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Speech

Aviation Deregulation: A Work in Progress

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Thank you for the invitation to be with you today. There's a lot to talk about, so let me get right into it.

I want to have a serious talk with you about the proper role of government as the airline industry – deregulated over a quarter-century ago – continues to reinvent itself.

Secretary Mineta and the Bush Administration have an ambitious aviation agenda, but to fully understand it you need to know that it is animated by two big ideas.

The first is that government has a fundamental responsibility to ensure that those features of the system *uniquely within the purview of government* are fully capable of accommodating whatever the market may deliver in terms of demand, and to do so safely and securely.

The second big idea is that airline deregulation is still unfinished business – a work in progress. We need to take it further to enable the industry to respond more effectively to the challenges and opportunities presented by the marketplace.

These two interrelated themes drive all of the Administration's efforts in the aviation sector. I would like to spend a few minutes today discussing some of the ways in which these themes are playing out at the moment. They will have profound implications, I believe, for the future of the industry.

Preparing for the Future

Although I want to spend most of my time today discussing the second theme – deregulation as a work in progress – I want to take just a few minutes to make a few points about the first – ensuring that the system is capable of responding to future demand. We must begin working now to ensure that we can meet the demands of passengers and shippers in the years to come. We are responding to that challenge in a number of ways, and two deserve special mention here. Simply put, we need to find more money, and we need advanced technology.

Money. With competition driving the price of airline tickets down and flooding the market with smaller aircraft, it doesn't take a CPA to figure out that relying on a percentage tax on the price of an airline ticket is no longer the right way to fund the aviation system. Accordingly, we are engaged in a thoroughgoing review of how we fund investments in our aviation system and of alternatives to the present scheme.

I can't tell you what the fix will be, because I don't know. But I can tell you that it will embody at least three important principles. First, any new funding mechanism will have to peg system revenues not to the price of an airline ticket but instead to the cost of providing service. Second, given today's tight budget environment, we won't be able to rely on a larger share of money from the General Fund. Finally, we have to find ways to fund the system that are fair to all of its users – in whatever category. If you represent any entity that has a stake in the outcome, you need to stay engaged. You can be certain that some big changes are on their way.

Technology. A closely linked element of our response to the capacity crunch is, of course, the Next Generation Air Transportation System initiative that Secretary Mineta announced nearly two years ago. This initiative isn't about writing reports. It's about pulling a group of agencies and industry stakeholders together in a highly focused, time-driven effort to develop a state-of-the-art operational concept for air traffic management, develop a timetable, and then deploy the new system. The participating agencies are working with OMB now to align their research budgets around NGATS requirements, and industry is working through a new "NGATS Institute" to engage their government counterparts. The initiative will transform the way we manage air traffic operations, and it will transform the quality of the air travel experience. NGATS is one of the most important aviation programs the government has undertaken in many years, and it is yet a further example of our determination to get out in front of changes before they swamp us.

So that's the first big theme: preparing for a robust future for commercial aviation.

Deregulation: Unfinished Business

The "Value-Added" Test. Let me turn, then, to the second animating theme of aviation policy for the Bush Administration: the conviction that deregulation is unfinished business, and that there is a lot more deregulating to be done. Our efforts in this regard are informed by a simple principle: *that our regulatory oversight of the airline industry*

needs to be limited to those areas in which that oversight adds value. For that reason, we have been reviewing carefully the entire corpus of DOT regulations in order to ensure that they pass this essential test. Where the value-added test is not met, we need to let go – as hard as that may be for us bureaucrats.

I am proud of the progress DOT has made during this Administration in easing the burden of regulation. Let me give you a few examples of what we've done thus far:

- We eased the requirements on airports relating to the filing of competition plans.
- We repealed in their entirety DOT's 20-year-old regulations governing the use of computer reservation systems.
- We streamlined procedures for licensing U.S. and foreign air carriers.
- We created an expedited, simplified procedure to award "route integration authority" for five years to all U.S. carriers who apply for it.
- We have eased tariff filing requirements for the airlines of countries with which the U.S. enjoys a liberal aviation relationship.
- We simplified the requirement for disclosure of code-share and long-term wet lease arrangements in print advertising.

