
- \* Civil Aviation Authority (CAA)
- \* Professor Eileen Denza
- DHL Air Limited
- easyJet
- \* European Commission
- FedEx
- \* Richard Gardiner
- German Directorate General for Civil Aviation, Aerospace and Shipping
- M J Hall
- Trevor Soames, Geert Goeteyn, Dr Peter D Camesasca, Howrey Simon Arnold & White LLP
- KLM Royal Dutch Airlines
- \* Loyola de Palacio, Vice-president for Relations with the European Parliament and Commissioner for Energy and Transport, European Commission
- Ryanair
- \* Department for Transport
- Brian Simon MEP
- \* Professor Piet Jan Slot
- \* Rt Hon John Spellar MP, Minister of State for Transport
- David Starkie
- \* Virgin Atlantic Airways Limited

APPENDIX 4  
**Glossary of Terms**













APPENDIX 5

**The “Freedoms” of the Air**

## APPENDIX 6

**The Exclusive External Competence of the Community**

This Note seeks to provide some clarification of the basic legal framework.

**(a) Legal Personality**

1. The Community has legal personality by virtue of Article 281 of the Treaty and capacity, within its field of competence, to enter into obligations binding in international law. The Community is party to a wide variety of international agreements. It is also a member of a number of international organisations. However, the Treaties do not expressly confer legal personality on the European Union and consequently, it is argued, the Union has no power to contract obligations binding in international law or to belong to international organisations.

**(b) Sources of Community competence**

2. The Community's competence to conclude international agreements arises from two sources.

(i) Express provisions in the Treaty. For example, Article 133 enables the Community to enter into tariff and trade agreements within the scope of the Common Commercial Policy. Other examples can be found in Article 111 (monetary and foreign exchange agreements), Article 155 (TENs), Article 174 (Environment) and Article 181 (Development co-operation);

(ii) The jurisprudence of the European Court of Justice. The Court has held that external competence may flow from other provisions of the Treaty and measures adopted within the framework of those provisions. Thus the existence of "internal rules" (sometimes referred to as the AETR doctrine) or of unexercised Treaty powers to adopt such rules confers external competence to the Community.

**(c) Competence – the legal implications**

3. The Community's ability to conduct external relations is restricted, as a matter of law, to those areas where it has competence. On the other hand, where and to the extent that the Community has competence, Member States' freedom of action is limited. They may not enter into agreements between themselves or with third States on the same subject matter. This is a consequence of the supremacy/primacy of Community law – Member States cannot prejudice the operation of Community law by entering into external obligations.

4. Where the transfer of competence is partial, because the Treaty expressly preserves Member States' competence (e.g. Article 174 (4)) or the internal rules, as is the case in relation to civil aviation do not occupy the whole field, then the Community and the Member States share competence. Both will be parties to the international agreement, which is commonly referred to as a "mixed agreement". Internal and external competence are therefore directly related.

5. The precise extent of Community competence in relation to a particular subject or agreement is frequently a matter of concern and debate between the Commission and the Member States. (The external competence implications of a proposal may therefore influence Member States' decisions on the adoption or extension of internal rules).

**(d) Transport Policy**

6. It is clear that the Community has competence in relation to external trade matters. Articles 131-134 enable the Community to conduct a common commercial policy with third States. The policy has facilitated the establishment of a customs union between the Member States and is based on uniform principles with regard to such matters as tariff rates, the conclusion of tariff and trade agreements with third States, import and export policy. It has been long recognised that the common commercial policy is an area where the Community has exclusive competence. But the precise scope of the common commercial policy has been hotly debated. In particular, does it include services and, in particular, transport. The matter came before the Court of Justice prior to the conclusion of the Uruguay round and the Court state the law in its Opinion 1/94.

7. In a lengthy, detailed and somewhat complex ruling the Court held that the common commercial policy covered some, but not all, modes of supplying services. The Court also held that international agreements in the field of transport were excluded from the scope of the common commercial policy: transport was the subject of a separate and specific title of the Treaty. But the Court went on to reaffirm its jurisprudence on the sources of Community competence (see para (b) above) and found, after a detailed examination of the *acquis*, that the Community had, by virtue of relevant existing "internal rules", (limited) competence in relation to transport.

