

International Aviation Club

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Good afternoon ladies and gentlemen. I am very pleased to have the opportunity to speak to you today. The International Aviation Club is well known for its highly knowledgeable and sophisticated audience and it's a welcome challenge to address such a group.

Before I turn to the main topic of my speech, allow me to digress for just a minute and give you a brief Northwest update.

For Northwest, as well as other U.S. air carriers, these are challenging economic times. The 2001 second quarter results to be announced this week will further confirm that.

Notwithstanding these economic challenges, airlines must still invest for the future and we are actively doing that, particularly at our airports. In December of this year, construction will be complete on Northwest's new WorldTerminal at Wayne County's Detroit Metropolitan Airport, a 97 gate state of the art terminal which will house Northwest, our regional carriers, and our alliance partners, KLM and Continental. Construction is also underway on a sixth runway. I am proud to say that working together with our friends at Wayne County in a unique public private partnership, our new facility is on time, on budget and will be the best connecting complex in the World with 12 international 747-400 capable gates built into the middle of and fully integrated with the terminal's domestic facilities.

At Minneapolis-St. Paul, we're in the middle of a \$2.4 billion expansion project which includes a new runway and a substantial number of new gates. A recent IATA survey of 90,000 travelers ranked the Minneapolis/St. Paul airport as one of the top ten in the world. In Memphis, a new runway recently was dedicated and a new regional air carrier facility has opened. Bottom line: we're adding substantial terminal and air field capacity to meet the significant increase in passenger demand that we all know is coming.

Former Secretary of State Dean Acheson entitled his memoirs Present at the Creation and advanced the view that the events and policies employed at the start of the Cold War were key to the development of foreign policy in the decades thereafter. I suggest that a parallel exists in the international aviation policy world particularly regarding the industry's efforts to meet consumers' growing demand for seamless international travel. So today what I would like to do is be "Present at the Creation" of airline alliances, particularly the first immunized alliance, Northwest-KLM, and see what we can learn from that history with respect to current and future international aviation policies.

Economic activity has become dramatically more global in recent years, and much of our prosperity in the US and elsewhere in the past decade has been due to the fact that we decided to jump into the global economy with both feet and do what we had to do to compete.

What that has meant for airlines is that our customers now do business worldwide, and they demand more international air service, to more places, than ever before. AND they want internationally, the same seamless on-line product that they have become accustomed to domestically. For our customers, the need for seamless international air service is no longer the exception, it is the rule.

We are not the only industry facing this demand from our customers. Banking, telecommunications, and

many other sectors are dealing with the same issue. What makes the airline business different from these other global competitors is that we do not have available to us several of the tools that these other industries use to respond to this customer imperative. Bilateral aviation agreements and prohibitions on providing domestic service in foreign countries limit where an airline can fly. How our industry is structured is influenced by citizenship requirements and restrictions on foreign ownership. And the extent to which one airline can cooperate with another is usually impacted by the laws of at least two countries and the collective bargaining agreements of at least two companies. In short, we have customers who want seamless, global travel, but some of the methods available to other industries to provide their customers with seamless global commerce are not available to airlines. We must use other methods to satisfy our customer's demands.

If not for these restrictions, it would be easy to envision airline companies that resemble other global enterprises with multinational corporate structures doing business throughout the world in ways that are responsive to the needs of both local and global customers while accessing the economies of scale that can be achieved only through truly global enterprise resource planning.

Faced with this reality, yet still needing to respond to customers' demands for reasonably priced seamless global service, airlines resorted to their customary resourcefulness and invented global alliances. In fact, the first real international airline alliance was created just ten years ago between Northwest and KLM.

Alliances, especially with the advent of the immunized alliance model as used by Northwest/ KLM, initially caused some debate as to whether this new device would meet the needs of consumers seeking more global service. At the time it was a theoretical debate since no one had any experience with this structure. But now we have ten years of experience and we no longer need to theorize. We can draw real world conclusions about alliances.

Let's take a few minutes to review the history of the original immunized alliance which should help us formulate conclusions regarding the policies for today.

In 1991, Northwest with a diminimus 3.5% transatlantic market share and KLM with a slightly larger 4.5% transatlantic share embarked on an experiment in international airline cooperation. The experiment initially involved new non-stop flights in markets that had never before been linked by transatlantic airline service. Back then, the Detroit/Amsterdam and Minneapolis-St.Paul/Amsterdam routes ranked 230th and 235th respectively in size of the US/Europe market. Together, these two routes had only 35 local passengers daily each way. (Then, as now, the number one US/Europe market is New York/London, which currently averages 3,000 local passengers daily each way).

Through reciprocal code sharing, the Minneapolis/St. Paul/Amsterdam and Detroit/Amsterdam flights connected KLM's European network with Northwest's US network. Linking those networks created a multitude of on line single and double connect opportunities between US and European cities. The result was additional flying opportunities, more convenient service between more destinations, and increased competition.

