

FROM LONDON TO NEW YORK: OPENING UP THE SKIES

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Irish consumers are well aware of the benefits of deregulation of the EU airline industry. Belinda Kingston discusses the current transatlantic regulation and details the further efficiency gains that may yet be extracted if deregulation of this sector is realised. She unequivocally asserts that Ireland would gain significantly from open skies.

Introduction

“Rule number one: there shall be no rules, other than that of the market”
(The Economist, 2003)

It is a striking paradox that the airline industry, which has done so much to promote globalisation, is itself stuck in a primeval past dominated by national pride and monopoly interests. Undoubtedly, powerful shiny planes are an apt symbol of modernity but the structure of the industry in which they operate is largely dictated by government interventions that are more appropriate to the 19th rather than 21st century. Air travel directed by inter-governmental deals dictating who can fly where, the number of seats available and, often, which fares can be charged, have resulted in inefficiencies and foregone consumer benefits (Economist, 2003). These deals have prevented the type of competition that has preserved the vitality of other industries. Some would even argue that, as a whole, the airline industry has regularly destroyed more wealth than it has created.

In November 2005, talks resumed in Washington between the EU and the USA in an attempt to negotiate transatlantic aviation deregulation. Progress in these talks could lead to an ‘open skies’ deal as soon as the beginning of 2006 (Meckler and Michaels, 2005). What are the costs and what are the benefits of such a deal? Is transatlantic deregulation the key to greater efficiencies in air travel? How would it impact on the Irish economy? This project endeavours to address these timely questions.

Section I will give a brief overview of transatlantic regulation. Section II will discuss recent negotiations in the field. Sections III and IV will make arguments in favour of transatlantic deregulation, making particular reference to the benefits for the Irish economy. Finally Section V will look to the future of aviation and what conclusions can be drawn there.

A Brief History

The US Airline Deregulation Act of 1978 freed US airlines from the control of the government bringing about huge changes in airfares and consumer choice. The EU benefited to an even greater extent from deregulation when in 1993 airlines were authorized to operate freely between all member states¹. On the first day of deregulation between the UK and Ireland, the Dublin-London airfares alone fell by 54% and have continued to fall competitively ever since (Barrett, 1997).

Alliances

Although the airline industries in the EU and USA have been successfully deregulated, airline movement between the two masses remains under tight control. Currently, alliances are proposed as the solution to many of the problems in aviation (Barrett, 1999), the US has struck a series of bilateral deals with various European countries which allows its carriers to fly from anywhere in the USA to destinations in Europe in return for direct access to many USA airports (Economist, 2005a). Unfortunately these deals frequently act only to further restrict competition, and, in the long run, collusion will never stand to make customers better off.

So, Why Choose Regulation?

A number of arguments have been used to answer this question:

Table 1: The Case for Regulation

Argument	Counter Evidence
A home-grown fleet of aeroplanes is beneficial for tourism - there is a level of national pride associated with seeing a countries national symbol flying across the Atlantic.	After European airline deregulation, tourism numbers grew from 2 million to 6 million in Ireland (Barrett, 2005). Would transatlantic deregulation be any different? ²

¹ Deregulation had occurred earlier between a small number of countries e.g. the Anglo-Irish Agreement in 1986 opened the skies between the UK and Ireland.

² We will look at gains to tourism more comprehensively later in the project.

A greater number of airlines would have to be given access to already busy hubs ³	New airports are created that are lower in cost and cause less congestion ⁴ .
Unrestricted competition leads to lower quality of service with safety implications.	Customers trade quality for price all the time. Airline safety can still remain regulated by the government.
Liberalisation would lead to gaps in service rather than an integrated network.	Integration can be expensive. Point to point is much simpler.

It is difficult to find satisfactory arguments in favour of transatlantic regulation and the majority of ones that are made are rapidly losing credibility as counter evidence comes to light.

Recent Negotiations

An issue which has received increasing coverage of late has been landing rights and foreign ownership of airlines between the EU and USA. Greater access to Heathrow is the big prize for the USA if open skies talks are successful. Under current rules, only two USA carriers – American Airlines and United Airlines can use Heathrow (Meckler and Michaels, 2005)⁵. Delta, Continental Airlines and other USA carriers can fly into Gatwick Airport but access there is also restricted. Virgin has attacked the USA position in the negotiations as an apparent attempt ‘to secure access to Heathrow for their airlines...while giving little or nothing in return’ (Wall Street Journal, 2005:4).

