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U.S.-E.U. Open Skies Deal and Its Implication for the Liberalization of International Air Transport Services: A Chinese Perspective

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As the primary mode of long distance transport between nations, international air transport plays an essential role in the development and prosperity of the global economy. While other services sectors have benefited immensely from the multilateral trading system, the air transport services have long been dominated by restrictive bilateral arrangements since the Chicago Conference of 1944. Following the successful deregulation of its domestic air transport regimes, the United States initiated an Open Skies campaign toward international air services liberalization in 1990s. The conclusion of the U.S.- EU Open Skies Agreement in April 2007 represents a landmark in the liberalization of international air services. This historic deal not only heralded a new era in transatlantic aviation, but also strengthened the path-dependence of air transport services liberalization. As a major economic power and potential aviation power, China would benefit immensely from the liberalization of air services. However, base on actual conditions, a controllable and phased-in approach toward liberalization is a more rational choice for China at present.

Keywords

Open Skies, Air Transportation, Five Freedoms, Bilateral Regimes

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I. Introduction

Air transport plays a crucial role in facilitating international commercial transactions. With the acceleration of economic globalization, the movement of goods and personnel worldwide has become more and more frequent, which leads to an increasing demand for international air transport services. Although the WTO multilateral trading system has made noticeable achievements in liberalizing trade in services since the Uruguay Round negotiations, the main body of international air transport services is still dominated by traditional bilateral arrangements, most of which are characterized by protectionism and restrictionism.

The United States emerged as the world's dominant aviation power after World War II and went to great length to promote the liberalization of international air transport services. During the Chicago Conference of 1944, the U.S. proposed a free-market philosophy in which airlines of all nations would have relatively unrestricted operating rights on international routes, but it was then too ambitious to be popular.¹ As the Chicago Conference failed to formulate a comprehensive multilateral framework for international air services liberalization, bilateral regimes based on protectionism and reciprocity became prevalent.²

Following the successful deregulation of its domestic air transport regimes in 1970s, the U.S. began to export Open Skies policy into international level through a strategy of "divide and conquer," which gave rise to much controversy within the European Union (EU).³ After undertaking an arduous journey, the U.S. and the EU eventually signed an Open Skies Agreement on 30 April 2007. This historic deal opened up air services between the EU and the U.S. by removing all caps on routes, prices, and the number of weekly flights between the two markets.⁴ Compared with the slim prospects of the Doha Round air transport services negotiations, the U.S.-EU Open Skies deal not only heralded a new era in transatlantic aviation, but also strengthened the path-dependence of air transport services liberalization. Faced with global aviation competition, China

¹ Paul Stephen Dempsey, *Turbulence in the Open Skies: the Deregulation of International Air Transport*, 12 *TRANSP. L. J.* 305, 312-13 (1982).

² Adam L. Schless, *Open Skies: Loosening the Protectionist Grip on International Civil Aviation*, 8 *EMORY INT'L L. REV.* 435, 438-39 (1994).

³ Jacob A. Warden, "Open Skies" at a Crossroads: How the United States and European Union Should Use the *ECJ Transport Cases to Reconstruct the Transatlantic Aviation Regime*, 24 *NW. J. INT'L L. & BUS.* 227, 238-39 (2003).

⁴ EU Press Release, *EU-US "Open Skies": The EU and the US Start Talks on Air Services Agreement to Reshape Global Aviation* (May 15, 2008), available at http://ec.europa.eu/transport/air_portal/international/pillars/global_partners/us_en.htm (last visited on May 25, 2008).

need to make a strategic choice on the basis of its actual conditions and specific interests.

II. An Overview of the Regulation of International Aviation

A. The Legal Status of Airspace above State Territory

From the inception of aviation activities of mankind, the legal status of airspace above state territory has become an unavoidable question in international law, especially when airplanes fly across the state boundaries. Could the aircraft from one state freely enter the airspace of another state and land on its territory? If not, what restrictions might be imposed?⁵ To answer these questions, European scholars initiated a heat debate on the issue of state sovereignty over airspace in early 1900s, and contributed a wide divergence of thought to this topic. Some scholars, influenced by the rule of freedom of the high seas, advocated the absolute freedom of air navigation, arguing that aircraft should be free to fly at any altitude without any right of control in the subjacent states.⁶ While others, influenced by traditional notions of sovereignty, advocated that a state had absolute sovereignty over all airspace supra-adjacent to its territory.⁷ Between these two extreme positions, there also appeared various intermediate schools of thought, such as the “limited altitude” theory and “limited sovereignty” theory.⁸

In 1910, when various states met at the International Conference on Air Navigation in an attempt to define airspace sovereignty in international law, opinions of the United Kingdom and France regarding “regimes of the air” diverged sharply, and the Conference failed to achieve its objectives.⁹

⁵ Jeswald W. Salacuse, *The Little Prince and the Businessman: Conflicts and Tensions in Public International Air Law*, 45 J. AIR L. & COM. 807, 810 (1980).

⁶ *Id.*

⁷ *Id.*

⁸ The “limited altitude” theory advocated freedom of the air existing above a certain altitude with airspace below that altitude being the “territorial air” of the subjacent state. The “limited sovereignty” theory followed a functionalist approach, whereby absolute sovereignty existed over supra-adjacent airspace depending on the type of aircraft or use to be made of the airspace by other states. For example, a state could claim sovereignty over supra-adjacent air to prevent passage of military aircraft but not civil aircraft. *Id.* at 810-811.

⁹ The United Kingdom and its supporters believed that airspace sovereignty extended *usque ad coelum* and a state was not required to treat foreign and national aircraft on an equal basis. On the other hand, France advocated limited sovereignty whereby a state could only enact certain regulations that would protect its interests. For more details, see Major Stephen M. Shrewsbury, *September 11th and the Single European Sky: Developing Concepts of Airspace Sovereignty*, 68 J. AIR L. & COM. 115, 128-29 (2003).

World War I did much to advance aviation technology, as well as to demonstrate the incredible destructiveness that air power could wreak during all-out war. Accordingly, the need for a state to protect itself prevailed over the advantages to be gained from freedom of commerce by air.¹⁰ When the first multilateral treaty concerning air law was signed following the 1919 Paris Peace Conference, two decades of debate over territorial airspace ended with a formal recognition under Article 1 of the treaty that “every Power has complete and exclusive sovereignty over the air space above its territory”,¹¹ which insured the right of all states under international law to regulate and control all aviation activities in their sovereign airspace.

B. The Chicago Conference and the Five Freedoms of the Air

As World War II entered its final stages, the major powers realized the need to make another attempt to establish a multilateral framework for the future growth and regulation of international aviation. With this in mind, representatives of fifty-two nations gathered at the International Civil Aviation Conference in Chicago in November of 1944. Initial optimism for a comprehensive multilateral agreement of air transport services soon faded, however, as economic and political rivalries emerged between a number of the Conference’s more prominent members, particularly the United States and the United Kingdom.¹²

The United States, recognizing that much of its military fleet would soon be converted to commercial use, pushed for a free-market system that would allow U.S. carriers to capitalize on their impending competitive advantage.¹³ To this end, it spared no effort in lobbying for the multilateral exchange of the “Five Freedoms” of air transport, which could be summarized as follows:

- (1) The freedom of an airline to fly over the territory of another country without landing (often referred to as freedom of transit).
- (2) The freedom of an airline to land in another country for non-traffic purposes, such as refueling or maintenance, without offering any commercial service to or from that point.
- (3) The freedom of an airline to carry passengers, mail and cargo from its own country of registry to another country.

¹⁰ *Id.*

¹¹ Convention Relating to the Regulation of Aerial Navigation art. 1 (Oct. 13, 1919), 11 L.N.T.S. 173.

¹² Dempsey, *supra* note 1, at 310-311.

¹³ Andras Vamos-Goldman, *The Stagnation of Economic Regulation under Public International Air Law: Examining its Contribution to the Woeful State of the Airline Industry*, 23 TRANSP. L.J. 425, 431 (1996).

