INTERNATIONAL AIRLINES

Panel leader:
Richard S. Golaszewski
Gellman Research Associates

Panelists:
Gerald W. Bernstein
SRI International

Robert L. Bowles
Federal Aviation Administration

Michael Pustay
Texas A&M University

Michael Goldman
Bagileo, Silverberg & Goldman, LLP

James Craun
Office of the Secretary of Transportation

Robert Duclos
Transport Canada (ACACA)

Introduction

The panel discussed events that could shape the growth of international airline activity in major market areas affecting the United States. In particular, the panel was concerned about those events that could either alter the forecast growth rates for aviation activity or change the locations at which such activity took place. The panel identified four factors that could cause the growth of the international aviation activity to differ from The level projected by using the normal economic and demographic variables typically considered in aviation activity forecasts:

- The regulatory environment for international air services,
- The structure of the market for international air services,
- Alliances among airlines, and
- Airline strategies such as code sharing.

The above factors are also likely to change at the same time in certain markets. The panel also observed that the financial restructuring of the Federal Aviation Administration (FAA) could affect the level of activity for all segments of aviation including domestic airlines, international airlines, and general aviation. The proposals to shift to full user funding could result in more of FAA's budget being paid for by users in the form of increased aviation taxes or fees for service. The aviation sectors which are asked to bear increased costs will have reduced demand, reduced profitability or both.

The panel was apprised of a difference in what FAA includes in forecasts of international aviation activity and what FAA proposes to measure in the future. Today, FAA forecasts cover only the international activity of U.S. air carriers. In the past, the total FAA workload could be scaled from this measure because it was believed that the mix of activity between U.S. and foreign carriers was relatively stable. However, international airline alliances and code sharing are causing shifts in the share of traffic carried by U.S. and foreign carriers. As such, it is difficult to ignore the activities of foreign airlines carrying passengers to and from the United States. In the future, FAA will measure international airline activity to and from the United States for all carriers. A major purpose of FAA forecasts is to estimate workload for FAA facilities, and the panel believed that the new methods of forecasting activity will provide a better indicator of the growth in demand for FAA services related to international airline activity. In addition, because there is a tax levied on international air passenger departures from the United States, the new measure of international airline activity should improve forecasts of projected tax receipts.

Forecast

The panel discussed how aviation activity might grow and the forces that will shape the demand for these services in four market areas:

- U.S.-Canada,

TABLE 1 NEW U.S. SERVICES PROVIDED BY CANADIAN AIRLINES

Air Canada	Canadian Airlines International
Toronto–Atlanta	Vancouver–Chicago
Toronto–Washington	Toronto–Chicago
Montreal–Boston	Toronto–Fort Lauderdale
Montreal–Fort Lauderdale	Toronto–Orlando
Montreal–Washington	Toronto–St. Petersburg
Ottawa–New York	
Ottawa–Washington	

Source: J. Craun, U.S. DOT.

- U.S.-Atlantic,
- U.S.-Pacific, and
- U.S.-South and Central America.

Of the above, FAA includes the U.S.-Canada market in the domestic traffic forecast. However, air services between the U.S. and Canada are governed by bilateral air service agreements. In the last year, such agreements have been significantly liberalized and are set to move to an open market. It is expected that there will be an increase in the growth rate in this market as it shifts from a highly regulated to deregulated position. James Craun of the Office of Aviation and International Economics made a presentation of current service trends in the U.S.-Canada market and identified how airlines have responded to the opening of the U.S.-Canada air services market. Materials used in his presentation are contained in Appendix B.

U.S.-Canada

Canada and the United States historically had a very restrictive bilateral air services regime with strict controls on capacity, entry, and pricing. The governments agreed to liberalize air services between the two countries effective in February 1995. Both U.S. and Canadian carriers have responded to the liberalization of air services between the two countries. Canadian carriers were afforded essentially open skies and have the ability to enter all U.S.-Canada market pairs. U.S. carriers were allowed open skies entry into all Canadian airports except Montreal, Toronto, and Vancouver. In the case of Montreal and Vancouver, additional services were limited for the first two years, while in the case of Toronto, there is a phased entry program over three years. The adjustment period was allowed so that Canadian carriers could reach a sufficient scale of operation before facing full competition from U.S. airlines. After this phase-in, an open skies air services regime will prevail between the United States and Canada.