8. Where the line presently lies between the Community's exclusive external competence and Member States' competence to conclude international agreements depends primarily on the identification of "internal rules" (ie the three liberalisation packages and other existing regulations in or affecting the sector). As the witnesses explained, any negotiation of matters within Member States' competence (eg traffic routes) may not in practice be separated from matters the Community's exclusive external competence (eg slots).

Dr Christopher Kerse

Second Counsel to the Chairman of Committees and Legal Adviser to the Select Committee on the European Union, House of Lords

21 January 2003

## APPENDIX 7

**US Official Comments on EU "Open Skies" Ruling**

**Date: November 8, 2002**

*U.S. bilateral "open skies" and other air services agreements with European Union (EU) member states remain in force despite the European Court of Justice's November 5 ruling that certain provisions of those agreements are contrary to EU law, says a U.S. Department of Transportation official.*

*The EU court decision "did not have any immediate impact on the rights of U.S. and European airlines to continue to conduct services pursuant to the challenged bilateral agreements," Assistant Deputy Secretary of Transportation Jeffrey Shane said November 8 to an American Bar Association forum in Florida.*

*Shane described his remarks as "a first reaction, and largely a personal one," to the long-awaited European Court ruling. He emphasized that the U.S. government is still studying the decision carefully and examining its implications.*

*The court decision affects U.S. bilateral air services agreements with eight EU countries: Austria, Belgium, Britain, Denmark, Finland, Germany, Luxembourg and Sweden. The case was brought by the European Commission, which argued that EU law gives the Commission sole authority to represent its members in air services negotiations with third countries and that EU members' bilateral agreements with the United States are therefore illegal.*

*Shane said the ruling was the subject "of some of the most galactically erroneous reporting in recent history." Contrary to many press reports, he said, the European Court "did not strike down" the bilateral agreements nor did it prohibit EU member states from continuing to conduct negotiations with the United States in their own right.*

*Instead, the court decision focused on specific provisions of the bilateral air services agreements dealing with four areas: 1) the allocation of airport slots; 2) the pricing of intra-European air services; 3) the rules governing computer reservation systems established in EU territory; and 4) restrictions on airlines owned by nationals of EU member states that are not party to the bilateral agreement.*

*Of those areas, Shane said, the fourth -- dealing with nationality clauses -- was the most interesting and potentially far-reaching element of the decision.*

*He said that press reports on this question had mischaracterized overall U.S. aviation policy as seeking to restrict competition. In fact, he argued, the United States has over the past decade sought Open Skies agreements with as many partners as possible, and has concluded 59 such agreements, including 11 with EU member states.*

*With respect to the air services agreements that were challenged in the European Court, Shane described the nationality provisions as "permissive," and said the United States has sometimes waived its objections under such clauses "in the interest of ensuring fuller participation in the aviation market by certain trading partners and to encourage competition." He also pointed to U.S. agreements "with partners from Scandinavia to Africa to the Caribbean" that explicitly accommodate operations by airlines under multinational ownership.*

*As further evidence of the United States' willingness to seek "creative" alternatives to nationality clauses, Shane cited the U.S. multilateral Open Skies agreement with Brunei, Chile, New Zealand, Singapore and, most recently, Peru. The agreement is "notable," he said, because it expressly prohibits any signatory country from objecting to operations by an airline that does its principal business in that country but is owned by non-citizens.*

*Shane also touched on the question of possible U.S. aviation negotiations with the EU, as an entity, following the European Court decision. While the decision did not confer a negotiating mandate on the European Commission, the United States "is not celebrating that fact," he said. U.S. officials, he added, "have said for many years that we look forward to the day when U.S.-EU negotiations will be possible."*

**Following is the text of Shane's remarks as prepared for delivery:**

**OPEN SKIES AGREEMENTS AND THE EUROPEAN COURT OF JUSTICE**

I am very happy to be here this morning -- and for more reasons than you might think. As I explained at the Forum's last meeting in Washington earlier this year, when I re-entered public service I was told I had to resign prematurely as Chairman of the Forum. I felt pretty guilty about that. My term, and the heavy lifting that goes with it, had only just begun. I felt that I'd managed to add the Forum Chairmanship to my resume without really earning it. Under the circumstances, therefore, the arrival of the Forum's invitation to speak to you today carried special meaning: it meant I'm not *persona non grata* around here after all. That's a great relief.

