

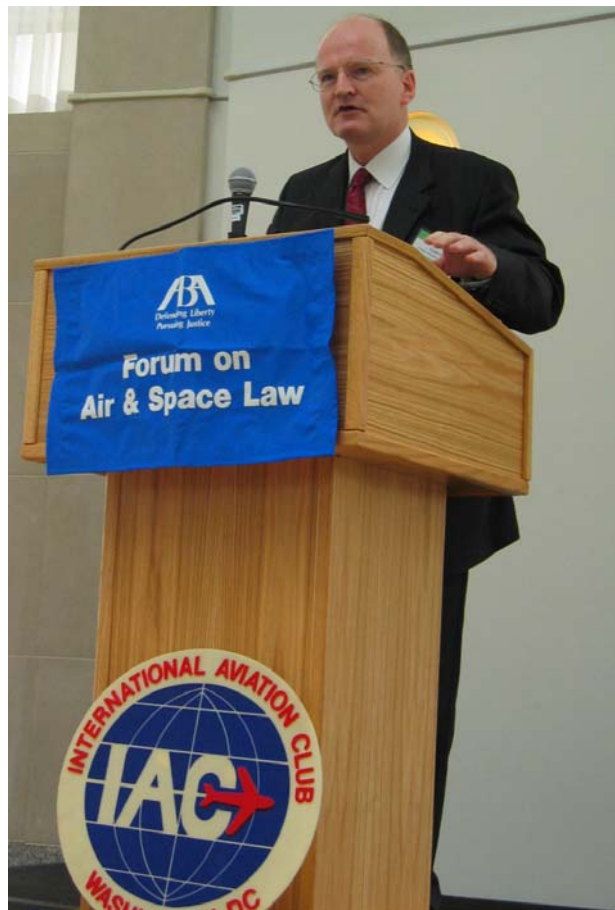
International Aviation Club American Bar Association

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Presentation

By

**Ulrich Schulte-Strathaus
Secretary General
Association of European Airlines**



Good afternoon, ladies and gentlemen, and thank you, for your very kind words of introduction.

Needless to say, I am grateful for this opportunity to be here today. I arrived here on a non-stop flight on United, Brussels-Washington. I mention this not so much because when going through some quite irritating turbulence my neighbour muttered quietly: “Flying is the second greatest thrill known to man. Landing is the first”. The real reason for mentioning the United flight is that United is the *only* carrier offering such flights. As you know, Sabena, the national Belgian carrier, went bankrupt. There is no doubt that the new Belgian carrier SN Brussels is doing an excellent job of establishing itself in a regional Belgian market; but intra-European consolidation does give rise to additional market opportunities for US carriers.

That says something about European consolidation!

We have had three rounds of negotiations between the EU and the US government, we are on the brink of the next round. The illustrious International Aviation Club had Rod Eddington talk about the British perspective two months ago – and I could not have said what he said better myself.

That says something about European integration! Europe and the Brits – I once asked a British friend of mine (I must admit I was somewhat exasperated) “When will the Brits finally adopt the metric system we all have in continental Europe?” He replied: “Oh, but we *are* moving towards the metric system – inch by inch”.

Let me expand on this European process for a few moments, though, before outlining why the Association of European Airlines has been so vociferously seeking an Open Aviation Area as a regulatory framework for the North Atlantic. I will resist the temptation to talk about my association, consisting as it does of 31 European flag carriers and major airlines, 21 of which have services on the North Atlantic, and compete against 6 US carriers, which had a market share of 49.9% measured in the number of flights. Instead, I will try to develop a few thoughts on where we in Europe are coming from, where we are headed and why.

The term “European Union” has many acronyms, ranging from “a complicated mess” to “bureaucracy” and even “history”, particularly when comparing European economic performance with the vibrant potential of Asia. Historically, however, the European Union is actually the result of a dynamic process. Originally designed to prevent the eruption of another World War, it developed into a European Economic Community, and from there to a political Union for Western Europe, which is now mutating into a truly European Union with a shift of its gravitational centre into Central Europe.