Before opening its markets to US airlines, the EU wants the USA to relax its rules on foreign ownership and control of carriers. USA law limits

³ The British government is tempted to block any transatlantic liberalisation that would allow more American carriers to use London’s Heathrow airport (Economist, 2005).

⁴ Passenger numbers flying into London Stansted have grown significantly, particularly with Ryanair making a stop there (Barrett, 2006). O’Leary says the key to Ryanair’s growth has been their fast 25 minute turnaround (2006). Congested airports like Heathrow do not allow this kind of turnaround time.

⁵ British Airways and Virgin Atlantic Airways are the only UK carriers allowed to serve the US from Heathrow (Wall Street Journal, 2005).

foreigners to owning a maximum of 25% of voting stock in a USA airline and no more than 49% of total stock. The rules governing EU airlines are more liberal. Pressed by the Europeans, George Bush is considering loosening the rules to allow foreigners to have influence over most operations. The question now is how much will these negotiations stand in the way of a deal being reached on transatlantic deregulation.

Now that a little groundwork has been done, it is time to move on to discuss the arguments in favour of deregulation.

The Arguments in Favour of Transatlantic Deregulation

Basic economics suggests that to reach a Pareto optimal allocation of resources, there needs to be perfect competition in the market. The transatlantic aviation market is not a perfectly competitive market. There are minimum sellers, entry is greatly restricted, alliances and cartel-like behaviour is evident and prices are high.

Natural monopolies are characterised by decreasing average costs meaning that one producer can supply a product at a lower price than if there were many firms competing against each other. However, aviation is not a natural monopoly so governments should not treat it as such. Whilst airlines have a heavy fixed cost base (their aircraft and computer systems), these costs are not sunk as they can be bought or sold.

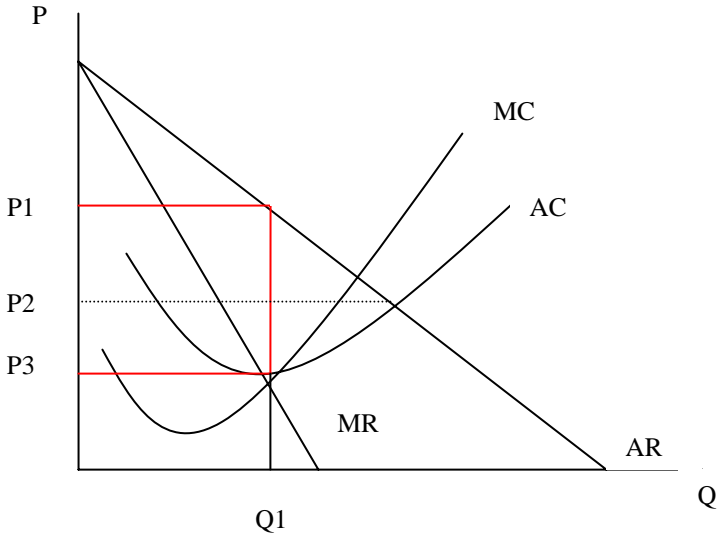
Contestability

Perfect competition is an ideal market type but is, in reality, very difficult to achieve. The Theory of Contestability, developed by William J. Baumol, aims to help markets yield the same competitive results but without requiring the same abundance of firms to do the job. A contestable market is defined as: “one into which entry is absolutely free and exit is absolutely costless” (Baumol, 1982:1). In this case imperfectly competitive markets can be contestable, because what is important is not actual, but potential competition⁶.

Suppose a firm enjoys a monopoly position in a perfectly contestable market. If it produces above marginal cost it will earn supernormal profits (shown by the area $Q1*(P1-P3)$):

⁶ Some, however, would argue that the US case shows that actual competition in the industry, if possible, is more beneficial than the threat of potential competition.

Figure 1: A Contestable Market



However, because of free entry and exit there is a threat of potential entrants coming in and sharing the profits. This reduces the price to where the firm is making only normal profits (i.e. at P2)⁷. Contestability will force the incumbent away from profit maximising towards sales maximising which benefits the consumer. In the long run, no economic profits and no inefficiencies are permitted in equilibrium, and equilibrium prices will tend towards marginal cost (i.e. at P3).