As you know, the European Court of Justice issued a very important and long-awaited decision three days ago. Because it was immediately the subject of some of the most galactically erroneous reporting in recent history, I want to offer you some facts about what the decision actually said -- at least as I understand it -- and some very preliminary thoughts about its implications for the future of trans-Atlantic aviation relations. I should emphasize, of course, that the U.S. Government is still studying the decision carefully and thinking hard about its implications. These remarks, in other words, are essentially a first reaction, and largely a personal one.

The case arose in 1998 as an effort by the European Commission to establish the proposition that bilateral air services agreements between individual Member States of the European Union on the one hand and countries outside the EU on the other -- notably the United States -- are contrary to EU law. The Commission argued that only it had the legal authority -- or "competence" in EU parlance -- to represent the Member States in the conduct of air services negotiations with third countries.

U.S. airline officials often discuss the U.S. Government's competence to conduct aviation negotiations, but I suspect they are not talking about our legal authority.

Anyway, the Commission's theory was that, within the EU, competence -- legal authority -- for the conduct of aviation relations with third countries has been vested in the Commission since the mid-90's, when the so-called "Third Package" completed the establishment of a single aviation market within the EU. The Commission argued that seven bilateral Open Skies agreements forged between particular Member States and the U.S. subsequent to that time -- and the U.S.-U.K. air services agreement -- were contrary to EU law. According to the Commission, the Member States simply did not have the legal authority to enter into those agreements.

A lot of speculation preceded the issuance of the decision -- particularly on this side of the Atlantic. What if the Court agreed with the Commission and invalidated our bilateral agreements? Would U.S. airlines continue to enjoy the rights they have to serve European destinations and beyond? Would European airline services to U.S. communities be interrupted? Would U.S. and European airlines still be able to price their trans-Atlantic services without worrying about regulatory restrictions as they can today? Would they be allowed to maintain productive trans-Atlantic marketing and code-sharing alliances, which are predicated most importantly on the guarantee of unrestricted market entry and the open route descriptions that are central features of every Open Skies agreement?

What if EU Member States were prohibited from conducting bilateral negotiations with the U.S. in their own right, but the Commission did not yet have authority to negotiate on behalf of the EU as a whole? We'd have nobody to negotiate with.

Mirror-image concerns, of course, were expressed in Europe.

Last Tuesday, November 5, we got the answers. The European Court of Justice rendered what American lawyers would call a "surgical" decision. Contrary to a great many headlines that appeared in the press, it did not strike down the bilateral agreements that were the subject of the Commission's complaint. Nor did the Court prohibit EU Member States from continuing to conduct negotiations with the U.S. in their own right. The Court certainly did not -- and indeed could not -- confer competence on the Commission to conduct negotiations with the U.S., a political decision that can only be taken by the EU Council of Ministers. And most importantly, the decision did not have any immediate impact on the rights of U.S. and European airlines to continue to conduct services pursuant to the challenged bilateral agreements.

Instead, the Court found that certain specific types of provisions in those bilateral air services agreements -- because they implicated subject matter that is now the subject of internal EU regulations that address the rights of non-EU nationals -- are contrary to EU law.

Specifically, provisions in bilateral aviation agreements that the Court found objectionable were those that:

- addressed the allocation of slots;
- governed the pricing of intra-European air services -- so-called "fifth freedom" pricing provisions;
- addressed computer reservation systems; and
- reserved the right to operate services under the bilateral agreements in question only to airlines substantially owned and effectively controlled by nationals of the EU Member State that is a party to the agreement.

I know that assessments of the decision from this side of the pond are not likely to be of great interest either to the European Court of Justice or to the Commission, but I have to say that, to this observer at least, the decision seems entirely unsurprising. Indeed, American lawyers will be reminded of our own doctrine of pre-emption: the well-established principle that state governments are prohibited from legislating with respect to any subject area "occupied" -- and thus pre-empted -- by our national government. Aviation lawyers in particular know about the principle because of a number of important decisions -- including some by the U.S. Supreme Court -- relating to whether and to what extent state governments retained the ability to regulate airline behavior following Congress's passage of the Airline Deregulation Act in 1978.