- (4) The freedom of an airline to carry passengers, mail and cargo from another country to its own country of registry.
- (5) The freedom of an airline to carry passengers, mail and cargo between two countries outside its own country of registry as long as the flight originates or terminates in its own country of registry.¹⁴

However, this ideal was not in line with the opinion of the United Kingdom and the majority of the developing countries who considered this policy as a threat to their economic interests as they felt that they were not in a position to compete with the more competitive American airlines. Fearing that the more powerful American aviation industry would dominate the international market in an unregulated free-market environment, the United Kingdom and most other states proposed the creation of an international authority to coordinate international air transport, which would be responsible for distributing routes and determining capacities, frequencies and fares.¹⁵

Up to the time of the signing of the Convention on International Civil Aviation [hereinafter the Chicago Convention] on 7 December 1944, the states attending the Chicago Conference were still unable to eliminate their divergences and agree upon a multilateral solution as to the exchange of air freedoms. The Chicago Convention, which laid the foundation for the international aviation regulation of the post-war era, reaffirmed that “every State has complete and exclusive sovereignty over the airspace above its territory,”¹⁶ and required that international air transport services should “be established on the basis of equality of opportunity and operated soundly and economically.”¹⁷ As the embodiments of the above principle, Article 6 of the Chicago Convention made it clear that “no scheduled international air service may be operated over or into the territory of a contracting State, except with the special permission or other authorization of that State.”¹⁸ In the light of this statement, the development of any scheduled international air service would necessitate further agreement (either multilateral or bilateral) among the states.¹⁹ As scheduled flights account for the overwhelming majority of international air transport services, the significance of Article 6 is self-evident.

¹⁴ Daniel C. Hedlund, *Toward Open Skies: Liberalizing Trade in International Airline Services*, 3 MINN. J. GLOBAL TRADE 259, 265-67 (1994).

¹⁵ *Id.*

¹⁶ Convention on International Civil Aviation art. 1, Dec. 7, 1944, 15 U.N.T.S. 295.

¹⁷ *Id.* Preamble.

¹⁸ *Id.* art. 6. As to non-scheduled flights, the provision of the Chicago Convention is less restrictive on the surface, but according to Article 5, their operation is still subject to regulations of the destination country.

¹⁹ Salacuse, *supra* note 5, at 825.

As an effort to provide a multilateral solution to the problems derived from Article 6, the Chicago Conference proposed two other multilateral agreements: the International Air Services Transit Agreement and the International Air Transport Agreement. The first Agreement was for the exchange of the first two freedoms of the air (the freedom to fly across the territory of another state without landing and the freedom to land for non-traffic purposes) among contracting states,²⁰ and the latter was for the exchange of all “five freedoms,” which include not only the first two “technical freedoms”, but also the three “commercial freedoms.”²¹ While the number of contracting states of the first Agreement currently reaches 118,²² only a few widely scattered small countries ever ratified the International Air Transport Agreement.²³

C. The Prevalence of Bilateral Regimes

As the Chicago Conference failed to reach solutions for the exchange of commercial air freedoms on the basis of multilateral liberalization foundations that would bring together a large number of states under one umbrella, it became clear that bilateral negotiations between individual pairs of nations would be the only viable option for the regulation of international air transport services.

In 1946, representatives of the United States and the United Kingdom met in Bermuda and concluded the Agreement Relating to Air Services (“Bermuda I”), which soon became the prototype for bilateral air transport agreements throughout the world.²⁴ Bermuda I represented a compromise between the free-market oriented Americans and the more protective British. The United States retreated from its earlier position that there be no international regulation of fares and agreed to allow the International Air Transport Association (IATA)²⁵ to determine fares relating to air traffic between the two countries, subject to both countries’ approval. In exchange, the British allowed designated carriers to determine capacity and frequency of service on each given route.²⁶

Over the next thirty years, numerous other countries followed the Bermuda model and entered into thousands of bilateral air transport agreements, creating a network of

²⁰ International Air Services Transit Agreement art. I.1, Dec. 7, 1944, E.A.S. No. 487.

²¹ International Air Transport Agreement art. I.1 (Dec. 7, 1944), E.A.S. No. 488.

²² See *Air Law Instruments*, available at http://flightservices.org/air_law.htm (last visited on June 20, 2008).

²³ Salacuse, *supra* note 5, at 826.

²⁴ Dempsey, *supra* note 1, at 316.

²⁵ IATA is an international trade body, created in April 1945 by a group of airlines. Today, IATA represents some 230 airlines comprising 93% of scheduled international air traffic. For details, see IATA INTRODUCTION, available at <http://www.iata.org/about/history.htm> (last visited on May 25, 2008).

²⁶ Schless, *supra* note 2, at 439-40.

international air transport regulation.²⁷ The core of these bilateral agreements was the exchange of commercial freedoms of the air (also known as “traffic rights”) on a fair and reciprocal basis, which was realized through the regulation of route, fare, capacity and frequency. Though these bilateral agreements varied somewhat in their contents, the majority of them were restrictive in nature. In most cases, the exchange of traffic rights was limited to the designated routes between contracting countries and only a few designated carriers could operate air services on each given route; fares were usually determined by IATA Traffic Conference and subject to both countries’ approval. In order to ensure fair and equal opportunity for the designated carriers of both contracting countries to operate air services on the specific routes between their respective territories, capacity and frequency were often pre-determined fairly to avoid carriers of one side unduly affecting the operation of air services of carriers of the other side.²⁸

With very few exceptions, the bilateral air services arrangements of the post-war era were characterized by protectionism and restrictionism, and their excessive emphasis on equity and reciprocity could rarely be found in other international economic treaties. In concluding bilateral air transport agreements, it seemed that contracting countries were pursuing an equitable sharing of aviation activities and a fixed share of benefits, rather than an equal opportunity to compete.²⁹ This situation could be ascribed to the following considerations:

On the one hand, civil aviation is not a purely economic activity or business. To most countries, it is not only associated with national security, but also has a great deal to do with national pride and prestige.³⁰ So it’s crucial for countries to ensure that their air carriers have a deserved share in international aviation activities.

On the other hand, many countries (especially developing countries) consider the benefits and incomes derived from air traffic across their sovereign airspace as exclusive national economic resources,³¹ which could only be traded on a fair and reciprocal basis. Accordingly, any benefits derived from the exchange of traffic rights and the opening of international air routes must be shared equally between contracting countries.

²⁷ Warden, *supra* note 3, at 230-31.

²⁸ Ruwantissa I.R. Abeyratne, *Would Competition in Commercial Aviation ever Fit into the World Trade Organization?* 61 J. AIR L. & COM. 793, 805-08 (1996).

²⁹ Salacuse, *supra* note 5, at 836.

³⁰ PAUL S. DEMPSEY, *LAW & FOREIGN POLICY IN INTERNATIONAL AVIATION* 21 (1987).

³¹ Salacuse, *supra* note 5, at 836-37.

III. The U.S.-E.U. Open Skies Deal

A. The U.S. Export of Open Skies Policy

Though the United States possesses the world's largest market for air transport services, competition within domestic market was heavily regulated until the late 1970s. The U.S. airline industry was placed under the control of the U.S. Civil Aeronautics Board, which was given the power to control routes and fares within the domestic market, and could approve or disapprove fares on international routes.³² In response to increased criticism toward economic inefficiency and high fares caused by heavy regulation, the U.S. Congress passed the Airline Deregulation Act in October 1978, which relaxed air transport restrictions in favor of a freer market and produced increased efficiency and benefits for both consumers and airlines.³³

Encouraged by the successes of domestic airline deregulation, the U.S. decided to export its liberalization ideals internationally by renegotiating pre-existing bilateral air transport agreements. To this end, the administration of President Jimmy Carter crafted a new aviation negotiating policy. Under this policy, the United States would offer foreign carriers expanded access to the U.S. market (including new, interior gateway cities), in exchange for pricing flexibility, which gives carriers freedom to set fares, and for promises from such foreign carriers to refrain from anticompetitive behavior.³⁴ Beginning in 1978, the Carter Administration negotiated a number of more liberal agreements with trading partners in Europe, the Middle East, and Asia. However, both the U.S. Congress and the American carriers bitterly criticized this idea of trading "hard rights" – new U.S. gateways for the benefit of foreign airlines – for "soft rights" – nothing more than the imprecise promises of foreign governments to stop regulating entry, fares, and schedules.³⁵

Mindful of the deficiencies of these earlier liberal bilateral agreements, in August 1992, the U.S. Department of Transportation (DOT) formally introduced and defined the Open Skies policy, which includes eleven basic elements designed to ease restrictions on the international aviation and serves as a guidance for the negotiation of Open Skies agreements between the United States and any other like-minded country.³⁶

³² Warden, *supra* note 3, at 231.

³³ Moritz Ferdinand Scharpenseel, *Consequences of E.U. Airline Deregulation in the Context of the Global Aviation Market*, 22 NW. J. INT'L L. & BUS. 91, 97-98 (2001).

³⁴ Schless, *supra* note 2, at 442-43.

³⁵ Jeffrey N. Shane, *Air Transport Liberalization: The U.S. Experience*, available at <http://www.dot.gov/affairs/jeffshane091806.htm> (last visited on June 25, 2008).