We certainly don't intend to stop there. Secretary Mineta announced several weeks ago that DOT would shortly seek comments on whether it should modify or repeal its airline advertising regulations. Moreover, DOT's General Counsel, Jeff Rosen, launched an outreach effort a few months ago seeking public comment on whether there are other opportunities within DOT's regulations for simplification, modernization, or even repeal. Some of you participated in that exercise, and we are grateful for your contributions. Our review of the submissions is in its final stages, and you will be hearing more in the near future about the ideas we propose to embrace.

NPRM on "Actual Control." And that brings me to our most recent effort to apply the value-added test to our regulation of the airline industry. Unless you were one of the people who spent last week recounting Pluto's moons, you probably heard that DOT issued a Notice of Proposed Rulemaking seeking comments on a significantly less restrictive interpretation of the statutory requirement that U.S. citizens exercise "actual control" of U.S. airlines.

This is an important, indeed pathbreaking proposal. Let me offer some background and explanation.

Today, in major industries, capital is allowed to flow freely across national borders so that competitors can establish a global market presence, exploit economies of scope and scale, respond effectively to customer demand and tap market opportunities wherever they arise. It's a well-established policy, and one that applies even to industries long thought essential to our national and economic security, such as financial services, automobiles, information technology, steel, and pharmaceuticals.

The one industry in which capital is *not* allowed to flow freely across national boundaries, as all of you know, is the very industry that has facilitated the globalization of all the others – commercial aviation. That's because most countries have strict rules governing the ownership and control of their airlines. Our own statute says that U.S. citizens must own at least 75 percent of the voting stock of an airline company, that the president and two-thirds of the directors and other senior managers must be U.S. citizens, and that U.S. citizens must "actually control" the airline. If a partnership wishes to invest in a U.S. airline, the statute says that each and every partner must be a U.S. citizen or the entire partnership is deemed foreign.

That's what the statute says, and it says it very briefly and clearly. Now you might think, if U.S. citizens do indeed own 75 percent of the voting shares of a company, that those U.S. citizens *are* in actual control of the company. Occupying two-thirds of the seats on the board of directors and two-thirds of the senior management jobs, you might think, would be the clincher.

And you would be right – unless the company is an airline. For airlines, a different jurisprudence has emerged. From the earliest days, administrative interpretations have gone well beyond the words of the statute and made the test far more restrictive. By that I mean that the Civil Aeronautics Board, while it was still around, and now the Department of Transportation have layered on top of the statute, by interpretation, a new and wholly optional requirement: that there can be "no semblance" of control by foreign nationals. What that means is, even where the clear and objective tests of the statute have been met, we will come in and apply an additional *sub*jective test – whether the influence of foreign nationals over the operation of a U.S. airline company somehow "crosses the line" and becomes tantamount to impermissible foreign control.

If you look at the cases over the years, you will learn that CAB and DOT sleuths have found that prohibited semblance of foreign control buried under a lot of different rocks. If a very large overseas customer of an airline invests in that airline, we might say that, because it has life or death power over the airline – it can take its business away, after all – it enjoys an impermissible level of control. If a foreign lender represents so large a portion of an airline's capitalization that it's in a position to dictate certain business decisions, it might enjoy an impermissible degree of control. If a U.S. citizen appears to be the beneficial owner of a U.S. airline, but that U.S. citizen has been staked to his ownership by a foreign friend or relative, we might again blow the whistle. It's not always easy to guess how we might rule on foreign control because, as DOT's Inspector General, Ken Mead, noted in a report to the Congress a year and half ago, the criteria aren't written down anywhere. It's for us to know and for you to find out.

As you can probably guess, it is this *administrative interpretation* of the statute, not the statute itself, that has been the most serious impediment to cross-border investment and cooperation in this industry.

So that's all by way of background. The proposal we announced last week, if we adopt it, would establish a different administrative interpretation of the statute. The newly

proposed interpretation would respect the language and objectives of the statute, and make our additional criteria for validating the citizenship of an airline both simple and explicit. Without changing any of the numerical ceilings in the statute – only Congress can do that – we would, if we adopt this proposal, allow far more scope for meaningful participation by offshore investors in the commercial decision-making that takes place in a U.S. airline. At the same time, we would continue to protect those features of a U.S. airline's operation in which government has a legitimate interest: safety, security, and national defense.

Specifically, we propose to add a new provision to the DOT Statements of Policy that appear in the Code of Federal Regulations. The new provision would list the factors that DOT will now look at – beyond the numerical tests in the statute – to determine whether an airline company is a U.S. citizen. It would apply in cases where there is significant non-U.S. investment in the airline. What's notable about the proposed list of factors is that it is very short. Rather than the long list of subjective tests created by years of case law, we would seek only four objectively verifiable answers:

- Will U.S. citizens be in a position to control decisions having to do with the Department of Defense?

