A Transaction Cost Analysis of Scheduled international Air Transport of Passengers

Ravoo, M.

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Chapter III - The Bilateral structure

3.1 - Introduction

Chapter II classified transactions and governance structures using elements from transaction cost analysis. These elements are now applied to air transport, following the approach described in that chapter. Section 3.2 outlines the history and content of the Bilateral transaction. Sections 3.3-3.5 consider the parties involved in the transaction, their objectives, the nature of the transaction and the transaction process in greater detail. The focus is on the traditional Bilateral structure as implemented in the Netherlands and, in particular, on the relationship between the state and KLM and Schiphol airport, these being the largest Dutch industry players. Section 3.6 categorises the Bilateral structure using the classification of the previous chapter and Section 3.7 looks at some further developments.

Recall that this thesis analyses the exchange and regulation of air transport rights through which access to the market for scheduled international passenger air transport is obtained. Market access comprises various rights to use airspace for transit and transport and the right to capture the benefits from this use. The states hold the property rights to the airspace above their territories, which means that only states are entitled to engage in every phase of the transaction. The execution of the transaction is partly delegated to third parties, namely airports and airlines.

The various rights to use airspace and to capture the resulting benefits are also known as ‘the freedoms of the air’, but in fact there is no real question of freedom. A central feature of the Bilateral structure is complete and absolute sovereignty of a state with respect to the airspace above its territory. The property rights to airspace belong exclusively to the state and its explicit permission is necessary prior to any transport. This has not always been the case: until the time airspace could be used for commercial (productive) purposes, there were no clearly defined property rights to the upper airspace. The rights to the lower airspace rested with the owners of the land underneath, who were entitled to the undisturbed use of their land. Only when technological developments opened up possibilities to use the upper airspace did it become worthwhile to create property rights. When these rights were specified, they were assigned to states. From an economic point of view, this was an efficient decision because it was expected that political factors would cause states to claim these rights. A direct allocation

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1 The air transport rights form the bulk of the property rights to airspace.
2 As stated in the introduction, this thesis does not look into freight transport or charters. An extensive overview of regulation in the air cargo sector is provided by Fennes (1997).
3 The reference to these rights as ‘freedoms’ can be traced back to the State of the Union speech by President Roosevelt in 1941, who referred to a new world order after the war in which there would be freedom of speech and religion as well as freedom from want and fear (O’Connor, 1971: 13).
made it unnecessary to conclude transactions (Demsetz, 1966: 66). There are strong political motives for assigning the property rights to states. States have been very much involved in air transport from the outset. At first, the primary motivation was to guarantee safety on the ground, which could be harmed by hazardous materials transported by air. The Peace Conference at The Hague in 1899, for example, issued a declaration in which the signatory states agreed not to transport explosive materials during a flight or to throw materials from a balloon. Also in 1899, a conference took place in Paris with the objective to research possible ways of developing air transport. The conference revealed two attitudes regarding air transport regulation. The first promoted freedom of the air, stating that free flight does not cause any damage. The second, at that time primarily supported by the British, strongly favoured state sovereignty with respect to airspace above their territories.

Aircraft were first used for military purposes in the first world war. Until then, they had been used mainly for communication or observation purposes. The effects could be seen at the Peace Conference that took place in Paris in 1919, as well as in the text of the ensuing Paris Convention. At the conference, there was a common understanding among the delegates that the free transport principles applicable to sea and inland water transport should not apply to air transport (Mendes de Leon, 1992: 13, Fennes, 1997: 60). The main reason for such an exclusion was that, at the time, the consequences of such freedom could not be foreseen. Furthermore, routes and airports along these routes had been developed with substantial investment by the states, which had to be recouped (Bin Cheng, 1962: 8-9); the French wanted to protect Paris; and the British wanted free air traffic to their overseas territories (Bouwens, Dierikx, 1996: 27-28). The conference resulted in the establishment of the principle that states should have complete sovereignty with respect to airspace above their territories, which meant complete assignment of property rights to states. Sovereignty notwithstanding, parties acknowledged in principle the right of free thoroughfare and the right to use civil airports in other states. To be sure, this was not a natural right but a privilege to be granted by the sovereign power (Verpoog, 1963: 13-14).

Although the Paris Convention did not deal with exploitation issues, the provisions of the treaty had a great impact. Sovereignty on the one hand impeded transport, since it could only take place when an approval had been given. This requirement further made airspace a valuable national asset, which could be used in trade negotiations (Doganis, 1991: 26). On the other hand, sovereignty stimulated transport in and between signatory states because an approval guaranteed an undisturbed operation. This provided the industry with the confidence needed to embark on ever-increasing investments in, for instance, aircraft or airport facilities (Bin Cheng, 1962: 8, Barzel, 1989: 73) and motivated the Netherlands to ultimately ratify the treaty in 1928.

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4 Convention relating to the Regulation of Aerial Navigation of 13 October 1919.
5 As laid down, for example, in the Mannheim Convention of 17 October 1868.
During the second world war, civil air transport in Europe came to a virtual standstill. At the end of the war, there was again a clear division between states that favoured a completely unrestricted development of air transport and states that wanted to retain sovereignty. Every state did, however, agree that, since air transport had become part of world-wide trade negotiations, it was necessary to reorganise the industry’s institutional structure. During the war, initiatives had already been taken towards an international conference that would deal with these aspects. The conference began in Chicago in November 1944. It showed considerable disagreement between the European states and larger states that made greater use of air transport. The Europeans mainly looked at air transport as an instrument specifically designed to safeguard links with their (former) colonies. This instrumental function is to some extent reflected in the names of national airlines, which often refer to the respective countries where the airlines are established: they carry the flag (‘flag carriers’) (Kasper, 1988: 70, Havel, 1997: 85-86). The United Kingdom, furthermore, thought of air transport as an infant industry that needed protection. In their opinion, freedom could only exist with sufficient regulation. For this purpose the British proposed establishing a multinational ‘International Air Authority’ that would have regulatory powers in such areas as the exchange of transport rights, tariffs, frequencies and capacity. To the United States a transfer of political powers in the trade domain to an international organisation was unacceptable. The delegates could not come to an agreement on these fundamental issues and the conference ended with a treaty - the Chicago Convention - which essentially deals with air traffic (i.e. operational) issues rather than exploitation issues.\footnote{7}

Of primary importance for the post-war development of air transport is Article 1 of the Chicago Convention. This article formulates the absolute and complete sovereignty of a state with respect to airspace above its territory. Together with Article 6, which states that scheduled air transport over or to a state can only take place with an explicit approval or permit from that state, the basic elements of the market were put in place. Exploitation issues were partly deferred to a future conference and partly addressed in two annexes to the Convention, namely the ‘Air Services Transit Agreement’ and ‘Air Transport Agreement’. In these annexes, for the first time, the air transport rights were divided into ‘freedoms’. The Air Services Transit Agreement codified the first two freedoms, while the Air Transport Agreement embodied the first five. Note that the annexes did not grant any right of transport as most states wanted to address the political aspects of their air transport relations through bilateral arrangements (Wassenbergh, 1957: 15-18, O’Connor, 1971: 43-45). Furthermore, the annexes, especially the

\footnote{6}{A tariff is the price charged for the carriage of passengers, baggage or cargo (excluding mail) and the conditions governing its availability and use (ICAO definition Doc 9587, Part II-A).}

\footnote{7}{Convention on International Civil Aviation, opened for signature on 7 December 1944. As at 16 June 1999, 44}
Air Transport Agreement, were not widely accepted.