On the 1st May of this year, there will be 25 Member States, all of them sovereign, accepting legislation co-decided upon by multinational institutions. For any non-European, this is where it becomes complicated. The European Union actually has several institutions. The EU Constitution provides for a *European Court of Justice*, the EU version of a Supreme Court. The *European Parliament* is directly elected by the European constituents. The *Council of, say, Transport Ministers*, can adopt legislation, although it is an executive organ, but it requires the support of the European Parliament in a co-decision process to do so. So they are jointly responsible for EU legislation. The national ministers each have one vote, with unanimity foreseen as a requirement only for a selected few issues of crucial relevance such as taxation. The *EU Commission* has powers to propose legislation, the Commissioners are selected by the Council and endorsed by Parliament. The Commission’s main function is to ensure non-discriminatory implementation of EU law.

In other words, the complexity stems from the need to balance core national interests with the requirement for a functional supranational entity. In political terms “European Union” is therefore not “either-or”; the issue is “and”. These are both Member States and sovereign States. The European governments *collectively* represent Europe’s interests abroad via the Commission, and they continue to develop their respective relations with Third countries *individually*.

As you know, in the aviation sector all EU Member States agreed to treat their collective territories as one single domestic aviation market. This was done by adopting three successive liberalisation packages, which gradually replaced the bilateral provisions by a single set of European provisions.

This development can perhaps be shrugged off outside Europe, but in my view the European airline liberalisation was the single most important legislation in post-war international aviation. For air travel, say, within Italy, or to and from other EU country, you have it all: no limitations on ownership and control, right of establishment, cabotage.

In effect, Europe followed the blueprint of the US domestic deregulation from way back in 1978 and extended it to cover all Member States of the European Union.

So what were the effects of this dramatic opening of 15 domestic markets? The impact on the market was actually less than had been anticipated. There were no major cross-border financial transactions. The airlines preferred to develop alliances. They hardly had any own operations within the territory of another Member State. Why? Because the airline operations had been adapted to the decade-old bilateral regime. National carriers flying out of their *capital cities* to Third Countries had, over time, established themselves as network carriers flying out of *hubs* to Third Countries.

It required a new airline business model to capitalise on the new market access opportunities. No frill carriers do not consider themselves as legacy carriers designed to provide a national economy with some form of aviation infrastructure; no frill carriers seize business opportunities. It is a business opportunity for an Irish carrier to benefit from the Irish social system, be registered in the UK, and operate from Belgium into France. And the consumers love it. The number of passengers flying on Ryanair has skyrocketed, if you'll pardon the expression. Christian Mandel, the CEO of SkyEurope, a Central European no frill carrier, encapsulated it quite nicely when he said: "We focus on marketing, marketing and marketing; anyone adequately trained can fly an aircraft from A to B. You full service carriers are in love with the product, and its high tech fascination, you do not pay enough attention to the sales pitch."

By tearing down bilateral regimes, European legislators paved the way for European consumers, and airlines, to think European. Price has become a key criterion to fly on non-stop short-haul services within Europe, not the nationality of the carrier offering that service. The market is no longer determined by national borders, but by market segments; we, as you in the US domestic market, have market segments determined by international network airlines, no frill carriers and regional niche players. We can expect to see further pressure for consolidation within at least two of these market segments. Network carriers in particular have to continue to reduce costs by striving for further economies of scale and scope.

But the three main clusters of activity will co-exist to provide for a plethora of products for the European consumer. That is the result of total liberalisation!

So, what is going on in Europe? My answer is, politically it is a dynamic process and economically, Europe is becoming one Single market.

Experts, of which there are many in this room, will of course point out that European liberalisation was actually not so much the result of political vision, as rather the result of a court case – just as the recent decision of the European Court of Justice on the 8 contested agreements between individual EU Member States and the USA triggered the mandate from the Council of Transport Ministers. This is evidently true.

The fact remains, however, that the Association of European Airlines was actually pivotal in drafting a scheme for a possible EU External Relations Policy many years ago calling for international economic

liberalisation. So this leads me to my second question: What is the true motivation for airlines to be seeking an Open Aviation Area?