³⁶ Benoit M.J. Swinnen, *An Opportunity for TransAtlantic Civil Aviation: From Open Skies to Open Markets?* 63 J.

In October 1992, the United States and the Netherlands, a long-time liberal in the aviation field, signed the first Open Skies agreement, which liberalized the air services between the two countries. The U.S.-Netherlands Open Skies Agreement “gives U.S. and Dutch airlines open entry into each other’s markets, unrestricted capacity and frequency on all routes and the greatest possible degree of freedom in setting fares.”³⁷ For the first time in history, carriers licensed in either the United States or the Netherlands were granted open access to international routes between the two countries.³⁸ Thus, American carriers may fly from anywhere in the United States to any airport in the Netherlands, likewise, the Dutch carriers may fly from anywhere in the Netherlands to any airport in the United States. In return for the Netherlands’ active support for Open Skies policy, the U.S. Department of Transportation also granted antitrust immunity to the strategic alliance between KLM Royal Dutch Airlines and Northwest Airlines shortly after the conclusion of the Open Skies Agreement.³⁹

The demonstration effects of the U.S.-Netherlands Open Skies Agreement exerted various degrees of temptation and pressure on other European countries, for the unrestricted aviation transport arrangements between the two countries gave the Dutch carriers an immediate competitive advantage over other European carriers – the total gateway access to the lucrative U.S. market.⁴⁰ Fearing that their carriers would be left behind, other European nations (such as Austria, Belgium, Denmark, Finland,

AIR L. & COM. 249, 269-70 (1997). The eleven basic elements of Open Skies policy are as follows:

- (1) Open entry on all routes;
- (2) Unrestricted capacity and frequency on all routes;
- (3) Unrestricted route and traffic rights, that is, the right to operate service between any point in the United States and any point in the European country, including no restrictions as to intermediate and beyond points, change of gauge, routing flexibility, co-terminalization, or the right to carry Fifth Freedom traffic;
- (4) Double-disapproval pricing in Third and Fourth Freedom markets and [i] in intra-EU markets: price matching rights in third-country markets, [ii] in non intra-EU markets: price leadership in third-country markets to the extent that the Third and Fourth Freedom carriers in those markets have it;
- (5) Liberal charter arrangements (the least restrictive charter regulations of the two governments would apply, regardless of the origin of the flight);
- (6) Liberal cargo regimes (criteria as comprehensive as those defined for the combination carriers);
- (7) Conversion and remittance arrangements (Carriers would be able to convert earnings and remit in hard currency promptly and without restriction);
- (8) Open code-sharing opportunities;
- (9) Self-handling provisions (right of a carrier to perform/control its airport functions going to support its operations);
- (10) Pro-competitive provisions on commercial opportunities, user charges, fair competition and intermodal rights; and
- (11) Explicit commitment for nondiscriminatory operation of and access for computer reservation systems.

³⁷ Hedlund, *supra* note 14, at 271.

³⁸ Aviation Transport Services Agreement, U.S.-Netherlands, art. 12-3(A) (Oct. 14, 1992), T.I.A.S. No. 11976.

³⁹ Hedlund, *supra* note 14, at 272.

⁴⁰ Warden, *supra* note 3, at 236.

Germany, Luxembourg, Norway, Norway, Sweden, Switzerland, and Iceland) followed the Netherlands' step and signed similar agreements with the United States subsequently.⁴¹ With this, the U.S. achieved its goal of "using an agreement with the Netherlands as a lever to get the rest of Europe to open up,"⁴² though this strategy of "divide and conquer" triggered intense controversy within the European Union.

B. The E.U.'s Pooling of Air Transport Negotiating Power

The EU (formerly known as the European Community (EC)), which consists of many sovereign Member States, did not have a single aviation market at its inception. Historically, the airlines of Europe had been regarded as "public utilities" and heavily regulated, owned, and/or subsidized by their governments.⁴³ Under the umbrella of the Chicago Convention, air transport relations between Member States were governed by traditional bilateral regimes in the same way as those between Member States and third countries. Though the goal of creating a European common market was set as long ago as 1957, its realization in the field of air transport consumed most of the ensuing half-century.⁴⁴

In March 1957, the six founding states (Belgium, France, the Federal Republic of Germany, Italy, Luxembourg and the Netherlands) signed the Treaty Establishing the European Economic Community [hereinafter the Treaty of Rome], which started the ambitious process of European unification. Realizing the importance of transport in the overall scheme of the European Community, the Treaty of Rome mandated a common transport policy in both general principles (Article 3) and separate provisions (Article 74-84).⁴⁵ However, due to its "public utility" character, air transport at that time was specifically exempted from the application of common transport policy by Article 84(2), which provided: "The Council, acting by means of a unanimous vote, may decide whether, to what extent and by what procedure appropriate provisions might be adopted for sea and air transport."⁴⁶ As most Member States originally owned or subsidized their airlines and resisted liberalization, the Council, which consists essentially of representatives of the Member States, was unable to adopt any concrete measure to regulate intra-Community air transport in the following decades.⁴⁷ It was

⁴¹ Swinnen, *supra* note 36, at 270.

⁴² Joan M. Feldman, *It's Time to Lead*, 29 AIR TRANSPORT WORLD 59, 60 (Oct. 1992).

⁴³ Paul Stephen Dempsey, *Competition in the Air: European Union Regulation of Commercial Aviation*, 66 J. AIR L. & COM. 979, 982 (2001).

⁴⁴ *Id.*

⁴⁵ The Treaty establishing the European Economic Community art. 3, 74-84, Mar. 25, 1957, 298 U.N.T.S. 11.

⁴⁶ *Id.* art. 84(2).

⁴⁷ Dempsey, *supra* note 43, at 1004.

not until the adoption in 1986 of the Single European Act, which set as its goal the creation of a single European market without internal frontiers in which the free movement of services (including air transport services), goods, labor, and capital is ensured,⁴⁸ that the Council began the liberalization of the civil aviation industry.⁴⁹ In preparation for the single European market's target date of January 1, 1993, the Council adopted three Packages of Air Transport Liberalization between 1987 and 1991.⁵⁰ When the Third Package⁵¹ became effective in 1993, the framework for a single aviation market within the EU, consisting of freedom of establishment and freedom to provide services, finally replaced the bilateral agreement system.⁵²

Though the three Liberalization Packages eliminated internal frontiers in the EU aviation market, they did not shape a common external aviation policy toward countries outside the Union. To ensure the competitive advantage of their national carriers, Member States went their own way and concluded individual Open Skies agreement with the U.S., which provoked great discontent of the European Commission. In the Commission's view, although the Open Skies agreements between the United States and EU Member States might accord benefits to consumers, the bilateral negotiations and agreements by individual Member States failed to take account of the fact that the EU had become one large liberalized market, similar in nature to the American market on the other side of the Atlantic. Instead of a balanced agreement between two partners of equal size, these bilateral agreements gave U.S. carriers significant operational benefits in Europe without according reciprocal benefits to European carriers in the United States.⁵³ The Commission believes that in the case of

⁴⁸ The Single European Act art. 13 (Feb. 17, 1986), 25 I.L.M. 506.

⁴⁹ Though aviation was exempted from the application of common transport policy, a succession of judgments by the Court of Justice between 1974 and 1986 made it clear that other Articles of the Treaty of Rome did apply to aviation. In April 1986, the Court of Justice found in the *Nouvelles Frontières* case that the European carriers' involvement in cartel-like activities were subject to the EC competition rules. In order to acquire a block exemption for their carriers under the EC competition law, the Member States had to pay a political price in terms of further secession of sovereignty rights in aviation matters to the Community. Furthermore, the Single European Act replaced the unanimous voting requirement under the Treaty of Rome with qualified majority, which means the Council could act upon Article 84 without facing the veto power of any single Member State. See Swinnen, *supra* note 36, at 258-59.

⁵⁰ *Id.* at 259-65.

⁵¹ The Third Package consisted of three Council regulations: Regulation 2407/92 on Licensing of Community Air Carriers, 1992 O.J. (L 240) 1; Regulation 2408/92 on Access to Intra-Community Air Routes, 1992 O.J. (L 240) 8; Regulation 2409/92 on Fares and Rates for Air Services, 1992 O.J. (L 240) 15.

⁵² Under this framework, nationals of Member States, subject to a set of common rules for air operator's licensing, could establish airlines in any other Member State and have traffic rights on substantially all EU routes without capacity and fares restrictions. See Scharpenseel, *supra* note 33, at 103-04.