3.2 - Bilateralism

Although formal treaties were used to exchange air transport rights as early as the period after the Paris Convention, it became an accepted practice after the Chicago Convention was concluded. It should be stressed that neither the Chicago Convention nor international law made this mandatory, although Article 6 of the Chicago Convention opened up the possibility of subjecting a foreign carrier receiving access to national laws. To facilitate the conclusion of formal treaties, the delegates to the Chicago Convention agreed on a model Air Services Agreement (also known and referred to as a ‘Bilateral’), which became an annex to the Chicago Convention. The manner in which Bilateral treaties govern the exchange and operation of air transport rights became known as ‘Bilateralism’.

In 1946, the United States and the United Kingdom concluded a Bilateral in Bermuda, dealing with the exchange of air transport rights over the North Atlantic. This Bilateral was a compromise between the two countries’ positions at the Chicago conference. The United Kingdom gave up its demand for a prior approval of frequency and capacity, whilst the United States accepted the tariff-setting procedure of the International Air Transport Association (hereafter: ‘IATA’). This ‘Bermuda I treaty’ has operated from 1946 onwards as a standard for Bilaterals concluded around the world. In 1959 the European Civil Aviation Conference (hereafter: ‘ECAC’) issued model clauses (hereafter: ‘Standard Clauses’) based on experience acquired under the Bermuda I Bilaterals and the model from the Chicago Convention. Both ECAC and the International Civil Aviation Organization (hereafter: ‘ICAO’) called upon their members to make use of the Standard Clauses. In practice, a more or less fixed Bilateral structure has emerged. It consists of three parts, namely the actual treaty, the annex and often an ‘Exchange of Notes’ or ‘Memorandum of Understanding’ (hereafter: the ‘Memorandum’).

The treaty itself provides market access. Two central provisions relate to tariff setting and capacity. The Bermuda I Bilaterals frequently state that tariffs will be set by the carriers that will operate services, where operational costs, a fair profit and tariffs of other carriers should be taken into account. This concept is also embodied in Article 7.1 of the Standard Clauses.

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185 states were party to the Chicago Convention. Source: ICAO 1999.

6 An alternative way of arranging approval was the issue of temporary permits by the destination state (Gidwitz, 1980: 154-155), which was common practice in the interwar period. Nowadays permits are mainly used by scheduled carriers in anticipation of an amendment of a Bilateral, for example to enable an extra frequency, such as the Bilateral between the Netherlands and Argentina. The use of permits is increasing as market deregulation leads to an increase in charter operations and charters operate on the basis of permits.

9 Infra, Section 3.3.4.

10 Infra, Section 3.3.4.
The establishment of a tariff may be referred to the tariff setting procedures of IATA\textsuperscript{11}, with transacting states retaining the right to approve or reject the outcome.

A basic principle of Bilateralism is the sovereignty and fundamental equality of the transacting states. This involves non-discrimination and equal treatment with respect to operational issues and mutual acceptance of licences and certificates of airworthiness. In addition, there is mutual acknowledgement of national laws and regulations regarding such issues as navigation, entry and clearance. There is no general uniformity in these rules, as noted by Balfour (1995: 30-31), who discusses the problems associated with having to meet various requirements related to aircraft certification, aircraft maintenance and crew licensing. Another consequence of the principle of equality is reciprocal exchange. The capacity clause often states that the primary objective of any transport should be to provide adequate capacity to and from the home country. In determining capacity, the interests of the other carrier need to be taken into account as both carriers should have a ‘fair and equal opportunity’. This ‘quid pro quo’ is a fundamental element of Bilateralism and mirrors domestic law. Klabbersons (1986: 26 and 86-87), for instance, observes that in many domestic legal systems agreements can only be considered legally binding if they involve a real exchange: if there is literally a ‘quid pro quo’.

Although the doctrine of consideration has never met with general acceptance in international law, in Bilateralism the concept of quid pro quo is a central theme. The content of the fair and equal opportunity principle varies greatly from an equal starting position, with the creation of ‘opportunity’ guaranteeing ‘fairness’, to the opposite extreme, which explicitly lays down the number of passengers that a carrier is allowed to transport within a given period (Dempsey, 1987: 63, Fennes, 1997: 90-93). The Netherlands adhere to the first interpretation which is also the current trend (ICAOa, 1998). Fennes (1997: 202) describes the practice of the United States, which often aim for maximum market access because they cannot secure an equal outcome in transactions with smaller states. A case in point is the 1992 Open Skies Bilateral with the Netherlands (also Bouwens, Dierikx, 1996: 226). Note that the Americans used the agreement in a strategy directed at creating a precedent in relations with larger countries.\textsuperscript{13} However, even an Open Skies Bilateral requires a form of reciprocity since every transaction is aimed at obtaining benefits of similar magnitude.\textsuperscript{14} A typical reaction on the part of states confronted with falling market shares for their carriers is to insist on frequency caps, schedule

\textsuperscript{11} Infra, p. 70.
\textsuperscript{12} The Open Skies Bilateral will not be analysed in this thesis because it differs significantly from a traditional Bilateral. Rights and benefits are exchanged on the basis of (sustained) competition and there is no prior regulation of access, capacity or price (Fennes, 1997: 206). Furthermore, although Open Skies Bilaterals are economically important to the Netherlands, traditional Bilaterals are still far more numerous.
\textsuperscript{13} The Americans followed an all-or-nothing strategy (Havel, 1997: 191, note 315), i.e. either all countries had to accept or the agreements would not enter into force. Havel (ibid.: 403) calls this the ‘encirclement strategy’.
\textsuperscript{14} Havel (ibid.: 198) mentions the denunciation of the US-Thai Bilateral because US carriers developed six times as much capacity as the Thai flag carrier. An alternative example of how benefits may be provided is the inclusion of the right of a non-US carrier to transport US officials under the terms of a Bilateral (ibid.: 163).
limitations and fifth freedom quotas. Some Bilaterals follow Bermuda I and use traffic potential originating from a state as the basis for determining capacity. Capacity determination may also be delegated to carriers, with states given an opportunity for review after a period of time. The review is known as an ‘ex post facto review’ and gives a state the opportunity to demand a reassessment of the agreed capacity on the basis of the operation of the rights during a prior period, when it feels that the fair and equal opportunity requirements are being infringed. The use of the ex post facto clause has decreased, however, and currently not many Bilaterals contain such a provision. Sometimes Bilaterals even require designated carriers to reach a commercial understanding on the capacity to be transported and on the carrier that is to be the agent of the transport. The lack of a single interpretation of the fair and equal opportunity requirement means that the Dutch preference for a liberal interpretation may not be shared by its trading partner. Fennes (1997: 114-118) describes a dispute with Zimbabwe over the meaning of reciprocity. The dispute began in 1980, when the Zimbabwean government refused KLM an expansion of capacity for fear of competition with its national carrier, Air Zimbabwe. In the early 1990s, operations by Zimbabwe’s charter carrier, Affretair, were declared scheduled services, thus enabling KLM to expand its services without infringing the equality requirement.