Certainly not to pre-empt a decision by the European Court of Justice, or to voice criticism of poor negotiations by national governments. In fact, my friend and colleague Jim May said it all when he spoke to the International Aviation Club on 17 February here in Washington. Although he referred only to the US market, he specifically went on to outline why three issues of prime relevance for the US industry (he called them “taboos”) should be tackled. He talked about the need to review the relationship between airlines and service providers; the need to review the relationship with unions; and the focus on the accumulation of fees, charges and taxes which threaten to suffocate further growth of our industry.

Ladies and gentlemen, these are not specificities of the US industry! These are issues my organisation has been dealing with intensively for the past 18 months. Driving force was Leo van Wijk, CEO of KLM, who very rightly said that it is not enough to successfully deal with a crisis; we must also attempt to identify why we are in that crisis and develop solutions to avoid ever getting into it again. If we are all in the same boat, then it is not enough to get the water out of the boat, we have to mend the leak.

AEA commissioned a study entitled “Towards an Efficient Air Transport System”, which has the for public and media-purposes unfortunate abbreviation TEATS. The author of the study, Professor Ken Button of the George Mason University, outlined amongst many other things, that one of the root causes of problems in our industry is the incoherent structure of the value chain. Given the importance of these structural questions, we created four projects, all spearheaded by a CEO of a European member airline, to drive a new thinking into our heads.

One such Project deals with the ...relationship between airlines and airports; a second with the relationship with Air Traffic Control; a third with the relationship with unions; and the fourth with the funding of security measures. Hopefully you can detect that the thrust is the same, but there are some subtle differences. In Europe the funding of security measures is still an unresolved issue. Many security measures actually protect society in general more than passengers on board a given flight. So why should airlines pay for such measures when at the same time the organisers of the European version of the Super Bowl do not pay for similar security measures? Asking for money from governments is no easy task anywhere. But in light of the declared AEA policy, to which all our members subscribe, namely to clearly reject state aids, we must take particular care to differentiate between the funding of public security measures - and state aids. So we are very much focused on this issue as well.

I hope you share my assessment that, in general, ATA and AEA seem to have identified similar problems.

So why is the Association of European Airlines pushing for an encompassing agreement?

Firstly, because we feel that on both sides of the Atlantic we as airlines are facing the same structural challenges which cannot be dealt with by a traditional Open Sky Agreement.

All airlines must cut costs. We are beginning to understand, however, that cutting costs in the traditional sense of ploughing through the organisation is not enough to come up with a competitive cost level. So we must also address costs which are beyond the control of airlines, costs which are just passed on to airlines by the service providers within the aviation value chain. Some of these service providers have oligopolistic structures, such as aircraft manufacturers, others, such as Air Traffic Control services, are under regulatory constraints, for example the legal requirement to *recover* their full costs, with little to no incentive to *reduce* their own costs.

We are seeking incentives for our service providers to also cut costs and enhance cost efficiency. How? We strongly believe time has come to liberalise the entire *aviation* industry, and not just the *airlines*. If it is true that airlines in the USA and in Europe have identified the same challenges, why not create one single framework which will cover the USA, the North Atlantic and Europe?

The second reason for seeking EU-US talks of a more comprehensive nature is the need to address the issue of ownership and control. It is important for the airline industry to achieve sustainable profitability. To do so, airlines must be able to access foreign funds, and not be restricted to “national” investors. The current bilaterally imposed restrictions on ownership and control prevent accessing internationally available funds, and also prevent cross-border mergers, and thus prevent the global aviation market from recovering sustainably and from consolidating.

So, we need the structures which help us further reduce our costs to the levels the market is expecting, and we need additional private investors to fund our recovery.

A third reason is the political desire for a paradigm shift. When monitoring the status of the EU-US talks, I am sometimes reminded of an experience I once had myself as head of a delegation in Japan, where I spent hours in quite tedious discussion with my Japanese counterpart until, finally, he smiled and said: “I see we are thinking on parallel lines.” I was thrilled, and it was only after the second glass of sake in the hotel that it dawned upon me that parallel lines never meet. I had actually just been told in an Asian manner that the discussions were senseless.