⁵³ For example, while U.S. carriers can fly freely from any point in the U.S. to almost any point in the EU under this patchwork of agreements, European airlines can only fly to U.S. destinations from their home bases. Moreover, while U.S. airlines can use their Fifth Freedom rights – the rights to operate air services from one country to a second

Open Skies negotiations, the only way for the EU to achieve a more balanced outcome is by pooling the negotiating leverage of all EU Member States together and arriving at a joint approach toward external policy. Though the Commission had repeatedly asked the Council to grant it a mandate to take over all air transport negotiations with the U.S., the Council declined to do so.⁵⁴ The Commission finally lost its patience and, in December 1998, brought before the European Court of Justice cases against seven EU Member States that have concluded bilateral Open Skies agreements with the United States (Austria, Belgium, Denmark, Finland, Germany, Luxembourg, Sweden).⁵⁵ The Commission argued in Court that:

- (1) The Commission has the exclusive competence to negotiate air transport agreements with non-EU countries on behalf of the Member States, and the Member States, by individually signing Open Skies Agreements with the U.S., had violated the Commission's exclusive authority.
- (2) The so called "nationality clauses" contained in these agreements, which restrict international traffic rights to air carriers owned and controlled by citizens of the country party to the agreement, caused discrimination in favor of the national flag carriers of each signatory Member State and against airlines of other EU Member States, thus violated one of the fundamental rules of the Treaty of Rome.⁵⁶

The Court of Justice issued its judgment on 5 November 2002. In regard to the Commission's first argument, the Court held that the Council had not granted the Commission expressed competence over external aviation agreements, nor did there exist such implied competence, therefore, the Member States had not violated the Commission's exclusive authority by signing agreements with the United States.⁵⁷

country and then on to a third – to fly between two points within the EU's internal market (provided that the second and third stops on the route are both EU signatory states), EU airlines have no such rights between different destinations inside the U.S. market. See Ruwantissa Abeyratne, *The Decision of the European Court of Justice on Open Skies - How Can We Take Liberalization to the Next Level?* 68 J. AIR L. & COM. 485, 488 (2003); see also Thomas D. Grant, *An End to "Divide and Conquer"? EU May Move toward More United Approach in Negotiating "Open Skies" Agreements with USA*, 67 J. AIR L. & COM. 1057, 1059-60 (2002).

⁵⁴ Grant, *supra* note 53, at 1059.

⁵⁵ The Commission brought an eighth case against the United Kingdom in respect of its "Bermuda II" agreement with the United States. In October 1999, the Netherlands also decided to join the cases in support of the other Member States. See EU Press Release, *Open Sky Agreements: Commission Welcomes European Court of Justice Ruling*, 5 November 2002, available at <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/02/1609&format=HTML&aged=1&language=EN&guiLanguage=en> (last visited on June 25, 2008).

⁵⁶ *Id.*

⁵⁷ Warden, *supra* note 3, at 243-44.

Despite this, the Court found that the “nationality clauses” contained within the Open Skies agreements, which allow the U.S. to deny access to carriers whose home nation has not signed an agreement and thus granted some carriers a privileged right of access over others, clearly violated Article 52-58 (“the right of establishment”) of the Treaty of Rome, which guarantee that nationals of one Member State must receive the same treatment in another Member State as that state's nationals.⁵⁸

As a result of the Court's landmark ruling, all air transport agreements containing “nationality clauses” must be renegotiated under acceptable terms. Meanwhile, faced with the U.S.'s strategy of “divide and conquer”, the Member States finally realized the importance of “speaking in one voice” in air transport negotiations. On 5 June 2003, the Council agreed on a package of measures that passes responsibility for conducting key air transport negotiations to the European Commission, and in particular granted the Commission a mandate to begin negotiations on a new transatlantic air agreement.⁵⁹

C. Elements of the U.S.-E.U. Open Skies Agreement

Based on the mandate given by the Council, the EU and the U.S. initiated the negotiations of an comprehensive air transport agreement in June 2003 and, after eleven working sessions, finally agreed on the first stage Open Skies Agreement, which was signed on 30 April 2007 at the EU-U.S. Transatlantic Summit in Washington. This new Open Skies Agreement, which was rewarded as “results that are unprecedented in international aviation since the Chicago Convention of December 1944”,⁶⁰ took effect in March 2008 and replaced all bilateral agreements between Member States and the U.S. thereafter.

The U.S.-EU first stage Open Skies Agreement consists of 26 Articles and 5 Annexes. Inheriting the spirit of existing bilateral Open Skies agreements, this Agreement not only eliminated nationality restrictions, but also achieved notable liberalization in terms of market access, capacity and fare.

1. The Elimination of Nationality Restrictions

The U.S.-EU Open Skies Agreement makes it clear that each Party shall allow a fair and equal opportunity for the airlines of both Parties, i.e. U.S. airlines and Community

⁵⁸ *Id.*

⁵⁹ EU News Release, *New Era for Air Transport: Loyola De Palacio Welcomes the Mandate Given to the European Commission for Negotiating an Open Aviation Area with the US*, 5 June 2003, available at <http://www.eurunion.org/News/press/2003/2003037.htm> (last visited on June 25, 2008).

⁶⁰ EU News Release, *Open Skies: EU Welcomes Draft Aviation Agreement* (Mar. 2, 2007), available at <http://www.eurunion.org/News/press/2007/2007020.htm> (last visited on July 25, 2008).

airlines, to compete in providing the international air transportation.⁶¹ According to Article 4 of the Agreement, the term “U.S. airline” means that substantial ownership and effective control of that airline are vested in the United States, U.S. nationals, or both, and the airline is licensed as a U.S. airline and has its principal place of business in U.S. territory; likewise, “Community airline” means that substantial ownership and effective control of that airline are vested in a Member State or States, nationals of such a state or states, or both, and the airline is licensed as a Community airline and has its principal place of business in the territory of the European Community.⁶² With the recognition of all airlines of Member States as “Community airlines” by the U.S., European airlines, irrespective of their nationalities, would now equally enjoy the benefits brought with the Open Skies Agreement.

2. Grant of Traffic Rights

In terms of traffic rights, the U.S.-EU Open Skies Agreement provides that each Party should grant to the other Party broad rights for the conduct of international air transportation by the airlines of the other Party, which include not only the first two technical freedoms, but also unlimited Third, Fourth, and Fifth Freedom rights. Based on these provisions, airlines of both Parties could not only operate “point to point” air services on any transatlantic route between the EU and the U.S. (Third / Fourth Freedom), but also operate air services on routes beyond the EU and the U.S. (Fifth Freedom). Specifically speaking, U.S. airlines could fly from points behind the United States via the United States and intermediate points to any point or points in any Member State or States and beyond, or vice-versa; and Community airlines could fly from points behind the Member States via the Member States and intermediate points to any point or points in the United States and beyond, or vice-versa.⁶³

3. Unlimited Capacity and Prices

According to the Agreement, each Party shall allow each airline to determine the frequency and capacity of the international air transportation it offers based upon commercial considerations in the marketplace. To this end, neither Party shall unilaterally limit the volume of traffic, frequency or regularity of service, or the aircraft type or types operated by the airlines of the other Party, nor shall it require the filing of schedules, programs for charter flights, or operational plans by airlines of the other Party, except for customs, technical, operational, or environmental reasons.⁶⁴

⁶¹ See Air Transport Agreement, U.S.-EU, art. 2 (Apr. 30, 2007), 46 I.L.M. 470.

⁶² *Id.* at art. 4.

⁶³ *Id.* at art. 3(1).

⁶⁴ *Id.* at art. 3(4).

Meanwhile, prices for air transportation services operated pursuant to the Agreement shall be established freely and shall not be subject to approval, nor may they be required to be filed.⁶⁵

Besides the above key elements, the U.S.-EU Open Skies Agreement also covers such things as aviation safety and security, commercial opportunities, customs duties and charges, user charges, government subsidies and support, environment protection, consumer protection, computer reservation systems, etc.⁶⁶ A joint committee consisting of representatives of the Parties was also founded under Article 18 to conduct consultations relating to the Agreement and to review its implementation.⁶⁷

With about 50 million annual passengers between the EU and the U.S., the U.S.-EU Open Skies Agreement covers by far the biggest international air transport market. The removal of market access restrictions will stimulate competition and improve consumers' welfare. It's estimated that the benefits for consumers could reach up to 12 billion euros over the first five years, and about 80,000 new jobs could be created on both sides of the Atlantic.⁶⁸

Building on the success of the first stage Agreement, the EU and the U.S. launched talks on a second stage Open Skies Agreement on 15 May 2008, which could lead to the removal of restrictions on the foreign ownership of airlines by investors from both sides, allow reciprocal access to domestic markets of both Parties and introduce a more consensual approach to the regulation of the industry.⁶⁹

IV. Implication for the Liberalization of International Air Transport Services

The accomplishment of the U.S.- EU Open Skies deal is by no means an isolated or accidental event. It's a natural result of both Parties' long-time pursuit of aviation deregulation and liberalization, as well as an apotheosis of realizing air transport services liberalization outside the multilateral trading system. However, this historic deal is a two-edged sword for the liberalization of international air transport services.