The ambiguity of the fair and equal opportunity concept is characteristic of the basic process governing Bilateral regulation. This process is one of consultation and diplomacy. It may consist of formal meetings of delegations with appropriate powers, or informal methods of communication. States use consultation on a continuing basis to manage their relationships, including those established by their bilateral air transport agreements. Technical problems in Bilaterals are typically handled by routine consultation between civil aviation authorities in the two states. Consultation is also the most important method of resolving air transport disputes (ICAO, 1994: §2.1).

An alternative, but less common, method of dispute settlement is arbitration, where issues are referred to an arbitral tribunal for resolution. The tribunal is usually made up of three arbitrators - one nominated by each party and the third (usually a national of a third state) nominated by the first two and acting as its president - who decide specific, mutually agreed questions concerning actions in dispute under the Bilateral. The tribunal usually determines its own procedures and its decision is binding on both states. The use of this method is rare because it is a costly and time-consuming process (ibid.). Moreover, arbitration is often politically unacceptable because it takes control over the dispute away from the disputing states and makes the outcome uncertain. This point will be discussed later in the section on

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15 Fifth freedom is the right to fly into the territory of a foreign state and there take on or discharge traffic destined for, or coming from a third state. Havel (ibid.: 181) notes France’s relationship with the United States. The French tactic of forcing the US to accept capacity restrictions was nothing less than a total denunciation of
compliance and enforcement.

The Bilateral exempts airlines from duties and charges for equipment, oil and other technical provisions necessary to operate aircraft. It further contains technical and operational provisions and covers designation and authorisation of the carrier that is to operate the rights exchanged. Each state designates a competent carrier or carriers to operate certain routes, where ‘competent’ means permitted under the laws and regulations of the designating state to engage in the type of operations covered in the agreement. The carrier is also subject to a nationality requirement, which is motivated by safety and political factors. A state only wants to grant rights to a specific state and wants to be certain about which carrier will operate any flights. It does not want carriers from other states to take care of the transport and so benefit from the exchange. In this respect, the Bilateral resembles a preferential trading arrangement, based on rules of origin. Since air transport entails the provision of a service by way of cross-border movements, the traditional rule of origin is replaced by a rule of ownership (OECD, 1997: 94). The nationality requirement means that substantial ownership and effective control of the airline have to be in hands of the citizens of the state to which the rights have been granted. Traditionally, the requirement is met when the board is mostly national and the carrier operates flights with domestic crew and aircraft. Current Bilaterals may contain a rather weak test, namely that the designated airline be incorporated and have its principal place of business in the designating state (ICAO, 1998a: 22). This demonstrates that under Bilateralism each state is effectively free to decide what exactly is meant by ‘substantial ownership’ (OECD, 1997: 76)\[16\].

Many countries (including the Netherlands) follow a policy of single designation, if not formally then in practice, and authorise a single carrier to operate the rights exchanged. An ECAC survey found that, although two-thirds of the Bilaterals do not require single designation, in only 8% of all cases has more than one carrier per country been designated (Williams, 1994: 70). The limited use of multiple designation can be attributed to the attitude of transacting states and to the small number of carriers interested in the operation of certain routes. Single designation contributes to a close bond between the state and flag carrier.

The second part of the Bilateral is an annex that makes specific the rights that have been exchanged. It addresses routes, commercial rights and accessory provisions. Route regulation is important to a carrier because the route is an important cost factor, and because route

\[16\]Havel (1997: 421) mentions a de facto waiver of the nationality requirement in the case of Aerolíneas Argentinas. In 1997, Iberia acquired a majority stake in the Argentinean flag carrier, but Aerolíneas Argentinas remained the designated airline of its country under the US-Argentina Bilateral. The United States Department of Transport (hereafter: ‘DOT’) accepted this, and overlooked the violation of the nationality clause in the parties’ 1985 Bilateral. In December 1999 Singapore Airlines acquired a 51% majoriy shareholding in the British carrier Virgin Airlines. Controversies similar to those of the Aerolíneas Argentinas case may arise.
flexibility enables it to enhance the value of its transport network by adding intermediate points in case of sufficient traffic potential. Bilateralism shows no uniformity in route regulation, which might vary from a freedom to fly to any point in the destination country and choosing any stop along the route to an explicit mention of an airport that is to be sole point of departure or arrival. The Air Transport Agreement contains the principle that a route should form ‘a reasonably direct line’ to and from the home state of the carrier. According to the United States at the Chicago Conference, ‘reasonably direct’ means the shortest distance. Other countries, including the Netherlands, feel that operational and commercial criteria should also be taken into account in choosing a route (Wassenbergh, 1957: 37). In practice, the economic importance of route flexibility has meant that disputes are not uncommon.

Finally, in executing the transaction, use is made of rights influencing the exercise of freedom rights (also known as ‘hard rights’). These accessory provisions deal with such matters as ground handling, sales and marketing, limits on the export of currencies and the use of computerised reservation systems (De Murias, 1989: 16, Fennes, 1997: 384). The provisions are usually referred to as ‘soft rights’ or ‘doing business rights’". A lack of fare flexibility, caused by the need for governmental approval, increases the relevance of non-price competition. Soft rights enable a differentiation of air transport services, which makes them important for the competitive strength of an airline. In general, soft rights are unregulated, leaving each state free to grant or refuse any soft rights and even to cancel rights previously agreed during operation. The resulting uncertainty has led to increasing efforts in negotiations to make these valuable rights part of the Bilateral.\textsuperscript{18}

The Bilateral frequently contains a third part, namely the Memorandum. Whereas the Bilateral must be registered with ICAO, the Memorandum is not subject to any such requirement. This offers the benefit of secrecy and allows the document to serve multiple purposes. First, it can be used to make additional arrangements without the need to go through a formal domestic approval process. This is also an advantage whenever the Bilateral is being amended. A Bilateral is entered into for an unlimited period, although termination is possible upon 6 or 12 months’ notice. Revisions may be required if the industry operates in a dynamic environment. Because a Memorandum can often be entered into by civil aviation authorities, the use of this instrument requires fewer formalities. Moreover, the Memorandum can be used to significantly deviate from the (publicly known) Bilateral without prejudicing future negotiations with third states. Secrecy can enhance the likelihood of reaching and quickly implementing an agreement, if only because the public and parliament in the home country remain unable to form an

\textsuperscript{17} Fennes (1997: 348, 383-387) objects to the use of the term soft rights because they are crucial to the operation of flights and in this respect as ‘hard’ as the so-called ‘hard rights’.

\textsuperscript{18} Intra, p. 74.

The analysis now turns to a description of the parties that are relevant to the exchange.

3.3 - Parties to the transaction
Chapter II pointed out that the analysis of any governance structure requires an investigation into the nature of and relationships between the parties involved. In air transport, where the state uses airlines and airports to realise its goals, certain agency aspects warrant particular attention. Sections 3.3.1 - 3.3.4 describe the respective roles of states, airlines, airports and the main international organisations.