But in these EU-US talks, the parallel lines should not be seen as the dividing line at a negotiation table, driven by short-term measurable mercantilist objectives. They should be seen as parallel lines pointing in the same direction, a direction defined by the political desire to create a framework for sustainable growth, to the benefit of all travellers on both sides of the Atlantic.

If both sides were to agree on the need for such political leadership, the talks could and should be based upon three guiding principles:

The first principle is to create a coherent framework for aviation, not just for airlines. This implies a commitment to avoid measures which negatively impact the ability of airlines to provide for mobility, hassle-free transportation, and economic growth. An Open Aviation Area should deal with, for example infrastructure issues, and envisage legislation against the abuse of a dominant position by major airports. Key is that the entire value chain is encouraged to increase cost efficiency, not only the airlines.

The second guiding principle is to avoid micro-management of this industry, and to focus instead on creating a stable and reliable framework. I am talking about a common approach on issues such as safety, security, competition policy and passenger rights.

Take security as an example. After 9/11, the US government adopted a series of effective measures to further significantly improve security. The war on terrorism is US-led, yes, but it has become a *global* war against terrorism. Terrorist atrocities can be committed anywhere in the world - against innocent citizens in Bali for example, in Istanbul, and recently within the European Union in Madrid. It has therefore become more important than ever to agree on mechanisms to implement appropriate protection, and to agree on the funding of such measures, as well as on insurance against third party liability. We must ensure that we maximise security, minimise hassle for travellers and create a level playing field for fair competition.

The third guiding principle is actually the ultimate objective: Aviation should not be treated differently to other industries. Aviation has matured in the course of the past decades. This should be reflected in the regulatory framework. An AEA member airline wishes to establish a subsidiary in the United States. This, I suppose, is a compliment for the way in which the US economy is perceived outside the USA. It is certainly good news for the US consumers. And even the unions should applaud the fact

that a non-US investor is prepared to create new jobs and business opportunities in the United States. Just as much as no-one objected to a majority British-owned Burger King creating new jobs in the USA.

Ladies and gentlemen, the first paradigm shift in aviation was the result of the US-led industrial deregulation: airline activity was no longer regulated in the US, but commercially driven. The second paradigm shift came about in Europe by adopting principles of the deregulation “made in the USA” to international transportation between sovereign European states and thereby creating a single aviation market within the European Union.

Time has come for a third paradigm shift: to accept aviation as a highly efficient mass mode of safe, speedy, reliable global transportation.

This is the context within which the question of the EU Commissioner, Mrs. de Palacio must be seen: is the US prepared to accept elements of a *new* package? New are two elements: we consider that the US Open Skies policy of the 90s merely opened *international* skies, but left the domestic skies (in particular the US domestic market) closed. So we are talking about true multilateral open skies. But this is not only about market access for airlines; more importantly, we are talking about an *aviation* agreement which resolves structural issues so that airlines will be able to recover their cost of capital on a sustainable basis.

The Association of European Airlines feels that we should lean on US leadership to help develop a blueprint for such a new era of aviation. Once both sides commit in a binding manner to a vision for the future role of international aviation, then, I feel, the two sides can and must sketch a road map for that development. It goes without saying that these talks are the most complex imaginable, and not all key issues can be (and I believe never have been) resolved in an election year.

Since arriving here I have had several discussions with good American friends; I have come to realise that AEA has homework to do here in Washington. We should come more frequently and listen, and invite you to come to Brussels so that we can explain in greater depth our perspective. Perhaps ATA and AEA should organise a seminar and institutionalise a more fruitful exchange of views and perspectives. But I do have the impression that we need more dialogue between the EU and the USA.

The AEA will continue to press regulators to make the cake bigger for all airlines and then to have the market determine who gets which part of the cake, and indeed who survives. I will personally continue to seek a dialogue with my American friends and counterparts. I am now looking forward to take any questions you may have.

Thank you.