⁶⁵ *Id.* at art. 13.

⁶⁶ *Id.* at art. 10-12, 14-16.

⁶⁷ *Id.* at art. 18.

⁶⁸ EU News Release, *EU-US Open Skies: A New Era in Transatlantic Aviation Starts on Sunday* (Mar. 28, 2008), available at <http://www.eurunion.org/News/press/2008/2008026.htm> (last visited on June 15, 2008).

⁶⁹ EU News Release, *Open Skies: The EU and the US Start Talks on Air Services Agreement to Reshape Global Aviation*, 15 March 2008, available at http://ec.europa.eu/transport/air_portal/international/pillars/global_partners/us_en.htm (last visited on June 30, 2008).

On the one hand, it set a successful model for the rest of the world to follow, which will eliminate many countries' suspicion or hesitation toward Open Skies policy and accelerate the course of liberalization. On the other hand, it strengthened the path-dependence of air services liberalization on bilateral or plurilateral reciprocitybased pattern, and thus will have negative influence on MFN-based air services liberalization within the multilateral trading system.

A. Demonstration Effects of The U.S.- E.U. Open Skies Deal

Air transport is not only a significant industry in its own right, but also is one of the most important instruments of international trade and the glue that holds the world's economy together. With the acceleration of economic globalization and trade liberalization, the international aviation industry is undergoing a revolution that will eventually convert it into a "normal" global industry. No matter how painful it might be, the process toward air transport services liberalization is irreversible. In order to stay ahead of the forthcoming global aviation competition, the world's two biggest aviation powers have already been engaged in a new round of strategic layout planning.

Since the establishment of Open Skies policy in 1990s, the United States has concluded Open Skies agreements with over 90 partners from every region of the world and at every level of economic development.⁷⁰ Besides, on 1 May 2001, the United States, New Zealand, Singapore, Brunei, and Chile signed in Washington the first plurilateral Open Skies agreement titled "Multilateral Agreement on the Liberalization of International Air Transportation" (MALIAT), which replaced the bilateral agreements between them. After entering into force on 21 December 2001, the MALIAT is now open to accession by others on terms no less favorable than those of the original signatories.⁷¹

On the other side of the Atlantic, the EU, not being content with just a single market success, has also put forward an ambitious aviation policy built on three key pillars:

- 1) updating bilateral agreements in the form of horizontal agreements, which would be negotiated by the Commission on behalf of the Member States in order to bring all existing bilateral air services agreements between Member States and a given third country in line with Community law;

⁷⁰ U.S. Bureau of Economic, Energy and Business Affairs, *List of Open Skies Partners*, updated on June 12, 2008, available at <http://www.airlines.org/economics/traffic/OpenSkiesPartners.htm> (last visited on June 30, 2008).

⁷¹ The MALIAT now has nine signatories: the United States, New Zealand, Singapore, Brunei, Chile, Samoa, Tonga, Cook Islands, Mongolia. See *Country Matrix of the MALIAT*, updated 12 June 2008, available at <http://www.maliat.govt.nz/country/matrix.shtml> (last visited on June 30, 2008).

- 2) creating a European Common Aviation Area (ECAA) with the EU's neighbors, with the aim to integrate partner countries in south-east Europe (Albania, Bosnia and Herzegovina, Croatia, the former Yugoslav Republic of Macedonia, Montenegro, Serbia, and the UN Mission in Kosovo) into the single market by 2010; and
- 3) seeking comprehensive aviation agreements with other key partner countries such as the United States, Canada, China, Australia, New Zealand, and India, in pursuit of twin objectives of market opening and regulatory cooperation in matters such as aviation security and safety.⁷²

The U.S.- EU Open Skies Agreement is neither the start, nor the end of the process of international air transport services liberalization; however, it is the most ambitious air services deal ever negotiated as well as an important step toward the normalization of the international aviation industry.⁷³ The EU and the United States are the two largest and most lucrative air transport markets in the world. Together they account for more than half of all global scheduled passenger traffic and 71.7 percent of the world's freighter fleet.⁷⁴ The liberalization of transatlantic air services, even in its first stage, has brought noticeable benefits to both sides of the Atlantic, such as lower airfares, new direct jobs, greater consumer choice, growth in aircraft and computer businesses, and foreign direct investment in surrounding airports with new traffic.⁷⁵ There is no doubt that the successful story of U.S.- EU Open Skies deal will eliminate many countries' suspicion or hesitation toward Open Skies policy and serve as a blueprint in international air services.

Moreover, with the intensification of global aviation competition, a "survival of the fittest" game is unavoidable among airlines. As airlines operating under the umbrella of Open Skies agreements will benefit enormously from more liberal or favorable access to international routes and thus gain a competitive advantage over their rivals operating under the traditional restrictive regimes, even the most protectionist countries will be under a lot of pressure to enter into liberal air transport arrangements. In fact, fearing of being left behind in global competition, more and more countries have begun to endorse the concept of Open Skies and seek to forge more liberal air transport agreements and refine existing ones. At the same time, various regional or plurilateral initiatives aimed at promoting liberalization among members to regional agreements or

⁷² Office for Official Publications of the European Communities, *Flying together: EU Air Transport Policy* 7-9 (2007).

⁷³ EU News Release, *supra* note 68.

⁷⁴ Eugene Alford and Richard Champley, *The Impact of the 2007 U.S.-EU Open Skies Air Transport Agreement*, available at http://trade.gov/media/publications/pdf/openskies_2007.pdf (last visited on June 25, 2008).

⁷⁵ *Id.*

like-minded countries have also been initiated or are under consideration.⁷⁶ It's foreseeable that the U.S.- EU Open Skies deal will greatly accelerate the pace of international air services liberalization.

B. The Effect of U.S.- E.U. Open Skies Deal on the Path Selection of Air Services Liberalization

As the most ambitious air services deal so far, the U.S.-EU Open Skies Agreement undoubtedly will affect the path selection of future international air services liberalization. No matter how liberal it may be, the U.S.-EU Open Skies Agreement essentially represents a reciprocity-based bilateral arrangement. Though the spread and intensification of this pattern will further air services liberalization at different levels, it may not be good news for comprehensive liberalization efforts within the multilateral trading system.

The international air services liberalization has long been harassed with a divergence between non-discriminatory multilateralism and bilateralism based on reciprocity. From a purely idealistic or theoretical viewpoint, the free exchange of air traffic rights at a multilateral level seems to be a more desirable and efficient approach, for it is fully consistent with the international character of aviation activities, and could provide clarity and legal certainty to all participants. However, it is not easy for the multilateralism to make its way in practice. Since most countries tend to associate international aviation activities with national security and pride and regard the rights to fly across their sovereign airspace as their exclusive economic resources, fairness, equity and reciprocity are strictly emphasized in the exchange of the benefits, privileges and concessions relating to the provision of air services.

Furthermore, in view of the disparities in economic and competitive situations among countries, it's extremely difficult, if not impossible, to precisely assess the potential market value of every air freedom right on every route at multilateral level and ensure that every country would benefit equally from the deal. Consequently, it's unpractical to set up a universal or uniform model for the exchange of traffic rights, for it all depends on the specific situation of each country or pairs of countries.

⁷⁶ According to quantitative analysis issued by WTO in 2007, more than 25 regional or plurilateral arrangements initiatives toward various degrees of air services liberalization have already been underway, such as the Pacific Islands Air Services Agreement, the Common Air Transport Program of the West African Economic and Monetary Union, the Association of South-East Asian Nations (ASEAN) Sectoral Integration Protocol for Air Travel, the Air Transport Agreement for a Common Aviation Area of the Association of Caribbean States, Euro-Mediterranean Air Transport Agreement, etc. See Council for Trade in Services, *Second Review of the Air Transport Annex Developments in the Air Transport Sector* (Part Three), WTO Doc. S/C/W/270/Add. 2 (Sept. 28, 2007), paras. 6-27.

Comparatively, the flexible bilateral arrangement, which focuses on individual routes or small sets of routes between pairs of countries, can better serve this purpose. Based on this reality, bilateral exchange of traffic rights between pairs of countries on a reciprocal basis has stood at the very core of the international air transport system since the U.S.'s unsuccessful efforts to realize multilateral air services liberalization at the Chicago Conference.