- Will U.S. citizens be responsible for decisions and activities relating to aviation security?

- Will U.S. citizens be responsible for carrier policies and implementation with respect to safety?

- Is the corporate documentation – the charter, the certificate of incorporation, by-laws, etc. – under the control of U.S. citizens?

The only other requirement would be that, for a non-U.S. investor to enjoy the benefits of the flexibility newly available through this proposed policy, that investor would have to be the citizen of a country that has an Open Skies agreement with the U.S., and that makes comparable investment opportunities available to U.S. citizens.

If the answers to those questions are in the affirmative and the numerical standards of the statute are met – a quick and easy determination – that would be the end of the inquiry.

Secretary Mineta said, when announcing the NPRM, that we expect the proposal – if we adopt it – to encourage investment in U.S. airlines from abroad. He said that because, for the first time in history, international investors in a U.S. airline would be in a position to protect their investment. We will have removed, in other words, the most important impediment to that investment: the seeming requirement that non-U.S. citizens today can have virtually no say in how their investments are used.

Consider some recent history. In 1989, KLM proposed to invest $400 million in Northwest Airlines as part of a restructuring of the carrier. DOT's approval of that

investment was carefully calibrated to ensure that, notwithstanding the magnitude of its stake in Northwest, KLM had precious little opportunity to participate in the management of the airline. That's because, under the prevailing interpretation of the statute, "actual control" by U.S. carriers meant "no semblance" of control by *non*-U.S. citizens. Relations reportedly became so testy between the management teams at Northwest and KLM that KLM withdrew its investment in 1997.

It is important to ask, after an episode like that, whether any important public policy objective was served by the restrictions that drove KLM away from its U.S. airline partner – and that cost Northwest hundreds of millions of dollars in much-needed working capital. Remember that value-added test I mentioned earlier: Might we have allowed a more robust cross-border corporate relationship, thereby maintaining the value of that substantial investment, without calling into question the actual control of Northwest by U.S. citizens, and without compromising any other U.S. Government interest? That is the question asked by the NPRM.

But the potential benefits of the new proposal go well beyond our interest in enhancing the availability of capital to U.S. airlines. Remember that, in addition to its Open Skies condition, the proposal would require reciprocity in investment opportunities. You know that many U.S. airlines participate in international alliances. These alliances represent a surrogate for the kind of globalization we've seen in other networked industries. We think our proposal, if adopted, would create an environment far more conducive to productive cooperation among airline alliance partners, providing new opportunities for U.S. as well as foreign airlines. It would facilitate, we believe, the further evolution of the world's airline industry into an even more robust and competitive global services sector. The main impediments to that evolution today, we believe, are the administrative policies that we are proposing to change with this new NPRM.

Let me try to make this as clear as I can. If we ultimately adopt the proposal we put out last week, U.S. citizens would *still* have to be in "actual control" of a U.S. airline for it to remain eligible to keep its certificate. They will own 75 percent of the voting stock in the airline; they will occupy two-thirds of the directorships; two-thirds of the officers will be U.S. citizens. *It will be a U.S. airline by any measure.* All we are saying is that the greater scope we propose to allow non-U.S. citizens for participation in the governance of a U.S. airline would no longer be deemed inconsistent with the finding of actual control by U.S. citizens, as it is today, provided that the short list of objective requirements in the proposed new CFR provision are met.

The Notice asked for comments within sixty days. The deadline is January 6, 2006. We hope that everyone with an interest in this subject will look at the proposal, consider it carefully, and then let us know what you think.

Some interested parties were extremely prompt, for want of a better term, in sharing their views with us: We saw some comments on the proposal even before we released it. Others appeared within the first 24 hours, before the ink was dry. Let me just say that we

spent many months deliberating over this proposal. We think it deserves more thought and consideration than was evident in those initial responses.

Impact on Labor. I'd like to address a special word to airline employees and their organizations. No observer of the financial challenges that our airlines have been working their way through can be oblivious to the impact on airline workers. This has been the most difficult period in the industry's history, and as the airlines have struggled to lower their costs the workforce has had to bear a tremendous amount of the burden. And I have to say personally, as somebody who spends a lot of time on commercial flights, that I am unfailingly impressed by the spirit of the crews that I see on those flights. The extraordinary safety record our airlines have achieved in recent years tells me that that spirit extends beyond the cabin and cockpit to the ramp and the maintenance bay as well. In spite of it all, airline employees continue to deliver a safe, reliable, and pleasant experience to their customers. I honestly think it's a kind of heroism under fire.