The problem with the transatlantic aviation industry is that whilst there are few firms (like in this contestable market); there are also barriers to entry resulting in high prices and a loss in consumer surplus. Airlines are not being forced to produce at marginal cost. Contestability theory argues that zero barriers to entry and exit into the aviation market will lead to a Pareto optimal outcome which is most efficient for all.

⁷ In general, the degree of contestability will determine the extent of the price change.

What does a contestable market require?

1. Low entry costs e.g. the ability of airlines to lease planes and have access to landing rights in airports
2. Freedom of exit e.g. ban the state saving of airlines about to go bankrupt
3. Access to the same technology and infrastructure as the incumbents e.g. computer reservation systems
4. Freedom to entice the incumbent's customers.

New entrants will keep incumbents efficient so they should be encouraged not excluded.

Obstacles to contestability in a deregulated market.

A number of barriers to contestability could arise if the transatlantic market was deregulated:

Hub airport slots – grandfather airlines may get preferential treatment with regards to property and landing rights.

Predation – incumbents could sell seats below cost to scare off new entrants. This action is difficult to prove, however.

State aids – as mentioned earlier, state could bail out failing incumbent airlines.

Frequent Flyer Programme – many customers are tied to a dominant airline.

Pro-competition policies that focus on efficiency rather than seniority would have to be put in place in each of these areas to ensure that entry and exit was not restricted.

Expected Benefits from Deregulation

The European Commission estimates that full liberalisation of the skies could boost transatlantic passenger numbers by up to 11 million a year, which is a 24% increase on routes that already generate revenues of \$18 billion (Economist, 2005b). The Irish Aviation Authority also believes that: “the EC/US agreement on open skies would lead to a substantial increase in Trans-Atlantic traffic while also impacting on the nature of our domestic traffic” (Irish Aviation Authority, 2004).

Protectionist policies have caused restrictions in air travel over the years - raising costs, rewarding anti-competitive behaviour and diverting trade elsewhere (Barrett, 1999). Domestic deregulation in the USA and Europe produced an explosion of low-cost carriers and clever new strategies. New routes were created and greater economies of scope allowed for

network size to increase along with passenger numbers and revenue. It seems certain that international deregulation would yield similar results (Economist, 2003).

The next section is going to look at the benefits of transatlantic deregulation in the Irish context, particularly looking at its affects on business and tourism.

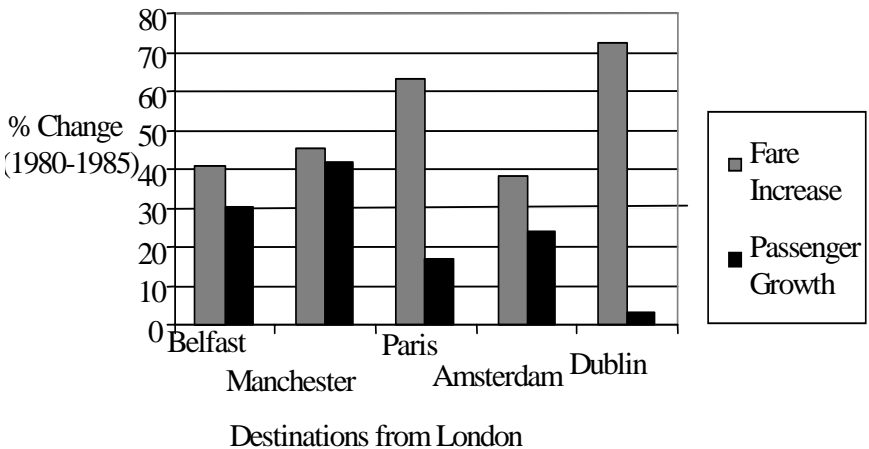
The Benefits of Deregulation for the Irish Economy

The impressive performance of the Irish aviation industry since its deregulation in December 1985 has become a model for other aviation markets. Are there lessons to be learnt here for transatlantic deregulation? An analysis of the impact of deregulation between Ireland and Britain might be helpful in answering this question.