During the 1986-1994 Uruguay Round negotiations, there were wild discussions among negotiators as to whether aviation services should be included within the WTO multilateral trading system under the rubric of the General Agreement on Trade in Services (GATS).⁷⁷ Though some negotiators such as Canada, Australia, Singapore and Switzerland proposed that as many areas of aviation services as possible should be subject to free trade rules of the multilateral trading system, the majority of negotiators stressed the peculiarities of the air transport sector, in particular the strong bilateral element which governs the sector's operation,⁷⁸ and feared that fundamental principles of the multilateral trading system, such as the unconditional Most Favored Nation (MFN) clause would deprive air service negotiators of essential flexibility and thus impede rather than advance liberalization. In the majority's view, since trade barriers in air services vary widely in form and impact across markets, even liberal nations tend to discriminate when granting traffic rights in order to counteract different restraints their carriers encounter in foreign markets. Under these circumstances, adopting unconditional MFN would undermine the ability of governments to tailor packages of economic rights according to the specific situation in particular foreign markets. Furthermore, as MFN requires that any concession granted to one state be applied automatically to all Members, many states would be likely to act as "free riders" and have no incentive to liberalize their own markets, which would run counter to the liberalization of air transport services.⁷⁹

Due to the divergences among negotiators, the final Uruguay Round Agreement designed a unique sectoral exclusion of air services in the GATS Annex on Air Transport Services [hereinafter the Annex], which defines the present coverage of air services with following paragraphs:

2. The Agreement, including its dispute settlement procedures, shall not apply to measures affecting:

⁷⁷ Abeyratne, *supra* note 28, at 833.

⁷⁸ Working Group on Transport Services, *Note on the Meeting 5-6 July 1990*, GATT Doc. MTN.GNS/TRANS/3, (Aug. 8, 1990) paras. 1-17.

⁷⁹ Abeyratne, *supra* note 28, at 839-43.

- (a) traffic rights, however granted; or
- (b) services directly related to the exercise of traffic rights, except as provided in paragraph 3 of this Annex.

3. The Agreement shall apply to measures affecting:

- (a) aircraft repair and maintenance services;
- (b) the selling and marketing of air transport services;
- (c) computer reservation system (CRS) services.⁸⁰

It could be easily concluded from these provisions that, except for three definitely listed services (aircraft repair and maintenance services, the selling and marketing of air transport services and computer reservation system services), the application of GATS to air transport services is strictly limited to measures affecting neither traffic rights⁸¹ nor services directly related to the exercise of traffic rights – though the Annex lacks a clear definition of “services directly related to the exercise of traffic rights”. As traffic rights stand in the core of air transport services, the exclusion of traffic rights from the GATS means that the main body of air transport services is still outside the regulation of multilateral trading system.

According to timetables set by the GATS, a new round of negotiations on trade in services was formally launched in 2000, during which the WTO Members are required to review developments in the air transport sector and the operation of the Annex with a view to considering the possible further application of the GATS in this sector. Though most Members consider it necessary to clarify the present coverage of air transport under the GATS (especially the scope of “services *not* directly related to the exercise of traffic rights”) and improve the quality of specific commitments made under current coverage, there is hardly any consensus so far among Members that more areas of air services (such as traffic rights) should be covered by the GATS. Specifically speaking, while a few Members such as Australia and New Zealand pointed out various deficiencies of bilateral arrangements and proposed to enlarge the GATS’s coverage of air services, most other Members tend to maintain the status quo. For instance, as the biggest beneficiary of the reciprocitybased liberalization, the United States believed that the almost total exclusion of air transport services from the scope of coverage under the

⁸⁰ See Annex on Air Transport Services, paras. 2-3.

⁸¹ The term “traffic rights” is broadly defined by the Annex as the right for scheduled and non-scheduled services to operate and/or to carry passengers, cargo and mail for remuneration or hire from, to, within, or over the territory of a Member, including points to be served, routes to be operated, types of traffic to be carried, capacity to be provided, tariffs to be charged and their conditions, and criteria for designation of airlines, including such criteria as number, ownership, and control. See Annex on Air Transport Services, para. 6 (d).

GATS had been farsighted and had contributed to the ongoing liberalization of air transport agreements through air services-specific agreements and the facilitating activities of ICAO and numerous regional fora; in view of the demonstrated success of the traditional, reciprocitybased air transport system, and the numerous promising initiatives ongoing bilaterally and plurilaterally, the greatest contribution the WTO can make in this sector is to ensure that existing venues and mechanisms for air transport liberalization be allowed to reach their potential.⁸² Without the support of the world's major aviation powers, a breakthrough is unlikely in the ongoing Doha Round negotiations.

It is not difficult to induce from more than half a century's evolution of international air transport regulation that the current system, under which the International Civil Aviation Organization (ICAO)⁸³ ensures uniformity of safety and technical standards and states exchange traffic rights on a reciprocal basis, has showed tremendous vitality in promoting the development of international air transport and ensuring a "fair and equal" opportunity for each state to operate international air transport. To a certain extent, most countries have developed a path-dependence on this pattern.

The successful story of the U.S.-EU Open Skies deal further indicated that the current system, with its flexibility and controllability, could be used not only for the purpose of protectionism, but also for the liberalization of air transport services. What is more, with the worldwide promotion of Open Skies policy and the intensification of regional economic cooperation, this reciprocitybased liberalization is no longer limited to bilateral level, but has expanded to plurilateral and regional levels (considering that the EU consists of many sovereign Member States, the U.S.-EU Open Skies deal itself is a mixture of bilateral and plurilateral arrangements). Under these circumstances, air transport services liberalization in the GATS framework will become less attractive or even repulsive to Members that have already been engaged in bilateral, plurilateral, or regional liberalization process, for the MFN's "free for all" effect will impair the vested benefits and competitive advantages they have acquired under bilateral, plurilateral, or regional arrangements.

To sum up, the U.S.-EU Open Skies deal has strengthened the path-dependence of

⁸² For a summary of different Members' options, see Council for Trade in Services, *Report of the First Session of the Review Mandated under Paragraph 5 of the Annex on Air Transport Services Held on 12 September 2006*, WTO Doc. S/C/M/84, (Sept. 27, 2006) *Report of the Second Session of the Review Mandated under Paragraph 5 of the Annex on Air Transport Services Held on 1 March 2007*, WTO Doc. S/C/M/87 (Apr. 10, 2007)

⁸³ The International Civil Aviation Organization (ICAO) was established under the Chicago Convention in 1944 as a means to secure international co-operation and highest possible degree of uniformity in regulations and standards, procedures and organization regarding civil aviation matters. See ICAO, *Foundation of the International Civil Aviation Organization*, available at http://www.icao.int/cgi/goto_m.pl?icao/en/hist/history02.htm (last visited on July 25, 2008).

air services liberalization on bilateral or plurilateral reciprocitybased pattern, and thus will have negative influence on MFN-based air services liberalization within the WTO framework. Due to the particularity of aviation sector, the ubiquitous protectionism, and the “free-rider” dilemma, the multilateral negotiations of air services liberalization is far from an easy task. It’s quite understandable that when liberal-minded Members such as the U.S. and EU could realize high level of air services liberalization through reciprocitybased arrangements quickly, flexibly and expediently, they will have little interest or patience in tough, time-consuming and (perhaps) fruitless air services negotiations under the WTO. And fearing of being left behind in global aviation competition, other Members will also be pulled into this kind of liberalization campaign. With the wide spread of Open Skies arrangements and other air services liberalization initiatives at various levels, the incentive and chances to include traffic rights into the GATS are becoming slim. There is no doubt that in the foreseeable future, the liberalization of air services will still follow the existing path outside the multilateral trading system, and advance on a reciprocal basis through bilateral arrangements in parallel with plurilateral and regional arrangements.

V. The Strategic Choice of China

With its large population and dynamic economy, China has become one of the world’s fastest-growing aviation markets. Average annual growth in air travel in China has been 16% between 1958 and 2002 and high growth rates of around 15% per annum are expected to prevail until 2020.⁸⁴ In 2007 alone, the total number of airline passengers passing through China’s airports reached 387.586 million – an increase of 16.8% compared with 2006; and the cargo & mail traffic throughput hit 8.611 million tons – a 14.3% increase than 2006.⁸⁵ China overtook Japan as the largest air travel market in Asia in 2004 and is now second only to the U.S. in terms of total scheduled departing seats. In spite of this, China’s airline industry is still at its initial stage of development, and much still remains to be done before it can confront the challenge of Open Skies. Faced with a new round of global aviation competition, China need to make a strategic choice on the basis of its actual conditions and specific interests.