3.3.1 - States
Bilaterals are concluded between formally equal states that hold the property rights to the airspace. In the Netherlands, the Civil Aviation Air Transport Division (hereafter: ‘CAA’), part of the Ministry of Transport, Public Works and Water Management (hereafter: ‘Ministry of Transport’), is responsible for air transport. The Dutch Ministry of Transport has multiple roles. First, within the governmental organisation, it is the ministry responsible for air transport policy. As such, it is responsible for the negotiation of Bilaterals. It also issues regulations, sometimes in co-operation with the Ministry of Housing, Regional Development and the Environment (hereafter: ‘Ministry of VROM’) and is entrusted with securing and monitoring compliance with these regulations. Finally, it holds financial interests in the air transport sector resulting from ownership in, for instance, Schiphol airport and KLM. A more detailed look into the ministry’s responsibilities shows that the combination of these roles is a potential source of conflict. Safety concerns, for example, could call for measures that harm financial interests. Furthermore, because some of its responsibilities lie outside air transport, the ministry will often look at factors other than the industry’s performance\(^\text{19}\).

As noted above, the Ministry of Transport is not the only department involved in air transport. A close link with foreign and environmental policies creates areas of responsibility and competence for the Ministry of Foreign Affairs and the Ministry of VROM. The Ministry of Foreign Affairs usually has three roles (Gidwitz, 1980: 120). First, it establishes a general international civil-aviation policy to guide the government in its air transport relations with other states. For example, it might endorse the operation of commercially non-viable routes for

\(^{19}\)This potential source of conflict has been acknowledged by the Minister of Transport, who in 1998 announced a process of disentanglement (‘bestuurlijke ontvlechting’) to reduce the multiplicity of roles and thus the chance of any conflict.
foreign policy reasons. Second, it provides the political or economic background necessary to evaluate air transport relations with specific foreign countries. It investigates the likely impact on general bilateral relations of various options available in any negotiations. Third, it is part of the delegation that negotiates the Bilateral. The Ministry of VROM holds competence in areas mainly related to land use and the environment.

The direct relationship between the state and air transport discussed above follows from the assignment of the property rights to airspace to the states and the sovereignty of states. These elements are reflected in Articles 1 and 6 of the Chicago Convention\(^{20}\), which in turn stem from national interests (for example, OECD, 1997: 72-73, Fennes, 1997: 61-62). Although policies differ among countries, the state’s air transport goal can generally be translated into three groups of reasons for state involvement. These are psychological factors, financial motives and political motives (O’Connor, 1971: 89, Wheatcroft, 1964: Chapter 3, Wassenbergh, 1957: 21-22). The second category of financial motives warrants some comment. The literature on air transport policy usually refers to this type of motive as ‘economic’. However, any objective of the state in so far as it uses up scarce resources can be deemed economic. In this sense, there are no economic ends (among others: Robbins, 1952: 16, 145, Hennipman, 1977: part 1 § 7 and 1995: Chapter I, more specifically pp. 20-21 and 27). The essential characteristic of a policy defined as ‘economic’ is the government pursuit of social welfare, encompassing every motive conceivable, by allocating the goods available within the economy and by influencing their use. For purposes of analyses, in this thesis the state’s social welfare objective (see Chapter II) will be translated into a sectoral air transport goal, and this goals will be translated further into subgoals. In addition, to be consistent with the literature on welfare economics, the use of the term ‘economic’ is avoided. The goals that are considered ‘economic’ in the air transport literature generate monetary and derived financial benefits for the state. Therefore, they are referred to as ‘financial’ goals below. A final comment that needs to be borne in mind throughout the analysis is that this thesis is not a welfare analysis. The goals are now considered in greater detail.

3.3.1.1 - Psychological goal

International ‘prestige’ is frequently cited as a reason for government involvement in air transport. Prestige can be described as the opinion the world holds of a carrier or a state, in a general or technological sense. It can be acquired through a domestic air transport industry and nationality requirements, such as the substantial ownership and effective control requirement applicable to airlines. The importance of prestige is diminishing with air transport being increasingly considered as a regular economic activity. However, for some countries, such as

\(^{20}\) Article 1 formulates the sovereignty of states with respect to the airspace above their territories, while Article 6 lays down the requirement of a specific permission prior to any transport.
developing countries and France, it is still very important. For developing countries, the operation of a domestic air transport industry puts them on an equal footing with developed countries and enhances self-confidence, while for France the existence of a flag carrier contributes to feelings of national identity. Dierikx (1999: 149) observes that financial aid to KLM after the second world war was motivated by prestige. Currently, prestige plays a limited role in the Netherlands. KLM, for example, is not majority owned by the state and the state’s ownership of Schiphol airport does not seem to be prestige related. A further example of the apparent absence of national prestige is the removal of the Dutch crown on KLM aircraft flying to Taipei, based on a request by the Chinese government. The ‘Scandinavian Airlines System’ (SAS), a joint holding company incorporated by the Scandinavian states of Sweden, Norway and Denmark, also illustrates that for some states national prestige in air transport is unimportant. SAS is designated to operate the majority of international route rights. The states no longer have their own flag carrier; instead SAS aircraft fly under a single name and are not clearly recognisable as carriers from any particular state. The designating state can no longer claim the benefits flowing from a good performance by the airline as it has to share any benefits with its partners. However, prestige is not altogether absent. In the Netherlands, the government’s decision to allow the Dutch aircraft manufacturer, Fokker, to go bankrupt caused a public outcry (Jagersma, 1994). A more recent illustration is the 1999 decision by British Airways to reinstate the English flag on its aircraft to comply with public sentiment.

3.3.1.2 - Financial goal

A further reason for state involvement is the financial goal. The state derives revenues and other financial benefits from air transport. In particular, the airline’s income contributes to foreign exchange reserves, while airport and airline services produce tax revenues, direct value added and indirect value added in related industries such as aircraft manufacturing. The air transport industry is a considerable source of employment. In 1999, 51,093 persons found a job in the air transport industry itself while a similar number of jobs were estimated to be held in industries related to air transport (Amsterdam Airport Schiphol, 2000). Because of these derived benefits, Dutch air transport policy actively stimulates location decisions by firms. The

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21 The flights are even operated by a separate KLM subsidiary (Dierikx, 1999: 336).
22 Sweden controls 3/7 of the shares, Denmark and Norway 2/7 each. National quotas are maintained. National registration remains necessary to meet the national identity requirement imposed by the Bilaterals.
23 NRC, De Firma, Rood-Wit-Blauw, 11 June 1999.
24 Note that VAT is excluded on international airline tickets, while public ownership of Schiphol airport exempts it from corporate income tax levied by the Dutch state.
25 This is only relevant to the extent that domestic airlines buy aircraft produced by domestic manufacturers (O’Connor, 1971: 93). Dierikx (1999: 160, 163) comments that whereas French and British carriers were required to operate with domestic material, KLM was free to order from foreign manufacturers and was not obliged to acquire Fokker aircraft. This provided KLM with a competitive advantage.
mainport Schiphol is important in this context. State ownership of shares in airlines and airports is a further source of state revenue. In the case of the Netherlands, KLM and Schiphol respectively paid NLG 28.9 billion and NLG 26.5 billion in dividends in 1998. The sale of KLM shares in 1998 contributed NLG 717.5 billion. Air transport also plays a role in promoting and facilitating transport and trade. This facilitating role is often overlooked because of its interaction with other factors. The viewpoint of air transport as a facilitator of transport and trade partly reflects a desire to co-ordinate the entire transport sector. Any such co-ordination is frustrated when the terms of competition differ across the various transport modes. Thus, Article 73 EC declares the provision of aid to the transport sector, with a view to such co-ordination, compatible with the EC Treaty.