In 1992, the Northwest/KLM experiment intersected with the US government's experiment in international aviation policy when the US and the Netherlands agreed to the first open skies agreement. The essential components of open skies were then and remain today the following: open entry on all routes; unlimited designations; unrestricted capacity and frequency on all routes; deregulated pricing; and open code sharing. At its core, open skies created a legal regime of open entry for markets but also required de facto open entry as well.

To maximize the chances that the US/Netherlands open skies experiment would work, particularly in light of the comparatively small size of the Netherlands home market (today the Netherlands is only 4.5% of the total U.S.-Europe market), the US granted Northwest and KLM antitrust immunity. This decision allowed the two airlines to operate as if they were one entity with a single network. In this case the US concluded that antitrust immunity was appropriate because Northwest and KLM presented no competition issues;

1. Each Airline operated in small markets with little local traffic
2. There was virtually no overlap between the two airlines. (In fact there was zero overlap when cooperation between KLM and Northwest commenced in 1991).
3. And Schiphol was an open airport with no restrictions as to slots, gates or other facilities. (As evidence of Schiphol's openness, since 1992, Delta, United, US Airways and Continental have all commenced new non-stop service to Schiphol from the US.)

The US hoped that the commercial success of alliances in an open skies environment would serve as sufficient incentive for other countries to completely open their markets and eliminate all legal and infrastructure barriers to entry.

With open skies and antitrust immunity as the foundation, Northwest and KLM further linked their networks so that now:

- Northwest/KLM operate a true common bottom line joint venture across the Atlantic. This allows both airlines to be equally committed to the customer regardless of whether the customer flies on a blue-tail or red-tail airplane. For example, between Los Angeles and Amsterdam there are 11 one stop and non-stop routing opportunities that provide full time of day coverage using a variety of KLM and Northwest flights. Because it makes no economic difference to us or to KLM which airline the passenger flies, since all the revenue flows to a common bottom line, there is no steering of the customer to one or another flight. It is the customer's convenience that determines their choice of flight.
- Together we have established a single decision making process for pricing, product, commissions, yield management, all trans-Atlantic schedules and the aircraft which fly these routes. In essence Northwest and KLM operate a single synthetic airline across the Atlantic and, by operating as one entity, have become a much more effective competitor.
- By making travel over our combined network seamless, Northwest/KLM is able to operate profitably on a route that could otherwise never support non-stop service. A good example is Memphis/Amsterdam, which is served daily non-stop with a KLM 300 seat MD11 airplane. With the help of our good friends in Memphis, who do an extraordinary job of extolling the attractions and benefits of Memphis, this route works even though the Memphis-Amsterdam market itself has only 17 local passengers daily each way.
- Similarly, this summer Northwest/KLM is operating five daily wide-body non-stop flights between Detroit and Amsterdam notwithstanding that today's Detroit-Amsterdam local passengers daily each way is a whopping 116. These frequencies give customers many choices throughout the day to bridge the Northwest and KLM networks.
- As a sign of the success of our alliance, since 1992, the Northwest/ KLM alliance has more than doubled its capacity in the US/Netherlands market. Has competition been reduced in this market as a result? No, the total capacity offered by our competitors has increased at similar rates during

this period.

Bottom line, an independent third party study calculated that over 450,000 consumers per year benefitted from the KLM/Northwest alliance and that fare savings to consumers from the alliance amounted to as much as \$185 million per year.

So what have we learned from our own version of Present at the Creation? Let's ask ourselves three questions.

Question One: Should the US policy of coupling the grant of antitrust immunity with an open skies agreement continue? I believe the answer is yes. When the original core principles of open skies and antitrust immunity are followed: and let's review them one more time -- de facto as well as de jure open entry on all routes, unrestricted capacity and frequency on all routes, deregulated pricing, no material concentration or overlap between immunity partners - consumers are big winners with immunized alliances. Alliances have done an excellent job of providing global service that customers want particularly in specific markets that never before had access to that kind of global reach.

Question Two: Is the grant of antitrust immunity appropriate in all circumstances where an open skies aviation agreement is in place? Here the answer is no.

In evaluating new alliance proposals and reviewing the results of existing alliances, the competition authorities must remain true to the core principles of open skies and antitrust immunity.

Press reports suggest that BA and AA are testing the waters to determine whether to pursue an antitrust immunity application in conjunction with a potential UK/US open skies agreement. While we do not know what exactly will be proposed, if anything, should BA and American seek antitrust immunity which would allow them to collaborate on price, schedules, yield management and other similar activities, then the tested waters should be very icy indeed. Such a proposed combination is inconsistent with the open market principles imbedded in the public policy justifications for open skies agreements and antitrust immunity.