⁸⁴ Air Transport Portal of the European Commission, *Global Partners – China*, available at http://ec.europa.eu/transport/air_portal/international/pillars/global_partners/china_en.htm (last visited on July 30, 2008).

⁸⁵ CAAC, 2007 Statistic Report on Civil Airport Operation, available at http://www.caac.gov.cn/C1/200803/t20080306_12721.html (last visited on July 30, 2008).

A. Reform and Deregulation of China's Airline Industry

Airline industry was heavily regulated in China from its inception. China's airline industry was founded during the early 1950s when the newly formed country needed airlines as a national instrument to carry out its policy for government administration, trade, and tourism. Prior to 1979, the industry was a paramilitary organization under the control of the Civil Aviation Administration of China (CAAC).⁸⁶ As a branch of air force for most of its early years, the CAAC regulated every facet of the airline industry - from safety, pilot training, and airworthiness, to aircraft purchases and the ticket fares that could be charged - and functioned as both a regulatory body and a commercial aviation entity.⁸⁷

The reform and deregulation of airline industry began in the late 1970s as part of China's general economic reform and opening-up policy. From 1979 to 1986, the CAAC administrative body was restructured to isolate the civil aviation and its business concerns from the militaristic focus of the air force. Meanwhile, the government divided the civil aviation sector into nine airlines, each of which incorporated under its own business license and was authorized to manage its operation independently and responsible for its own losses and profits.⁸⁸ In 1987, the State Council passed an airline reform program designed to separate the regulator from also being the operator, break the CAAC's monopoly, and encourage the entry of new carriers into the domestic market. In an effort to facilitate new market entry, the CAAC also simplified the existing procedural requirements for route approval.⁸⁹ As a result, there emerged a proliferation of small local carriers, and the airline industry soon became inundated with forty-one air carriers in 1993.⁹⁰ To promote the development of air services market, in 1997, the CAAC put forward the policy of "one ticket price and different discounts", which enlarged the price fluctuation range from 10% to 40%.⁹¹

Following China's WTO entry in 2001, the airline industry further accelerated its pace toward marketization. In June 2002, the State Council approved "Provisions on Foreign Investment in Civil Aviation", which loosed the limits of foreign investment in civilian airports, public air transport enterprises, general aviation enterprises and air

⁸⁶ Anming Zhang & Hongmin Chen, *Evolution of China's Air Transport Development and Policy Towards International Liberalization*, 42 TRANSP. J. 31, 32 (Spring 2003).

⁸⁷ Wu Jianduan & Xu Lining, *Corporate Takeovers: Legal Aspects of Takeovers Among Chinese Airlines*, 68 J. AIR L. & COM. 583, 606-07 (2003).

⁸⁸ Zhang & Chen, *supra* note 86, at 32-33.

⁸⁹ *Id.*

⁹⁰ *Id.*

⁹¹ Guilan Liu, *Learn to Buy Air Tickets*, PEOPLE'S DAILY, Dec. 2, 1997, at 10.

transport related projects.⁹² At the same time, domestic private capitals were also allowed to enter the airline industry. In order to foster a more efficient airline industry that will be able to successfully compete in the ever-growing international air transportation market, in October 2002, the Chinese government successfully separated all nine affiliated airlines from the CAAC and consolidated them into three large airlines groups – Air China, China Eastern, and China Southern. Furthermore, with the enlargement of market access and price flexibility, more and more private and low-cost airlines such as Spring and East Star entered in succession into the domestic aviation market since 2005, which brings more choice and benefits to passengers.

It should be noted, however, that China's aviation reform and deregulation is far from completion, as government control and intervention still exist in various aspects of the industry. For instance, though the "Big Three" airlines groups were separated from the CAAC, they are still owned and controlled by the State-owned Assets Supervision & Administration Commission (SASAC) of the State Council. Meanwhile, the importation of aircrafts and jet fuel is monopolized respectively by China Aviation Supplies Holding Company (CAS) and China National Aviation Fuel Group Corporation (CNAF), and domestic airlines have very little choice in the purchase of aircrafts and jet fuel.

B. China's External Aviation Policy and Strategy in Global Competition

In China, as in many other developing countries, aviation has long been regarded as a symbol of national pride and prestige. Under the Chicago Convention system, the aviation relations between China and other countries are similarly governed by traditional bilateral agreements. In order to protect its fragile airline industry and to ensure a "fair and equal" opportunity to operate international air transport, China has historically adopted very conservative policies in bilateral air transport negotiations. For example, according to the so-called "one route, one carrier" policy, usually only one Chinese carrier and one foreign carrier were designated to operate the air services on any given international route.⁹³ In bilateral exchange of the Third and Fourth freedoms, the reciprocity principle was based typically on the actual market shares between Chinese and foreign carriers rather than on the capacity provisions, and a carrier might even be compensated if it did not make the revenue that is equivalent to its share of bilateral operations.⁹⁴ In addition, Chinese government once required that Chinese passengers must take Chinese airlines' flights if their travel is for administrative affairs

⁹² See Provisions on Foreign Investment in Civil Aviation, art. 3, approved by the State Council on June 12, 2002.

⁹³ Zhang & Chen, *supra* note 86, at 36-37.

⁹⁴ *Id.*

for various levels of government and large state-owned enterprises, or for activities sponsored by the government.⁹⁵

However, following the deregulation and growth of its airline industry, China has recently revised its protectionist practices in external aviation relations and accelerated its pace toward international liberalization. It is witnessed that Chinese government in recently years has amended bilateral air transport agreements with partners such as the United States, Japan, South Korea, Finland and Singapore, which led to more liberal and flexible arrangements in market access and traffic rights exchange. For example, the newly amended U.S.-China aviation agreement of 2007 allows for 13 new daily flights operated by U.S. carriers to and from China within five years, bringing the eventual total up to 23 per day (as opposed to the 10 daily flights currently operating to Beijing, Shanghai, and Guangzhou). The deal also will provide U.S. cargo carriers with virtually unfettered access to Chinese markets by lifting all government-set limits on the number of cargo flights and cargo carriers serving the two countries by 2011.⁹⁶ In April 2003, the CAAC granted Singapore Cargo Airlines permission to exercise the Fifth freedom rights between Singapore and Chicago via Xiamen and Nanjing, which is the first time that China opened up the Fifth freedom rights to foreign carrier.⁹⁷ Meanwhile, to support the realization of the ASEAN-China Free Trade Agreement in 2010, China and ASEAN agreed at the Sixth ASEAN-China Transport Ministers Meeting of 2007 to work toward an ASEAN-China Regional Air Services Agreement with provisions for gradual liberalization of cargo services as well as passenger services.⁹⁸

In spite of China's efforts toward international air services liberalization, the current bilateral regime governing its external aviation relations is still restrictive and is a far cry from Open Skies arrangement. Under Open Skies arrangements, determination of routes, which airlines will fly those routes, and how often airlines may fly those routes, are left to free-market and competitive forces rather than the governments of the nations

⁹⁵ *Id.*

⁹⁶ U.S. Department of Transportation, *U.S. Transportation Secretary Peters and Chinese Minister of Civil Aviation Yang Reach New Agreement to Double Number of Passenger Flights, Ease Most Restrictions on Cargo Flights between two Countries*, available at <http://www.dot.gov/affairs/dot5207.htm> (last visited on July 30, 2008).

⁹⁷ Shuiyi Bao, *The Prospect of the Development of Chinese Civil Aviation Industry*, 75 CHINESE CIVIL AVIATION 51 (Mar. 2007).

⁹⁸ See ASEAN-China AVIATION COOPERATION FRAMEWORK, adopted on Nov. 2, 2007, available at <http://www.aseansec.org/21154.htm> (last visited on July 31, 2008). The substantive elements of the ASEAN-China Regional Air Services Arrangement would include, but not limited to, following provisions:

- a. removal of restrictions to the number of points in the route schedule;
- b. no limitations on third and fourth freedom traffic rights between ASEAN and China;
- c. no limitations on fifth freedom traffic rights between ASEAN and China;
- d. no limitations on frequency and capacity, as well as the type of aircraft;
- e. charter operation as an element; and
- f. multiple airline designation.

involved,⁹⁹ while in bilateral air transport agreements between China and other countries, these matters are still under various degrees of government control. This status is closely rooted in the fact that Chinese airlines, although undergoing decades of reform and deregulation, are still less competitive than their foreign rivals in terms of price, services and convenience. Specifically speaking, as state-owned enterprises, China's "Big Three" airlines groups have not yet got rid of bureaucratic and monopoly character, which hampered their improvement of management and services. Meanwhile, due to the lack of autonomy in such matters as the purchase of aircrafts and jet fuel, most Chinese airlines could not effectively control and reduce their operation costs, and thus have no advantage in price competition. Furthermore, after years of strategic planning, many foreign airlines have already established hub-spoke networks around the world that brings enormous convenience to international passengers, while Chinese airlines are still at their early stage of international market exploitation.¹⁰⁰ Under these circumstances, Open Skies is obviously not bliss to China's airline industry.