Especially in a trade-oriented country such as the Netherlands, air transport plays a strategic role. Various policy documents and decisions (for instance, Voorlopige Raad voor Verkehr en Waterstaat, 1991, KEPD, Ministry of Transport, 1997, Ministry of Transport, 1999b) contain references to that effect. The financial benefits to the state vary in size and can be substantial for a small country with a large air transport industry. A state may thus want to use its influence to protect or improve its current position.

In formulating its air transport policy, the state faces some dilemmas. The performance of the industry as a whole may come into conflict with the performance of an individual firm. More specifically, the public may benefit from an expansion of capacity even though a particular airline is experiencing excess capacity. The dilemma is complicated by the fact that a decrease in capacity to boost load factors could lead to a transfer of potential customers to other forms of transport. The state faces another difficult situation in its choice between the interests of the national carrier and the interests of the public. Citizens are generally equally well-served by foreign companies. In deciding whether a foreign airline should be allowed to operate a route in competition with domestic airlines, the state is usually persuaded by financial interests and domestic lobbies to restrict entry by the foreign airline. Most routes are thus dominated by the airlines of the final destination countries. An example of the opposite situation is given by Forsyth (1998: 76-77). In Australia, the government realised that it would be very difficult to restrict Asian airlines carrying passengers from Australia to Europe on a sixth freedom basis. Since many of these passengers were Australian, the government was prepared to allow them low fares rather than protect the domestic airline. Australia has not

26 'Mainport' is a term coined by Dutch policymakers and is defined in the 1995 Key Environmental Planning Decision ('Planologische Kernbeslissing', hereafter: 'KEPD') as 'an airport that is the home base of and central European airport for at least one of the future dominating airlines'.
28 Note that the promotion of transport and trade has both income and redistribution effects.
29 Sixth freedom traffic is a combination of two freedom rights, namely, the third (transport from the home country to a third country) and fourth (transport from a third country to the home country) freedom rights. The sixth freedom right is traffic from country A to country B via a carrier's home country. Infra, p. 72.
been as prepared to allow foreign carriers to operate routes on which its nationals make up only a small proportion of the passengers.

A dilemma of a different nature is the conflict between financial goals and concerns for the environment. These concerns will be discussed in the next section.

3.3.1.3 - Political and social goal
This category covers the entire range of political and social goals which a state could pursue. Derived from the ultimate objective to guarantee the continuing existence of the state, important considerations include military motives, such as the ability to draw on a civil air transport industry during military emergencies (Borenstein, 1997: 529), the creation and development of domestic airports, as well as the accumulation of expertise. An example falling into this category of goals is given by Gidwitz (1980: 146), who describes the American acquiescence to Icelandair’s low-fare service between the United States and certain European points in exchange for Iceland’s membership of NATO and the location of a key American air force base on its territory. Once again, conflicts might arise. Security considerations could lead to a particular route being closed, thus increasing the costs faced by an individual airline. Political considerations are also present in the maintenance of air links between (former) colonies and the mother country and in the promotion of air transport to countries where the state wants to increase its influence. Dierikx (1999: chapter II) gives many examples of how these factors have influenced the air transport relationship between Indonesia and the Netherlands after Indonesia became independent.

The exchange of air transport rights is associated with good relations among states. Gidwitz (1980: 23-24) cites the Bilateral between the United States and the former Soviet Union. A further example is Taiwan’s national carrier, which operates flights between the Netherlands and Taiwan on the basis of an agreement at the airport level. The absence of a Bilateral can be attributed to the controversy over Taiwan’s position as a sovereign state. In discussing the United States’ procedure for accepting foreign designations, Havel (1997: 167) also notes the important role of foreign policy. For instance, the President of the United States may review DOT decisions with respect to the award or transfer of route authority and may reject a DOT action on grounds of ‘foreign relations or national defence considerations’.

Social considerations lie behind the provision of air transport to remote regions as a means of developing or integrating such regions. The establishment of an air link in such cases is cheaper and faster than constructing a road. In many instances regulatory structures have implicitly embraced this role of air transport by fostering cross-subsidisation of services (OECD, 1997: 103). Other social goals cover such areas as external safety, healthcare and working conditions in the industry. Environmental protection is gaining importance as a social goal. Air transport generates negative externalities in the form of noise problems, the emission
of pollutants, accident risks and congestion. While the share of air transport in global environmental pollution is still small, this share is growing steadily due to high growth rates in air travel. Environmental problems may be quite severe at a local level (Schipper, 1999: 184, Button, forthcoming), while local environmental lobbies tend to be powerful at that level (Van den Bergh, 1994: 68). Reflecting these pressures, the Dutch KEPD formulates requirements that capture a dual objective (‘dubbel doelstelling’) of strengthening Schiphol’s ‘mainport’ function whilst simultaneously improving the quality of the airport environment. The KEPD lays down strict environmental conditions, including a noise zone delimiting the operation of Schiphol airport and a maximum of 44 million passengers annually by the year 2015. Local air quality and accident risks are to be kept at predetermined levels. Environmental provisions have been part of the Dutch model Bilateral since the mid-1990s, in line with growing concerns for the environment, which form a general feature of the Western European economies (Kirchner, 1992: 44). The Bilateral provisions vary between requiring a best effort and an explicit mention of the aircraft type to be used. The multiple options available indicate the room for manoeuvre desired by states as they tailor their Bilaterals to meet the demands of any given relationship.

Note that there is no economic incentive for any single country to initiate internalisation strategies beyond those with immediate national implications (Button, forthcoming). This may provide a reason for dealing with environmental issues at an international level. Chapter V will look into this issue further, when discussing the effectiveness of the Community structure.

The above discussion shows that in the air transport industry, as in other industries, the state pursues various goals. These goals may conflict and may also change, depending on financial or political circumstances (Hennipman, 1995: 34). The inclusion of environmental provisions in the Dutch Bilaterals illustrates the point, as do the examples given by Havel (1997, 183, note 274). He explains how the German government adjusted its attitude according to the financial position of Lufthansa when negotiating a new Bilateral with the United States. Dutch policy traditionally aimed at acquiring a maximum of transport rights to support the transport network (for instance, Voorlopige Raad voor Verkeer en Waterstaat, 1991: 34-35, Ministry of Transport, 1998b). The relatively small potential of originating and destination traffic to and

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30 Pollutants include carbon dioxide, benzene, methane and carbon monoxide. Note that noise nuisance is getting the most attention in terms of public concern and policy issues (Schipper, 1999: 43-44).

31 This dual objective may be considered an outcome of the Dutch model for decision-making, namely the ‘poldermodel’. This model is claimed to be a modification of the so-called Rhineland model, which captures a regulated market economy with a comprehensive system of social security and where government, employers’ organisations and labour unions consult each other about the goals to be pursued and on the policy instruments to be used (Bolkestein, 1999: 97-98). The extensive consultations lead to vague decisions and compromises, often incorporating conflicting goals.