The Impact of Deregulation on the Dublin-London Route

The deregulation of air transport between Ireland and Britain brought about reductions in fares of over 50% and a doubling of passenger numbers (Barrett, 1997). Graph 4.1 shows the performance of the Dublin-London route in comparison to other European routes over the period 1980-1985 (before deregulation) according to a CAA study:

Figure 2: Comparison of Fare Increases and Passenger Growth

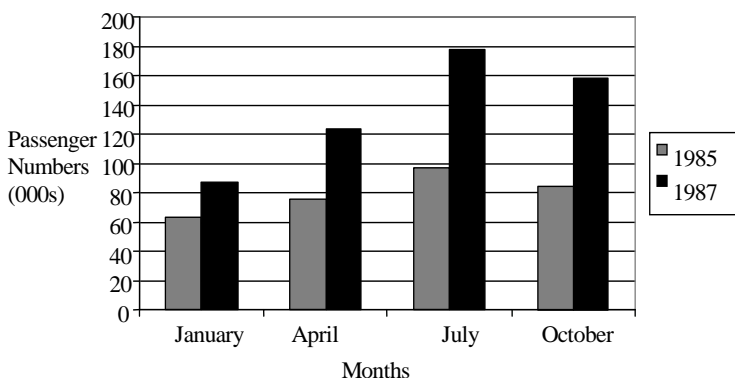


Source: Barrett, S. (1997)

Of the 11 routes compared in the study the London-Dublin route had the largest fare increases (72.6%) and the smallest passenger growth (2.8%) over the time period⁸.

As a result of deregulation the Dublin-London route has become the second busiest route in Europe after London-Paris. The contracting market of 1980 to 1985 became the fastest growing European market over the years 1985-1994, with growth of 184% (Barrett, 1997)⁹. Even during the first couple of years of deregulation passenger numbers soared, as Graph 4.2 illustrates:

Figure 3: Dublin-London Passenger Increases during Initial Deregulation



Source: Barrett, S. (1997)

Between 1986 and 1987 passenger numbers increased by 64.9% and the initial *price* impact was a 54% reduction of the incumbents fare by Ryanair (Barrett, 1997). Deregulation caused a shake up of the incumbents as they were forced to cut costs and run more efficiently or they would face losing even more market share.

The rapid increase in low cost airline seats also had positive knock-on effects for a stagnated Irish tourist industry. In 1994 an Irish Government Green Paper on Aviation stated that airline deregulation had increased visitor numbers by approximately 60%, tourist earnings by IR£560million and jobs

⁸ It is also noted that the time prior to deregulation was characterised by low staff productivity and high costs for all of the incumbent airlines serving these routes.

⁹ This was 1.95 times the growth rate of France, 2.16 that of the Netherlands and 2.62 that of Germany.

by 25,000 between 1987 and 1993 (Barrett, 1997). In addition, outward business travel increased by 50%. As a whole the economy was made more competitive¹⁰.

It has been argued that much of the success of the Dublin-London route is attributed to the strong Irish population that lives in the UK. This factor would surely benefit us if deregulation between the USA and Ireland was to come about.

The Benefits of Open Skies to the Irish Economy

Between 1995 and 2002 Ireland gave USA companies their highest rate of return on investment in foreign countries (US Bureau of Economic Analysis, 2003). In 2003 Ireland accounted for 6% of all USA FDI coming into Europe. The USA remains as Ireland's third most important destination for Irish exports and the third most important source for its imports (Embassy of Ireland- Washington DC, 2005). According to the IDA, they supported 478 USA companies in Ireland in 2004, including huge global multinationals such as Intel, Dell and Boston Scientific (Irish Development Authority, 2004). These USA companies provided employment for over 90,000 people. Easier access to Ireland will increase our competitiveness in terms of contending for more FDI which will bring about more jobs and GDP growth. Quite evidently access to the USA is key to the continued success of the Irish economy.

Currently there are direct flights from Ireland to a number of USA cities. The IDA has global offices in many of them but would benefit significantly from access to an even greater number who are presently inaccessible directly from Ireland. Point to point access is appealing to business travellers, saving money and, more importantly, time.