Overall, there has been growth of 30 to 40 percent in the number of seats offered in the U.S.-Canada market during the first year under the new agreement. There has been a larger percentage increase in capacity by Canadian carriers. The growth rate in passengers carried has lagged somewhat and is on the order of from 10 to 15 percent on an annual basis. If the difference in growth rate between seats offered and passengers carried remains, the market eventually will have to shake out, with some of the new services being withdrawn. The panel believed that carriers are experimenting with new markets and will remain only in those that allow profitable operations. In fact, there has already been some exit from newly served markets.

Canadian carriers are generally adding service to major U.S. cities and to popular U.S. resort destinations for Canadian tourists (Table 1). An exception is Canadian Airlines International (CAI) which, because of its alliance with American Airlines, is also adding service to American's hubs. The Canadian carriers appear to be shifting existing charter service to scheduled operations, such as Air Canada's and CAI's flights to Florida. Air Canada is adding point-to-point service and serving secondary markets with its Canadian Regional Jet (RJ) aircraft. For operations at the four high density airports in the United States governed by slot rules, Canadian

TABLE 2 NEW SERVICES TO CANADA PROVIDED BY U.S. CARRIERS

American	**Reno-Air**
Chicago–Calgary	Reno–Vancouver
Chicago–Ottawa	
Chicago–Winnipeg	
Dallas–Montreal	**United**
Dallas–Vancouver	Denver–Calgary
Miami–Montreal[1]	San Francisco–Calgary
Miami–Toronto[1]	San Francisco–Vancouver
Continental	**USAir**
Newark–Montreal	Washington–Montreal
Houston–Vancouver[2]	Washington–Toronto
Newark–Vancouver[2]	Pittsburgh–Toronto
Delta	**Midwest Express**
Atlanta–Montreal	Milwaukee–Toronto
Atlanta–Toronto	
	USAir Shuttle
America-West	Boston–Montreal
Phoenix–Vancouver	New York–Montreal
Northwest	**Value Jet**
Detroit–Halifax	Washington–Montreal
Detroit–Ottawa	
Minneapolis–Calgary	
Minneapolis–Montreal	
Minneapolis–Regina	
Minneapolis–Saskatoon	
Minneapolis–Vancouver	

[1]Transferred
[2]Discontinued

carriers will be treated like U.S. carriers as far as slot allocations, the ability to buy and sell slots, and so forth.

Most U.S. carriers appear to be adding spoke flights from their hubs in the United States to points in Canada. For example, as shown in Table 2, American has added service to Canada from its hubs in Chicago, Dallas, and Miami; and Northwest has added service to a number of smaller Canadian cities from Detroit and Minneapolis. While it would technically feasible for a U.S. carrier to serve east to west traffic in Canada over a hub in the northern United States, customs clearance and immigration clearance procedures (as well as prohibitions on cabotage) would not make such service attractive to passengers.

In addition to hub-oriented services by U.S. carriers, American Airlines is also adding flights from the United States to Vancouver because of its code-sharing relationship with CAI. It will serve some transpacific markets from Vancouver by code sharing on CAI flights. The U.S.-Canadian agreement allows unlimited code sharing if a carrier has the underlying traffic rights to third countries.

Both Air Canada and CAI had to undergo a phase of cost reductions prior to Canada entering into an open skies agreement so that these airlines could effectively compete with U.S. carriers. The phase-in of liberal authority for U.S. carriers seeking to serve the largest Canadian markets also provides Air Canada and CAI with a window of opportunity to establish frequent service to some U.S. markets before they must face competition from the full range of U.S. carriers. This provision allows for the smaller size of Canada's airlines in relation to the U.S. megacarriers.

Because of the size of the airline markets in Montreal, Toronto, and Vancouver, the phased entry of U.S. carriers on routes to these cities will stretch out the adjustment period for increased traffic growth due to the U.S.-Canada agreement. The panel believed that a growth rate of from 10 to 15 percent in enplanements should be the base for each of the following two years. Growth in available seats is expected to be at somewhat higher rates initially as carriers seek to identify profitable new market opportunities. However, once the initial flurry of activity is over, the growth in seats each year should mirror the growth rate of passengers.