Alliances at their best have two key pro competitive attributes; they join two or more airlines with mostly end to end networks and they occur in an environment where other competitors are not precluded from entering with new competition.

It should be self-evident that the alliance proposed by American and British Airways proposed five years ago and potentially again today, meets neither test. First, American and BA are both already dominant competitors in the U.S.-London market with substantial overlap between them. This direct competition is occurring in very large markets which have some of the largest volumes of local traffic of any international routes.

Consider this: 61% of all slots at London Heathrow operated on London-U.S. flights are held by either British Airways or American Airlines and they would be operating as a single airline in those markets should antitrust immunity be granted to them. A full blown alliance between them in the U.S.-London market would produce a greater level of concentration in the U.S.-London market than a merger of United and American in the U.S. market.

Second, the context for this alliance is the biggest and most closed market in the North Atlantic. The key issue here is London Heathrow Airport. It is London's biggest airport, it is the UK's biggest airport, it is the biggest airport in all of Europe for US passengers. There is about twice as much passenger traffic US

to Heathrow as there is between the US and the next biggest destination in Europe.

And Heathrow is not simply locked tight against new competitors today, it has a legacy of being a closed airport. The fact that average fares between U.S. and London markets are 30% higher at Heathrow than at Gatwick demonstrates why there is little prospect that the anti-competitive wall built around Heathrow will ever voluntarily be weakened.

Yes, we would all like to see an Open Skies Agreement with the UK. The U.K. is the United States' most important travel destination, our most steadfast ally. But the fact is that an Open Skies bilateral with the UK, coupled with antitrust immunity or other forms of enhanced cooperation between BA and American without the real prospect of open competitive entry at Heathrow, would be a step backward, not forward, in the effort to increase competition over the Atlantic.

I've heard the argument made recently that the have-not airlines could gain access to Heathrow by purchasing slots or, alternatively, obtaining slots from their alliance partners. I've also heard the argument that a British Midlands-United alliance somehow reduces the problem of Heathrow access. I think the opposite is true. The problem with both arguments is that purchasing slots requires a willing seller. If we had both a British Airways - American alliance and a United - British Midland alliance, which is also on the table for consideration, 75% of all Heathrow slots would be held by those carriers and their current alliance partners, and I don't just mean US-UK slots, I mean 75% of ALL slots at Heathrow.

All other airlines would hold the 25% of the remaining slots. The largest slot holder outside of the BA/AA and UA/BK alliances would hold a mere 2% of the slots. I predict that no one will willingly part with slots to Heathrow. In particular, European carriers with U.S. alliance partners require their Heathrow slots for their own European networks as Heathrow is just as important to a European network as it is to a transatlantic network.

In short, without substantial competitive access to Heathrow, and that includes slots, gates, counter space and other facilities necessary to operate an airline, the BA-American alliance

should not be afforded antitrust immunity.

Question 3: If we take a step back from present day issues and take a longer term view, a logical question is whether the current rules of the road regarding foreign ownership, etc. should be modified to facilitate the further development of seamless global alliances. Here I would suggest a qualified answer.

- Undoubtedly, policy makers are going to be faced with proposals to change the rules by which global alliances are governed. From purely the perspective of which structure works best to maximize alliance synergies and create the most efficiencies, we believe the Northwest-KLM experiment shows that a common bottom line whether attained through joint ventures or cross border mergers is the answer. Faced with the relentless pressures of reducing yields and rising costs, airlines will need to take advantage of every available synergy and efficiency and in our judgment over time will look to increasingly integrate their international alliance networks.

There are clearly legitimate competing concerns to maintain in place policies such as foreign ownership restrictions, cabotage and a bilateral aviation agreement regimen. But let's recognize that the continuation of these policies come at a price. Over time, policy makers will have to weigh the benefits attained from these current rules against the efficiency and other consumer benefit losses resulting from airlines not being able to

operate as other multinational companies do.

In conclusion, U.S. policymakers can look back on the last decade of alliances with considerable pride. They took the initiative and opened up a new set of possibilities for airlines to meet the demands of consumers for global service. They did not passively allow airlines to go down the path of alliances unguided; they set clear terms and conditions for going down that path, terms and conditions designed to assure effective competition and thereby to protect consumers.

The result has been a vast improvement in global air transportation. We are doing a much better job of meeting the needs of our customers for truly global networks of air transportation. And we are doing it in ways that have not harmed competition, and which in fact often increase competition.

All because the right policy choices were made here. As we go forward, we should not depart from those original and successful policies; we should not lower the standards of what we require of an immunized alliance with respect to full and effective competition, and leave consumers with less protection.

Just as policymakers can look back on the past decade with considerable pride that they struck the right course for consumers and competition on alliances, we want them to look back a decade from now and be able to draw the same conclusion.

Thank you very much.