With the acceleration of economic globalization and trade liberalization, the process toward air services liberalization is irreversible. The conclusion of the U.S.- EU Open Skies Agreement marked the opening of a new round of global aviation competition that is characterized by reciprocal and free change of traffic rights. It is an opportunity as well as a challenge to the rest of the world, including China. It's undeniable that Open Skies arrangements could bring huge welfare to both consumers and the global economy, that airlines operating under the umbrella of Open Skies agreements could benefit enormously from more liberal or favorable access to international routes and thus gain a competitive advantage over their rivals operating under the traditional restrictive regimes. That's why so many countries have been pulled into this game and so many liberalization endeavors have emerged from around the world. However, without the relevant protection and restriction, this "survival of the fittest" game might be a catastrophe to numerous small or less competitive airlines, especially those of developing countries. Just as China cannot resist the tide of economic globalization, it is unable to evade the forthcoming global aviation competition. In order to better grasp the opportunity and confront the challenge, China must make a strategic choice on the basis of its actual conditions and specific interests:

Firstly, China should hold active attitude toward the trend of international air services liberalization. Air transportation has long been the life-blood of trade,

⁹⁹ Ashley Renee Beane, *Aviation Relations between the United States and China: Are Open Skies on the Horizon?* 72 J. AIR L. & COM. 803, 830 (2007).

¹⁰⁰ Shaochen Liu, *Competence Research on Chinese Civil Aviation Enterprises (III)*, 56 CHINESE CIVIL AVIATION 33, 36 (Aug. 2005).

commerce, and tourism, and played a vital role in the economies of individual nations and of the world. As the world's third largest trading power and one of the most attractive destinations for foreign direct investment, China would benefit immensely from the liberalization of air transport services, which would not only facilitate the further prosperity of China's external business and trade, but also provide domestic airlines with valuable opportunities to exploit new market, accumulate experiences and strengthen competitiveness. With this in mind, it is in China's best interest to continuously loosen its aviation policy and actively participate in bilateral, regional or plurilateral arrangements aimed at promoting air services liberalization on a reciprocal basis.

Secondly, the degree and pace of air services liberalization in China should be set with great care. It's widely admitted that a level playing field is the precondition to free competition. China's airline industry is still in its primary stage of reform and deregulation and therefore is far behind those of developed countries in various aspects. Until the completion of marketization reform and the elimination of undue government intervention, Chinese airlines would not be able to go head-to-head with powerful foreign rivals. Considering the specific conditions and poor competitiveness of its airline industry, the U.S.- styled Open Skies agreement, under which market forces determine everything, apparently does not fit China at the present time. Out of these concerns, a controllable and phased-in approach toward air services liberalization is the most rational choice for China, at least for the time being. In other words, China should still retain necessary control over such key points as the determination of routes, frequencies, and designation of carriers in the negotiation of any kind of air services liberalization arrangement, although this kind of control could and should be weakened gradually at a pace consistent with the growth of its domestic airline industry.

VI. Conclusion

Global transportation networks are the glue that holds the world's economy together, and international aviation in particular provides the critical link between economies on a global scale.¹⁰¹ In spite of its international character linking people and countries, the air transport sector has long been heavily regulated and intervened by governments out

¹⁰¹ Jeffrey N. Shane, *Liberalization: More Important Than Ever*, Remarks on the 13th Annual International CEO Conference (May 9, 2005), available at [http://ostpxweb.dot.gov/S-3/Data/International%20CEO%20Conf%20\(5-9-05\).pdf](http://ostpxweb.dot.gov/S-3/Data/International%20CEO%20Conf%20(5-9-05).pdf) (last visited on July 31, 2008).

of national pride, prestige or security considerations.

Although the Chicago Conference of 1944 achieved a great deal in harmonizing technical and safety standards of international aviation, it failed to formulate an acceptable set of multilateral rules relating to the exchange of air traffic rights. As a result, bilateral agreements focusing on the reciprocal exchange of market access have become the mainstream pattern of international air services regulation. These agreements vary in form but are typically restrictive and protectionist in terms of the regulation of routes, capacities and prices.

With the advancement of trade liberalization and economic globalization, it has become increasingly clear that the traditional restrictive bilateral regimes can no longer meet the rapidly changing needs of airlines, consumers or the global economy, and a fundamental transformation of international air services regulation is inevitable. As a pioneer in this transformation, the United States put forward the Open Skies policy in 1992 and initiated an ambitious campaign toward international air services deregulation and liberalization. Going through all kinds of hardships, the Open Skies campaign is now in full swing at various levels.

The U.S.- EU Open Skies Agreement, encompassing 60 percent of world air traffic, represents a landmark in the liberalization of international air services. It not only heralded a new era in transatlantic aviation, but also laid solid foundations for a revolution in the international aviation industry that will see it treated as a “normal” global industry.¹⁰² The successful story of this historic deal has set a good example for the rest of the world to follow. Faced with a new round of global aviation competition, more and more countries will be compelled to make a strategic choice between liberalization and marginalization.

While other sectors of the economy have benefited immensely from the multilateral trading system, the air transport sector constitutes an anomaly under the GATS due to the dilemma of reconciling bilateral reciprocity that dominates air services negotiations with the MFN principle underlying the multilateral trading system. On the other hand, the U.S.- EU Open Skies deal, together with other liberalization initiatives, have injected new vitality into the traditional reciprocity-based system of air services regulation so that it can better accommodate the trend toward liberalization. When the world's major aviation powers have obtained vested benefits and competitive advantages through reciprocity-based liberalization, the prospect to include “hard rights” of air services into the multilateral trading system becomes dim in the foreseeable future. Therefore, the

¹⁰² EU News Release, *Open Skies: Jacques Barrot in Washington to Sign Historic Aviation Deal at the EU-US Transatlantic Summit* (Apr. 30, 2007), available at <http://www.eurunion.org/News/press/2007/2007044.htm> (last visited on July 25, 2008).

liberalization of air transport services will continue to advance within the existing reciprocity-based system through bilateral, regional, and plurilateral arrangements.

Since the commencement of general economic reform and opening-up in the late 1970s, China has achieved a great deal in deregulating its airline industry, including the enlargement of market access and price flexibility, but Chinese airlines still have a long way to go toward full marketization. Although China is a “big” player in the field of international civil aviation, it is far from a “strong” player. Compared with many foreign rivals, Chinese airlines are still left far behind in aspects such as the quality of service and management, cost control, network construction, earning capacity, etc. This situation derives largely from long-time and complicated government intervention and control, which could not be changed overnight. As was indicated by the experiences of the U.S. and EU, domestic airline deregulation and reform is the precondition to external liberalization. With this in mind, it is obviously not fair for Chinese airlines to go head-to-head with powerful foreign rivals in unlimited international competition until they are free from excessive government intervention and become truly independent market players.

As one of the world’s major economic powers and a potential aviation power, China should and would actively participate in various levels of initiatives aimed at promoting air services liberalization on a reciprocal basis. It will not only facilitate the further growth of China’s external business transactions, but also provide domestic airlines with valuable opportunities to exploit new market, accumulate experiences and strengthen competitiveness. However, it should always be born in mind that the level and pace of international air services liberalization must be consistent with that of domestic airline deregulation. Considering the specific conditions and poor competitiveness of its airline industry, China should still retain necessary control over such key points as the determination of routes, frequencies, and designation of carriers in any kind of air services liberalization arrangement – no matter how liberal it might be. Although this kind of control should be weakened gradually along with the growth of domestic airline industry (as was shown in the newly amended U.S.-China aviation agreement of 2007), now is not the time to abandon it entirely.

Based on these considerations, the U.S.- styled Open Skies agreement, under which market forces determine everything, apparently does not fit China at the present time. Not matter how hard the U.S. and EU may try to peddle the concept of Open Skies to China, which represents a potential gold mine for their airlines, Chinese government is well-advised to insist on its control over the level and pace of liberalization. After all, a controllable and phased-in approach toward air services liberalization is the most rational choice for China, at least for the time being.