In recent years, the growth in enplanements between the U.S. and Canada has been below two percent per year (*Airline Business*, October 1995, 52). The panel believed that the liberalization of air services between the U.S. and Canada has definitely stimulated traffic, and that there will be a one-time increase in growth associated with the liberalized air services regime. After that, growth should return to a more normal annual rate, but higher than that observed under the restricted market. The U.S.-Canada experience points to what can be expected by liberalizing formerly highly restrictive air services regime. That is, there will be a one-time spurt in the rate of traffic growth but these markets also will achieve a greater rate of growth than regulated markets even when the adjustment period is over.

U.S.-Atlantic

Some additional traffic stimulation is expected on the North Atlantic from the continued establishment of alliances between U.S. and European carriers. This would result from either fare reductions, improved service quality, or both. In addition, European carriers are likely to continue attempts to reduce their own costs and by passing this cost reduction on to passengers in the form of lower air fares. While this cost restructuring will principally affect intraeuropean traffic, it may also affect transatlantic traffic as the single European airline market is established in 1997, The particular nature of airline alliances between U.S. and European carriers may lead to a near-term shift away from transatlantic flying by U.S. carriers. When carriers enter into an alliance, they generally reduce overlapping services. It appears that U.S. air carriers are more willing or able to reduce or redeploy their own capacity and, as a result, the European partner continues to fly the long-haul transatlantic segments (Some of the reduction in transatlantic flying has also occurred as carriers, such as Delta, have restructured route networks that they have acquired).

Northern European carriers have been more successful in reducing their costs, and this will put additional pressure on inefficient carriers in Southern Europe. As the airline markets between European countries open up, high-cost carriers will either have to reduce costs or lose market share. In addition, the European Union is trying to eliminate state aid and to provide airport slots to new entrants. Both of these policies should stimulate competition among Europe's airlines and may cause incumbent airlines to lose market share.

Airline alliances between U.S. and European carriers are also changing the shape of transatlantic air services. Delta, which had established a hub in Frankfurt, has now entered into an alliance that includes Sabena, Swissair, and Austrian Airlines. Apparently, Delta will move the locus of some of its European activities from Frankfurt to Brussels and Zurich. Delta recently filed for antitrust immunity for its European alliance, stating it had met the requirement that all participating carriers are from countries that have open skies bilateral agreements with the United States. Delta also stated that this combination of airlines results in a grouping of carriers that would not be viewed as dominant on competitive grounds.

U.S.-Pacific

The panel expected that Asian carriers will continue to focus on the inter-Asia and Asia-Europe markets, because they offer the most profitable opportunities for expansion. The market between North America and Asia is not large or lucrative enough to be a major concern for these carriers. If American Airlines enters into a code-sharing agreement or strategic alliance with Japan Airlines, this would be the most significant alliance to date between a U.S. and Asian carrier. Apparently, All Nippon Airlines (ANA) and Delta have entered into a code-sharing agreement, but this has not yet been approved by the U.S. DOT. As noted above, American Airlines has also entered into a code-sharing agreement with CAI and is now focusing some activities on feeding CAI in Vancouver to connect with long-haul flights to points in Asia.

U.S.-South and Central America

Cyclical patterns of growth in aviation activity are expected between the United States and South and Central America. In some years, growth rates between the United States and South American countries will be high, but they will not be uniformly high across all countries in a single year. A large proportion of the market is still comprised of traffic to the Caribbean

Islands and Mexico. Much of this traffic is served by the American Airlines hubs in San Juan and Miami. American Airlines has established a dominant position as the one network carrier serving South and Central America.

Airline Alliances

With the continued establishment of alliances between airlines throughout the world, the industry is becoming increasingly global in its reach. Carriers are seeking to expand the reach of their networks and alliances. While not cost-reducing per se, this allows economies of density and scope that permit a carrier to increase market share or yields. More carriers are likely to seek the benefits of an international alliance. However, there may be some carriers which may not be attractive as a partner in an alliance. These carriers are likely to have lower growth in international markets. There is an increasing trend towards carriers seeking antitrust immunity in the United States so that they can fully exploit agreements with alliance partners. International airline alliances also may lead to shifts in traffic among airports as U.S. carriers seek to concentrate international service at their hubs.