32 The opinion of the ‘Voorlopige Raad voor Verkeer en Waterstaat’ also uses the term ‘sustainability’, but more in the sense of a sustainable link between the carrier and the Netherlands. Infra, section 4.5.5.
from the Netherlands and the limitations inherent in a strict interpretation of the fair and equal opportunity requirement have meant a preference for liberalisation (Bouwens, Dierikx, 1996: 114). In recent years, there has been a change away from acquiring a maximum of rights towards a policy that will optimise a selective network of air links to, from and via the Netherlands (Ministry of Transport, 1998b). The policy contains elements of selection and differentiation. More specifically, the state should select the transaction partner that offers the greatest contribution to the development of the ‘mainport’, yet minimises the claims on scarce environmental and infrastructural capacity. Together these aims may be dubbed the selective network goal. It is a complex goal because it does not, in fact, capture a single goal but all of the aspects described in Sections 3.3.1.1-3.3.1.3. Moreover, liberalisation remains important as a prerequisite for selectivity because a strict interpretation of the fair and equal opportunity requirement harms states that lack physical or economic size. These states are restricted in their ability to negotiate agreements based on equality and cannot afford to be selective. Liberalisation can reduce this disadvantage by stimulating the elimination of strict requirements.

Chapter II noted some of the problems that arise when there are multiple objectives. Although multiple objectives create a certain flexibility, they may be difficult to realise if they cannot be prioritised. Moreover, the vagueness of some of the goals listed above makes it difficult to determine whether they are being realised and, if they are, whether this is happening in the most efficient way. The reliance on agents, namely airlines and airports, to gather information, make decisions and execute the transaction complicates things further as these agents have to assign a weight of their own to each of the goals (Goldberg, 1976: 432).

3.3.1.4 – Implementation of the air transport goal in the Bilateral structure

The previous sections identified the elements that constitute the selective network goal. In order to evaluate the extent to which the state has achieved its goal, these elements need to be translated into requirements to be met by the industry when providing air transport and airport services. To induce the industry to meet these requirements the state needs appropriate instruments (e.g. interest harmonisation, a reward structure, monitoring). The Dutch state has partially translated the selective network goal in a memorandum (Ministry of Transport, 1998b) formulating requirements that pertain to the provision of air transport and airport services. The memorandum identifies three areas for special attention:

1. the volume of traffic,

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33 The Oxford dictionary defines ‘liberalisation’ as ‘making liberal’, which in turn is defined as ‘making free, favouring free trade and gradual political and social reform that tends towards individual freedom or democracy’. Chapter IV will elaborate on liberalisation in the context of the European Community.

34 On the other hand, liberalisation coupled with a non-discrimination requirement may limit the state’s ability to be selective. Chapters IV and V will discuss this dilemma further.
2. the composition of the fleet that uses Schiphol airport and
3. market behaviour.

Note that the Selectivity memorandum does not explicitly address the financial, psychological or political elements of the government air transport goal. These elements are, however, covered in other policy documents, such as the KEPD, the 1998 Cabinet decision and the MIT 1999-2003. For instance, the MIT discusses the maximisation of economic benefits subject to a given claim on scarce environmental capacity. Note also that none of the documents rank the goals in order of importance.

3.3.1.4.1 - Traffic volume
Requirements aimed at the volume of traffic include a cap on the volume of traffic at Schiphol airport and a ban on night flights using certain types of aircraft. In addition, Bilateral capacity clauses may be used leading to requirements on the frequencies available to airlines. The instruments used to force or stimulate the industry to meet the requirements are the airline and airport designations, various permits, slot co-ordination and access policy for charter traffic and incidental flights. Access policy involves deciding requests on the basis of political variables affecting air transport.

3.3.1.4.2 - Fleet composition
Requirements aimed at the composition of the fleet include restrictions in Bilateral agreements on the types of aircraft to be used. In addition, states may – on a multilateral or even on a global basis – agree to requirements on the phasing out of noisy aircraft. As an example, ICAO member states have agreed to phase out Chapter II aircraft. For member states of the European Community, European legislation formulates additional measures, which are interpreted very strictly. They have even been expanded at the domestic level, adding further requirements on the use of the airport. The Selectivity memorandum also mentions developing a ‘Marshall plan’ aimed at less developed countries and airlines with fewer financial resources. The plan would involve financial aid to induce recipient countries or airlines to acquire modern aircraft, thus lowering noise pollution around Schiphol airport and enabling

35 The MIT plan (‘meerjarenplan infrastructuur en transport’) contains actions that need to be taken to realise the government’s policy agenda with respect to transport.
36 These factors indicate the difficulty of arriving at a clear air transport goal.
37 A ‘slot’ is the scheduled time of arrival or departure available to an aircraft movement on a specific date at an airport. IATA Scheduling Procedures Guide, 20th edition, July 1996.
more aircraft movements. A more detailed development of this plan has been delegated to the airlines.

3.3.1.4 Market behaviour

Requirements aimed at market behaviour include the KEPD requirement that, by the year 2015, five million airline passengers should have switched from aircraft to trains for short journeys (Project Mainport en Milieu, Schiphol, 1993: 144, annex 3). In addition, the state aims to be selective in choosing the countries with whom Bilaterals will be concluded and the frequencies to be agreed. Domestically, Schiphol is obliged to introduce a tariff regulation imposing differential aircraft charges and a system of bonuses or fines to silent or noisy aircraft. The Ministry of Transport uses its right of approval as an instrument. There are also proposals for fiscal measures at the international level, such as a tax on aircraft fuel or value added tax on international airline tickets, which may lead to domestic legislation. Finally, the Selectivity memorandum suggests that a covenant with the sector can produce more concrete targets and stronger commitments regarding environmental protection.

In addition, a 1998 Cabinet decision adds that the industry should initiate technical and operational measures as part of a new ‘Optimisation strategy’ (Ministry of Transport, 1998c: 19).

Section 2.5 explained that the effectiveness of a governance structure can be inferred from interstate and state-industry relationships. For example, the structure of the relationships between the state, airlines and airports influences the industry’s ability to determine how the state’s goals should be prioritised. At the same time the governance structure should contain instruments that enable the imposition and realisation of requirements that capture those goals. The policy documents outlined above are consistent with this approach, in that many of their requirements depend upon the co-operation of the airports and airlines. Moreover, the focus on Schiphol airport in the state’s air transport policy and the acknowledgement that a ‘mainport’ status requires the presence at the airport of a mega-carrier confirm the importance of state-industry relationships41. The next three sections describe in greater detail the interstate relationships, the relationships between the state and its agents, and some of the tools available to induce the agents to co-operate. The discussion focuses on the situation prevailing in the Netherlands, but some remarks also apply to relationships in air transport outside the Dutch context.

41 A mega-carrier is defined in the explanatory memorandum to the KEPD (1993: 165) as an alliance between airlines that operate a world-wide hub-and-spoke system. The memorandum further states (ibid.: 15) that there cannot be a mega-carrier without a ‘mainport’ nor a ‘mainport’ without a mega-carrier.
3.3.1.5 - Interstate relations

Bilateralism allows for a policy aimed at the volume of traffic because it is possible to incorporate in a Bilateral provisions on such variables as capacity and time of operation. The actual implementation of this policy requires a system of slot allocation. Similarly, it is possible to pursue a policy aimed at the composition of the fleet through Bilateral clauses, which become part of domestic legislation. Measures that steer market behaviour are more problematic. Transacting states may try to promote other forms of transport, such as high speed trains, but this option is usually limited to transport between adjacent countries. Tax measures may be used but require protection against free riding. It was noted above that the Bilateral structure allows states to discriminate as they can freely select the countries with which Bilaterals will be concluded. However, the number of states with which the Netherlands do not have a Bilateral is negligible, so that this instrument only applies in the event of an amendment, such as negotiating an extra frequency. There is a more general problem with requirements imposed at the interstate level. Even if the governance structure permits imposition of certain requirements and the use of appropriate instruments, the domestic state must be able to get them accepted by the foreign state. The Bilateral features of state sovereignty and equality are important factors influencing that ability. With respect to its agents, however, the state has the power of coercion. The next two sections will focus on the state-industry relationships.