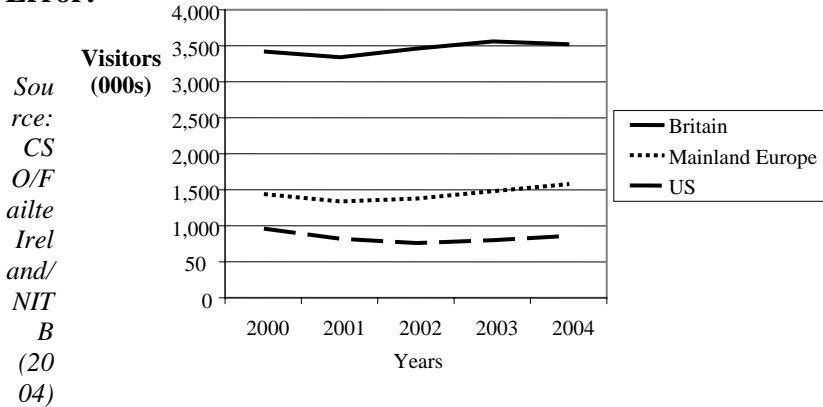
Moving on to look at tourism, the trend for direct flights has been growing steadily amongst visitors here too. Areas like Dallas and San Francisco have large untapped populations that would have an interest in flying to Ireland direct (Irish Hotels Federation, 2004). Between 1989 and 2002 over half of USA visitors flew directly to Ireland, while 46% came via mainland Europe. O'Leary claims that cheap fares and direct flights have allowed European visitor numbers to Shannon to reach over 3 million.

¹⁰ In terms of other European routes, deregulation has not been as transformational as hoped. Few EU carriers have been inspired to start extensive fare competition and low cost providers on mainland Europe are not as common. Is there an opportunity to push contestability in these markets? New entrants need to be encouraged.

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The American market is vital to the tourist industry, accounting for revenues of approximately €750 million. The Irish Hotel Federation is calling on the Irish Government to negotiate an open skies deal as soon as possible with America (Irish Hotel Federation, 2004). They believe an agreement will increase US visitors by over 1 million. Tourist numbers from the US fell between 2000 and 2004, but rose from Britain and Mainland Europe, as shown below:

Figure 4: Tourist Numbers Coming to Ireland
Error!



The drop in visitor numbers from all locations in 2002 can largely be accounted for by the events of September 11th. However, as numbers rise again it is important that the US market is captured as much as possible. There is ongoing scope for the industry to expand. Deregulation would only be a help in doing this.

In summary there are various reasons why deregulation would be beneficial to the Irish economy:

1. The existing example of Irish-British deregulation shows the potential gains in total welfare because of decreases in fares and increases in airline productivity.
2. Route expansion would encourage more businesses and holidaymakers to Ireland bringing in more revenue.
3. After a lull in world tourism at the beginning of the century, people are starting to increase their travelling. The Irish tourist industry needs to promote Ireland as an exciting place to travel and needs to be able to offer competitive prices to do this.

Future Prospects

The airline industry will face a number of changes in the coming years, many of which will impact on the shape of 'open skies'.

The events of September 11th brought about a difficult period for many airlines, particularly for those in North America. The period also saw a decline in the profitability and popularity of state-owned airlines. What will the future bring for the industry? Rigas Doganis (2001) in his book *The Airline Business in the 21st Century* makes a few suggestions:

Alliances will become increasingly integrated and dominant. The three largest alliances will carry as much as 60% of air traffic and completely dominate many sectors. Governments and regional bodies such as the EU will have to enforce competition rules to make sure these alliances do not abuse their power.

New low-cost carriers will force all carriers to cut costs. The main emphasis will be on reducing the cost of labour through staff reductions, more efficient work practices and outsourcing. Not only will they outsource catering but even actual flying. Airlines will also increasingly relocate to low-wage economies to maximise cost efficiency. E-commerce will continue to help lower costs and improve customer service¹¹.

Pressure will increasingly be put on hub airports for landing rights. However, a greater use will be made of satellite and smaller airports, many of which will be former military airfields. Most importantly, Doganis (2001) sees a complete liberalisation of the skies on the cards. Restrictions on ownership, market access, capacity and prices will be progressively eroded, until there are 'clear skies' and we have a truly global airline business.

¹¹ This year Ryanair will allow customer to check-in online, reducing staff costs and big queues for customers.

Conclusion

It is time for the transatlantic aviation industry to spread its wings and be free from its parent's reigns. The arguments in favour of regulation are not strong enough to hold any longer. Contestable markets have proven to be more efficient in promoting innovation and in attaining welfare optimising outcomes. This paper has argued, in some detail, that the positive affects that deregulation could bring to Irish business and tourism are significant enough to warrant an Irish plea for open skies.

In conclusion, government should have authority over such standards as security, environmental oversight and safety in aviation but no more. Once again, economists will refer back to Adam Smith and argue that the market must rule.

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