Now we fully understand that the prospect of any additional uncertainty for the industry will be wholly unwelcome to airline employees at this particular moment, and so you can be expected to look at this proposal very carefully – even skeptically. We want you to do that. It's our conviction, in proposing this change, that it will not create uncertainty, but rather stronger cross-border partnerships. We think it could generate additional capital and enhance the overall health of the U.S. airline industry. At the risk of repetition, today's U.S. airlines will still be U.S. airlines tomorrow. They will have to comply with all the same laws that they comply with today, and – as Secretary Mineta said in announcing the proposal last week – all employee protections that were in place before the proposal would remain in place if we adopt it. If you think we are wrong in that assessment, please tell us why. We want to hear from you.

Impact on US-EU Aviation Talks. Finally, I would like to say a word about our negotiations with the EU toward a possible breakthrough aviation agreement – one that would bring an entirely new level of liberalization to trans-Atlantic air services. Everyone knows that the European Community has indicated that it wants to see progress in the removal of U.S. restrictions on foreign investment in U.S. airlines. At the same time, Secretary Mineta has made it abundantly clear that U.S. investment rules cannot and will not be a topic for negotiation. If we decide to make changes, we will do so in response to our assessment of what is in the best interest of the United States.

Tentatively, at least – until we have reviewed the comments – we think the proposal we have just issued *is* in the best interest of the United States. Indeed, we think it is long overdue. If the EU talks were to collapse immediately after reconvening next week, we would not abandon the proposal, but would see it through to its conclusion. We think – at least as a preliminary matter – that the restrictions we propose to ease represent anachronisms that no longer advance legitimate objectives. We are proposing to get rid of them for the same reason that we seek to get rid of any regulation that no longer delivers value.

But I will not stand here and pretend that we don't care whether the proposal will have a positive impact on the US-EU talks. Of course we do. I won't mince words: We want to conclude that agreement – not only for the market access that U.S. carriers will achieve, but because it can be expected to enhance the quality of competition across the Atlantic in a dramatic way. A bilateral agreement between the U.S. and the European Union would bring nearly 750 million people and many of the world's great airlines together under a single liberalized regime. It would take liberalization to the next level, linking two huge markets and allowing airlines from both sides of the Atlantic unprecedented flexibility in how they build, manage, and expand their operations. It would give us the momentum to do even more in follow-on U.S.-EU accords. And it would instantly become a new template for aviation liberalization elsewhere in the world. From an American perspective, a U.S.-EU agreement would be, quite simply, the most important thing we could do to further the work-in-progress we call deregulation.

We ask our friends in Europe to take our proposal seriously. European airlines in particular should evaluate it carefully and let us know what they think. We believe, if we ultimately adopt the proposal, that it would facilitate much or all of what European airlines seek to achieve in the near term within a newly liberalized U.S.-EU aviation marketplace, and that the proposal will bring important benefits not only to airlines on both sides of the Atlantic, but to the users of air transportation as well.

Some critics on the other side of the ocean have already complained to the Commission that it should hold out for a complete sweeping away of U.S. restrictions on investment – that nothing less than the right of establishment will be a satisfactory concession by the U.S. in return for the agreement.

We all know that the perfect is the enemy of the good; but this is the first time in my experience that the perfect has declared all-out war on the good. I have to confess that I have grown weary over the years of hearing people argue that we should sacrifice achievable liberalization on the altar of what, in the near term at least, is clearly unachievable. It's an old ploy, and it's looking a bit shopworn. When the liberalization we can achieve now is nothing less than a transformational agreement between the United States and the European Community, the argument seems even more transparently protectionist. The proposal we have just made, if ultimately adopted, would engender a new level of cross-border cooperation between alliance partners and, together with a "beyond-Open-Skies" agreement between the U.S. and the EU, would facilitate globalization on a scale heretofore unseen in civil aviation. It represents a tremendous opportunity.

Yes, deregulation is a work in progress. An aviation agreement between the U.S. and the EU would represent very important progress indeed.

Thank you for inviting me to share these thoughts with you.

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