3.3.2 - Airlines

The state executes the rights exchanged through an airline (and an airport), though the airline is not a party to the Bilateral. In the Netherlands, as in most countries, the relationship between the state and airline in terms of the airline’s decision-making power is created by designation (Wassenbergh, 1993: 83-84). Designation turns the airline act into agent for the state.

Presently, a significant number of air carriers have their principal place of business on Dutch territory. Of these, KLM, Transavia Airlines, Martinair and Air Holland are the most important agents. Except for KLM, the carriers began their operations in the non-scheduled market but have, over the past few years, also offered scheduled services. The motivation behind this action is that the scheduled market offers greater certainty, especially by making possible a year-round rather than a seasonal operation. KLM holds the majority of shares in two of the

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42 In October 1999 the number of Bilaterals with the Netherlands as a party stood at approximately 135.
43 The airlines are not entitled to claim rights derived from the Bilateral. Havel (1997: 188, note 302) discusses an indirect claim: US carriers may contest actions by foreign governments via a domestic procedure and the DOT may take corrective action, such as suspending the operation of a route by another state’s designated carrier.
44 Air Holland has often had financial difficulties and at the end of 1999 suspended payments. In December 1999 it became known that Air Holland would again start operations with new shareholders.
three competing carriers\textsuperscript{45}. It also participates in other European and non-European carriers and has concluded a number of co-operation agreements\textsuperscript{46}. In this respect, KLM resembles many other air carriers. What is not so common is the relatively strong position that KLM holds in relation to its captive market. It is the 14th airline in the world in terms of passenger kilometres flown\textsuperscript{47}.

A carrier qualifies for designation on the basis of domestic rules. Generally, a carrier first has to obtain a licence. In addition, it can only apply for designation in the state where it is located and where the nationality requirement is met. In the Netherlands, the applicable procedure is laid down in the Air Transport Act of 1958, as amended. Note that the procedure distinguishes between Community and third country traffic. With respect to the latter category designation requires an explicit consideration\textsuperscript{48}. In addition, the designation regime depends on the carrier in question. KLM holds a so-called ‘open permit’, which means that it can fly any route without a specific reference in its permit (Ministry of Transport, 1994: 10). The permit of any other Dutch scheduled airline is route-specific, and every additional designation requires an amendment of that permit. KLM’s elaborate route network generally offers the greatest potential to contribute to the selective network goal. This means that if single designation is the outcome of a Bilateral negotiation and KLM has expressed an interest in operating a given service, an application for designation by the other Dutch carriers will usually be refused. In such a case, a carrier can appeal the decision via an administrative procedure. However, the limited chance of succeeding without damaging future relations with the state has meant that the procedure has only been used once\textsuperscript{49}. If KLM is not interested, applications from other carriers will be examined by the CAA as early as the contact phase. This examination takes place on the basis of business plans submitted by the carriers and CAA’s own information. Factors such as the opinion of the other state and rights that have recently been granted to a carrier are also important. There is no formal selection process or procedure but there might be an informal hearing in which applicants can present their plans.

Once an airline has been designated, it becomes the agent of the state. Whether the airline

\textsuperscript{45} Martinair 50\% and Transavia 80\%. KLM reached an understanding to obtain the remaining 50% of Martinair in 1998. However, after an investigation by the EC Commission into the effects of this agreement on competition, KLM decided not to proceed. It was expected that too many conditions would be attached to an approval of the agreement. The agreement was subsequently dissolved.

\textsuperscript{46} KLM has agreements with Northwest, Alitalia, KLM Cityhopper, Braathens, Regional, Martinair, Transavia, Kenya Airways, KLM UK and Eurowings. It has co-operation agreements with, among others, ALM, Maersk, Cyprus Airways, Tyrolean, KLM (Air) Excel and Ansett. In 1998 KLM and Alitalia signed an extensive co-operation agreement with far-reaching consequences.

\textsuperscript{47} Source: Airline Business, September 1999.

\textsuperscript{48} The question may arise whether such explicit consideration is consistent with EC legislation, given that Regulation 2408/92 in respect of Community carriers only allows for an operating licence and an air operator’s certificate. This question will be looked at in Sections 4.4 and 4.5.7.

\textsuperscript{49} This was a legal procedure started by Air Holland against the CAA concerning a Bilateral with Nepal (Reisrevue, 1998).
acts in the interest of the state depends on the extent to which the state’s goals overlap with those of the airline and, if there is no complete overlap, on the structure of the state-airline relationship. The following points are worth noting.

In the Dutch case, the state aims to build a selective network, while the airline aims at continuity (see Section 2.5). The airline’s continuity objective implies that the state’s interests as an important stakeholder are at least partly taken into account. Moreover, KLM is listed on the stock exchange and has to satisfy shareholders’ interests. This means that the airline’s objective overlaps with financial elements of the selective network goal. However, there is no full overlap between objectives. One problem faced by the state is that the selective network goal may embrace social aspects that conflict with the airline’s objective. These aspects may lead to requirements that restrict airline operations. Slot co-ordination and night restrictions at Schiphol airport are examples. The state therefore has to use additional tools to co-ordinate its relationship with the airline. These tools were identified for the general agency problem in Section 2.5 as the reward schedule facing the agent, various control mechanisms and interest harmonisation. They will be addressed in turn.

It is difficult to structure the airline’s reward schedule appropriately. The pay-off to the airline consists of additional income from the operation of designated services and its size is more or less independent of the airline’s contribution to the state’s goals. The designation process, for example, is not based in any significant way on information or expectations concerning the airline’s behaviour or output. Moreover, there is a strong preference for KLM. The airline’s load factors, which determine operating income, largely depend on the airline’s marketing activities and yield management.

The set of instruments used by the state to control the airline is in line with the areas targeted by the state in its attempt to build a selective network (see Section 3.3.1.4). One important requirement targets flight operations. There are, for instance, procedures for departing aircraft which determine the preferred flight path. They are known as ‘SIDs’ and are established by the Ministry of Transport on the basis of consultations between ATC, the carriers and an advisory commission on noise pollution (‘Commissie Geluidhinder Schiphol’). During a flight, the actual flight path, which is registered, must stay within a given tolerance zone determined by elements like load factors and weather conditions. Subject to the condition that flight safety takes top priority, deviations from the zone may be enforced through criminal law (the firm is prosecuted). There are also technical requirements on incoming and outgoing aircraft to ensure a safe and efficient flight operation. These requirements are part of the

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50 Designation does entail an indirect comparison of airlines. The realisation of a selective network is more likely with the KLM network and thus implies a preference for KLM.