What the European Court said -- if I can paraphrase it in American terms -- was that certain aspects of civil aviation have been pre-empted by EU regulations, and no EU Member State has the ability to agree to any provision in an air services agreement that runs counter to those regulations. Conversely, those aspects of aviation that the Commission has not pre-empted through regulations remain legitimate fodder for bilateral negotiations.

Many of the press stories earlier this week said that the Court struck down "central features" of the aviation agreements between the U.S. and the eight EU Member State defendants.

Let's examine that proposition. As most observers of the aviation negotiating process know, there is only one feature of any bilateral agreement that can legitimately be termed "central." That is the provision that spells out the traffic rights made available by the agreement. These agreements are mainly about one thing: the operation of commercial flights between the territories of the contracting parties, as well as operations from the other party's territory to the territories of non-contracting parties. Without traffic rights, there would be no purpose in having any agreement at all. Traffic rights, in a real sense, are the whole point of an air services agreement.

The European Court of Justice did not find the provisions awarding traffic rights to be contrary to European law, except in one respect that I will come to in a moment. So the most central feature of all was not struck down by the decision.

Let's consider, then, the provisions that were struck down.

First, provisions relating to the allocation of airport slots were held to be contrary to EU law. But the Court also found that not one of the bilateral agreements that were the object of the Commission's complaint contained any such provision. So no action is necessary on that score.

Second, provisions governing the pricing of intra-European air services were also held to be contrary to EU law.

In an earlier day, when airplanes had much shorter range and Fifth Freedom operations represented an important factor in the conduct of economically viable air services, the U.S. fought hard to secure the ability of U.S. carriers to be price leaders in those so-called "beyond" markets. The provision therefore can be seen as a vestige of a bygone era.

Today, particularly in Europe, U.S. combination carriers have mostly abandoned Fifth Freedom operations in favor of code-shared connections with alliance partners. Moreover, the EU itself no longer regulates prices for intra-European air services, so that even all-cargo operators -- those who might otherwise want to retain the comfort provided by those Fifth Freedom pricing provisions -- can rest easy. And finally, because most of our open-skies agreements with EU member states already recognize that EU law does not entitle U.S. airlines to be price leaders on intra-EU routes -- the agreements even cite the relevant EU regulation -- the ruling actually doesn't affect the pricing opportunities actually available to U.S. airlines today. It is hard to argue, in other words, that these

very narrow provisions relating to Fifth Freedom pricing are in any way essential to the integrity of our Open Skies agreements.

Third, the Court found provisions dealing with computer reservation systems objectionable because, again, there are EU regulations on the subject. I know a lot about those provisions because I negotiated a few of them during the 1980's when I was at the State Department. They were important provisions then for two important reasons: First, a few U.S. carriers owned their own systems and felt that they could not compete fairly in Europe unless they were in a position to place their systems in European travel agencies alongside the systems owned by the competing national carriers. Second, the U.S. Government was concerned about the serious bias that it found throughout the European systems at that time.

The situation today is quite different. First, no U.S. airline owns a CRS [computer reservation system] solely in its own right. Second, as the Court found, the EU does indeed have regulations governing the CRSs deployed in EU territory. The U.S. and the Commission have sparred from time to time over whether EU rules are overly prescriptive and thus impede innovation. That debate aside, we can certainly acknowledge one important feature of those rules: Their underlying purpose is to ensure fair competition. Indeed, our European counterparts think their rules are better than ours in that regard. The point now is not whether EU rules are better than U.S. rules or vice versa; the point is that we both have rules! Some of our open Skies agreements even include an explicit statement acknowledging that in the event of a conflict between EU rules and the rules set forth in the agreement, our EU partners will have to abide by the EU rules. Again, therefore, the continuing requirement for these CRS provisions in Open Skies agreements with our EU trading partners seems open to question.

Finally, the European Court held contrary to EU law all provisions allowing the U.S. and our EU trading partners to prohibit air services under a bilateral agreement by any airline that is not a citizen of the EU Member State party to the agreement. Because EU law, dating as far back as the Treaty of Rome, includes the right of establishment and national treatment for all Member States, any provision in which an EU Member State agrees to allow the United States to veto services by an airline owned or controlled by citizens of a second EU Member State represents discrimination by the first Member State against the second. In other words, Germany is not allowed to discriminate against the airlines of France by agreeing that the U.S. may reject services offered between Germany and the U.S. by any carrier that isn't substantially owned and effectively controlled by German citizens -- which Air France certainly is not.