Airline alliances could lead to increased concentration in some individual markets, particularly those connecting the hub of a U.S. carrier with a major European gateway airport. For example, American Airlines pulled back its Philadelphia service to London in response to the BA-USAir alliance, in spite of reported load factors in the 80-percent range. American indicated that all the high-yield traffic was going to the BA-USAir alliance because of BA's dominant position in London and USAir's dominant hub in Philadelphia. It is possible that the JFK-Brussels market, under Delta's alliance with Swissair, Sabena, Austrian would become a similarly concentrated market. It would be hard for a network carrier to enter a market where the airports are dominated by alliance carriers at both ends. This is not to say that such a market, because it may have high yields, would not be attractive to a low-cost carrier. Moreover, prices in the gateway cities may be disciplined by one-stop services on competing networks. Most network carriers will either fly to or from their hubs, or to or from a major gateway in Europe.

Early indications are that the United-Lufthansa alliance is working well. This alliance should be particularly dominant in the Chicago-Frankfurt market and the Washington-Frankfurt market because the partners dominate the airports at both ends.

More alliances are expected between nonaligned European and U.S. carriers at major gateways in the U.S. and Europe. Some of these alliances could be with regional airlines offering connecting service.

The expected shift of long-haul flying to the low-cost partners in alliances still has not materialized.. The common belief is that U.S. carriers have reduced their unit costs to levels well below those of the European carriers. Yet, in many of the alliances, the European carrier is doing the majority of the long-haul flying. This may be because U.S. carriers have been reluctant to add long-haul equipment while they are repairing their balance sheets after years of losses. There also are poor data on the relative efficiency of U.S. and European carriers. This is a major impediment to developing more detailed forecasts of traffic and market share in international airline markets.

The existing hub and network opportunities, as well as the existing rights of carriers, shape the need for alliances. For example, United and Northwest are trying to maintain dominant positions in the Pacific which have been enhanced by Fifth Freedom Rights obtained by the United States immediately following World War II. Both Delta and All Nippon Airways and American and Canadian Airlines International have entered into alliances affecting the Pacific market area. The U.S. partners are trying to extend the reach of their networks further into Asia even though they do not have the capital to invest in new long-range aircraft, nor do they want to invest a lot of money going head-to-head with United and Northwest, which clearly have superior market positions. It is difficult for a carrier to get sufficient rights on a piecemeal basis and to acquire enough aircraft to develop the scale to compete directly with Northwest and United in the Pacific.

There are still many political impediments to achieving airline alliances in Asia. In the case of the United States, Japan wants to renegotiate the bilateral air services agreement because it believes that unfavorable conditions were imposed on it immediately following World War II. Hong Kong and the Peoples Republic of China are still difficult markets to broach for U.S. carriers because these countries see a value for their home carriers in maintaining the existing restrictions in the bilateral agreement (The U.S. recently reached an agreement for a new bilateral agreement with Hong Kong). Asian carriers seem to be focusing on inter-Asian markets and have less interest in access to the United States because of relatively low yields and strong incumbents such as United and Northwest. Therefore, there is little to offer an Asian country in return for allowing additional U.S. carriers to serve that country. It is difficult to reach firm conclusions to change the existing forecast for the U.S.-transpacific market because of the crucial role of Japan in this market. If Japan enters into a more open agreement with the United States, these changes could have a large effect on the FAA forecasts because of the size of Japan's airline market and its key geographical location on the routes between Asia and the U.S West Coast.

The United States, on the other hand, is reluctant to give up its advantaged position in the Pacific, and United and Northwest would probably argue to maintain the status quo. Other U.S. carriers such as Delta and American may be more willing to deal in a renegotiating posture with Japan if they thought they would receive more rights to serve the Pacific. Japan believes that its carriers are disadvantaged by its bilateral agreement with the United States because about 70 percent of the travelers in the U.S.-Japan market are Japanese, but JAL and ANA are losing market share to United and Northwest. A new runway in Tokyo, were it to be built, would definitely affect the forecast. No major structural changes in the near term in the Asian market.

With regard to antitrust, both the Department of Justice and Department of Transportation examine a carrier's request for antitrust immunity of an alliance. However, the decision on immunity rests with the DOT. Carriers have to pass a traditional merger analysis at DOT which generally asks the question: If the carriers were operated as a single firm, would they have an untoward effect on prices in the markets? A critical factor in assessing this threshold issue is whether the foreign carrier in an alliance seeking antitrust immunity is from a country which has open skies agreements with the United States. State aids and government ownership of a foreign carrier would be impediments to the United States granting antitrust immunity.

It is likely that additional alliances will apply for antitrust immunity now that the most recent alliance between Delta and Swissair, Sabena, and Austrian Airlines has applied for it. A key issue in antitrust immunity will be defining the relevant market and whether one-stop service or service at competitive airports is viewed as an effective limit on monopoly power of an alliance. If antitrust immunity becomes viewed as a necessary condition for a successful airline alliance, this could spur additional liberalization in Europe. If, for example, United and Lufthansa wish to apply for antitrust immunity, it would require that Germany enter into an open skies agreement with the United States Given that nine smaller countries in Europe have recently signed open skies agreements with the United States. (and that the United States already has an open skies agreement with the Netherlands), the addition of Germany to the group of countries with open skies agreements with the United States could stimulate other countries to request open skies agreements.

The major reason carriers have been seeking immunity from the U.S. antitrust laws is that it allows a combination of sales forces and allows the alliance members to freely discuss pricing. This reduces selling costs and allows the entire network of the alliance to be marketed by the sales force of each of the member carriers. Without antitrust immunity, the two carriers in the alliance must still market independently of one another and cannot discuss systemwide pricing strategies. Basically, the companies want to be able to deal when negotiating with large customers, and business travel is what the alliances appear to be fighting over.

Data Deficiencies

The panel found that existing data on carrier costs and traffic, especially data showing that an airline is actually carrying code-share traffic, are not sufficient to analyze what is happening at a micro level in international markets to and from the United States. For example, in the case of code-sharing or blocked-space agreements such as Delta passengers flying on Virgin Atlantic, these are reported as part of the U.K. carrier market share in T-100 data. Both the DOT's own study of international code sharing and the GAO study of code sharing called for improvements in traffic data filed by U.S. and foreign carriers to understand not only who carried the traffic, but also who sold the particular ticket. This is becoming increasingly unclear with the new airline alliances. For example, DOT obtains data on what is happening vis-a-vis European carriers only when there is a leg flown by a U.S. carrier on a complex itinerary.

Additional Forecast Needs

The panel identified a need for the FAA to begin forecasting international air cargo traffic. FAA indicated that it had ceased forecasting international air cargo immediately following cargo deregulation when data became sparse. The panel believes that, at present, this market is more stable with the principal players being the large integrated carriers such as Federal Express, UPS, as well as the belly cargo and all freight activities of the major airlines. However, the panel did recognize that new entrants such as Atlas Air and Polar Air Cargo are forces to be reckoned with in the international air cargo market. Currently, these recent start-up airlines are flying wet lease operations for some U.S. and foreign carriers.

Summary

The largest emerging trends in the international airline markets are the gradual shift of growth and traffic from traditional U.S. gateways to carrier hubs. The removal of restrictions overseas would also tend to stimulate the U.S. market for international airline services. In the U.S. domestic market, new entrants are providing price discipline. Even though they may not serve an airport with many flights, they tend to discipline the yields available to other carriers. The panel speculated as to whether new entrants could also provide competitive discipline on yields in the international markets. If so, then the improved service offered by the carriers in an alliance is likely to stimulate additional traffic growth. Finally, the U.S. policy of liberal approval of code shares seems to be a force leading towards more open international markets. The increase in airline alliances may lead to more frequent services with smaller aircraft, a trend that has been recently observed in the international markets. This would tend to result in slightly higher growth rate for aircraft operations than passenger enplanements, as average aircraft size is reduced.