This is the element of the Court's decision that is most interesting and that is likely to have the most far-reaching implications.

The first thing to be said about this finding is that it's all about Europe; not about the U.S. To refer again to the press, I've seen accounts suggesting that the clever Americans have established a huge advantage over our European trading partners by retaining these nationality clauses in our bilaterals. That characterization misses some very important points about U.S. aviation policy.

First, as you know, U.S. policy since 1992 has been to seek Open Skies agreements with as many partners as possible. We are up to 59 such agreements, including eleven with member countries of the EU. When the U.S. signs an Open Skies agreement with another country, it agrees to allow airlines of that country to fly to any airport in the vast landmass of the United States from anywhere in the world, usually subject only to the requirement that the flight serves a point in the carrier's home territory. Because the U.S. has Open Skies agreements with eleven EU Member States, we have already agreed that flights from the airlines of those countries can depart Europe from any city in any of those countries.

Second, the offending nationality provisions are permissive. In other words, they do not require the U.S. to reject a carrier originating flights to the U.S. from a country on the ground that it isn't owned and controlled by citizens of that country. Indeed, the U.S. from time to time has waived its objections under such clauses in the interest of ensuring fuller participation in the aviation market by certain trading partners and to encourage competition. And we have agreements with partners from Scandinavia to Africa to the Caribbean in which we have worked out understandings that explicitly accommodate operations by airlines characterized by multinational ownership.

Finally and most important, we entered into a multilateral Open Skies agreement a couple of years ago with four of our partners in APEC -- the Asia-Pacific Economic Cooperation forum. The partners are

Brunei, Chile, New Zealand, and Singapore. Peru acceded to the agreement earlier this year and we have actively encouraged other trading partners -- both within and outside of APEC -- to join as well.

That agreement is notable for its departure from the conventional approach to airline nationality. The agreement expressly prohibits any signatory country from objecting to operations by any airline that has its principal place of business in the country from which its flights originate on grounds that it is not owned by citizens of that country. The airline must be controlled by such citizens, and the benefit is available only to airlines of countries that are parties to the multilateral agreement, but the agreement nevertheless represent a significant step forward in the liberalization of the traditional nationality clause.

I hope that I have made clear here today that the United States is prepared to look creatively at nationality clauses. We certainly do not treat the traditional formula as sacrosanct.

The last point I would make about the Court's decision relates to the prospects for conducting negotiations with the EU as an entity. As I indicated earlier, the Court did not and could not confer a negotiating mandate on the European Commission. But the U.S. is not celebrating that fact. We have said for many years that we look forward to the day when U.S.-EU negotiations will be possible.

The U.S. quest for liberalization in air services has not abated. In Europe and elsewhere, we have sought that liberalization wherever we could find it. We might have saved a lot of money and a lot of time if we could have negotiated with the Commission in Brussels instead of conducting talks with the Member States one by one. But negotiating separately with each Member State has resulted in a broad array of trans-Atlantic air services that are already largely deregulated -- at least compared to the regimes in place a decade ago, prior to our first Open Skies agreement with the Netherlands. The bilateral option is still available to the U.S., and you can be sure that we will continue to pursue it where further market opening initiatives appear to be within reach.

The question now is this: How can we take liberalization to the next level? In my judgment, an essential prerequisite is a like-minded partner on the other side of the negotiating table that represents an airline industry and an aviation market comparable to our own. The EU airline industry, taken as a whole, and the EU aviation marketplace, taken as a whole, certainly satisfy that test. Will it be a long, difficult negotiation? Of course. Will we need time to transition to a more liberal regime? Probably. But such negotiations would compel both sides to think seriously about how the trans-Atlantic market can be made more robust and competitive. And the end result, by creating a more open market and the economic and structural opportunities that come with it, will be a healthier airline industry and increased consumer welfare on both sides of the Atlantic.

We have no control whatsoever over the timing, form, or content of a possible Commission mandate. We will continue to watch and wait. Some speculate that this week's decision by the European Court of Justice will accelerate the delivery of a mandate to the Commission. We look forward to hearing from our European counterparts whether they think that will happen, and if so, when.

Many thanks for allowing me to share these thoughts with you this morning.

*(Source: the Office of International Information Programs, U.S. Department of State.)*