51 An SID is a ‘Standard Instrument Departure’.
aircraft manual, ICAO annexes and JAR OPS\textsuperscript{52}. The airline is required to train its crew accordingly. In addition, aircraft are allocated to routes. Although there are no legal requirements prescribing the use of routes, Schiphol airport and ATC determine on the basis of an agreement the preferred order of runways to be used\textsuperscript{53}. Their ranking is established on the basis of safety, efficiency and environmental impact, whereby safety prevails in case of a conflict. A further area of attention targeted by the state is the composition of the fleet. The type of aircraft used is influenced directly via the required registration of the aircraft. Certain aircraft types will not be entered into the register. It is also influenced indirectly via airport charges and a number of requirements directed at Schiphol airport. There is a slight differentiation of airport charges across aircraft type, and some aircraft types may not be used at Schiphol airport at certain times. The composition of the fleet is also being addressed via the ‘Marshall plan’, whose development has become the responsibility of the Dutch airlines\textsuperscript{54}. The additional capacity at Schiphol airport flowing from the use of silent aircraft will, however, benefit all airlines. The area of market behaviour reveals further incentive problems. Although the PASO covenant\textsuperscript{55} and KEPD require the industry to promote a substitution of rail for air transport, so far any concrete actions have been limited for a lack of incentives. Exacerbating the situation is the difficulty of monitoring performance during the execution phase. The state’s monitoring abilities are impaired because the airline’s activities take place largely outside the territory of the state, which makes undesirable behaviour difficult to uncover. Any behaviour control is therefore limited to operations in the Netherlands. Output control is feasible to some extent because it is possible to analyse the tax and foreign exchange income. On the whole, however, the airline has ample opportunities to manipulate information. Designated carriers, for instance, are often able to conclude commercial agreements without revealing the contents to the state. Most importantly, none of the control mechanisms really motivate the airline to behave appropriately. The indirect instrument of designation provides only a limited incentive, given the strong preference for KLM\textsuperscript{56}. Any punishments (e.g. fines, revocation of permit) are either not severe enough or are not used in practice\textsuperscript{57}. This makes interest harmonisation an

\textsuperscript{52} The JAR OPS are rules established by the Joint Aviation Authorities (‘JAA’), a group of European Air Traffic Control Organisations that deals with operational issues. Infra, Section 4.4.

\textsuperscript{53} Agreement of 1997. The noise preferential runway use system is also part of the airport’s Operations Plan. Infra, Section 3.3.3.

\textsuperscript{54} Note that the Marshall plan has not led to any tangible measures and has informally been abandoned.

\textsuperscript{55} ‘Plan van aanpak Schiphol en omgeving’, a policy covenant between public and private parties. Parties to PASO were Schiphol airport, the Ministries of VROM and Economic Affairs, the CAA, the municipality of Haarlemmermeer and the province of North Holland. The 1989 PASO was signed by these parties plus the municipality of Amsterdam. The project organisation preparing the 1991 PASO comprised the above parties plus representatives of KLM and the Ministry of Home Affairs. The covenant formulates agreements between these parties to implement the state’s goals.

\textsuperscript{56} See also ‘Voorlopige Raad voor Verkeer en Waterstaat’ (1991: 49).

\textsuperscript{57} The airline rather than the pilot is charged with the criminal offence. At the airline level, this financial disincentive is not strong enough to influence behaviour.
important instrument in the state-airline relationship.

There are certainly opportunities to harmonise interests. In the first place, the airline depends on the state for market entry. A policy of single designation, in particular, creates certainty and induces the airline to co-operate. This applies specifically to the flag carrier. In the case of KLM, a large network makes the state attentive to KLM’s objectives when formulating air transport policy. KLM’s shareholding in two of the three other main Dutch carriers extends the argument beyond KLM. In addition, state-airline relations are long-term and close. In some cases the airline has been made financially dependent on the state. Over the years, the Dutch state has given KLM guarantees for the repayment of debt and has subscribed shares at times when market conditions would not support a private placement (KLM, 1987: 9, Dierikx, 1999: 149-150). It may seem that the airline uses some bonding in the form of adherence to global common standards (e.g. maintenance standards). However, these activities are not primarily aimed at the state but at foreign airlines who are potential buyers of maintenance services at foreign stations. A home carrier may provide maintenance services to other carriers. Generally speaking, the airline need not convince the state of its eligibility to operate air transport services because existing long-term relationships provide the state with ample information about the characteristics of the airline. Finally, common ownership has been identified as an instrument that can harmonise interests (also: Balfour, 1995: 29, Button et al., 1998: 66-68). The Dutch state has not exploited this option to any degree, although it held a maximum in KLM’s share capital for a long period of time. Currently, the state holds 14% of KLM’s shares and is represented on the supervisory board. Shareholding is not the main element determining the closeness of the bond between state and airline.

To sum up, the overlap between the state’s selective network goal and the airline’s continuity objective is sufficiently strong so that the airline tends to act in the financial interests of the state. There is less overlap between the airline’s objective and other aspects of the state’s air transport goal. The state has formulated various requirements to influence airline behaviour, such as restrictions on flight operations. However, the state lacks well-designed control mechanisms making it difficult to completely eliminate moral hazard. Moreover, traditional remedies for moral hazard are not effective. The reward schedule facing the airline is flawed and monitoring is seriously impaired. Enforcement mechanisms, such as the ability to withdraw permits or impose fines, are rarely used or not effective in motivating the airline. Nevertheless, state-airline relations are close and the level of interest harmonisation sufficiently high to induce the airline to co-operate with the state.

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58 KLM has always been a private entity. The state’s shareholding was also motivated by the nationality requirement (Dierikx, 1999: 28). To be able to respond to other states invoking the nationality requirement, the reduction in shareholding was combined with a procedure enabling the state to increase its interest to 50.1%
3.3.3 – Airports

The Dutch airport system comprises one national airport in addition to five regional airports and twelve smaller airfields. The airport’s facilities are necessary to execute the exchange of air transport rights. An airport is designated as an airport under national law. The airfield designation provides the airport with a right to serve and domestic law provides that aircraft can only land at an airport. At the same time citizens have a right to be served. Because the rights assigned to the airport reduce opportunities available to the public, the airport’s designation also provides that the airport must allow all traffic. The airport designation is usually the only formal relationship between the airport, on the one hand, and the state (or designated carriers), on the other. The Bilateral, more specifically the route scheme and frequency provisions, determines the use of the airport, but the airport is not a party to the agreement.

Airports are utilities, which are characterised by important economies of scale and scope. The assets of most utilities are highly specific and cannot be deployed elsewhere. Furthermore, utilities typically serve a substantial proportion of the national voting population. The first two characteristics imply that there are unlikely to be many providers of basic utility services. Widespread domestic consumption implies that the prices charged by utilities will always be a political issue. Huge quasi-rents make utilities very vulnerable to administrative expropriation, which can occur via the setting of prices below long-run average cost or via specific investment requirements. These factors help to explain the extensive regulation that is used to influence the airport’s behaviour. Moreover, unlike airlines, airports are relatively easy to monitor and control, making them a prime target for state regulation. However, while regulations do succeed in constraining airport behaviour, they fail to co-ordinate activities in the industry and can lead to inefficiencies (Gidwitz, 1980: 119). To give an example, the airport has to make substantial investments with long lead times. These investments might not be tailored to potential demand, as the airport may have insufficient information on the exact content of a Bilateral agreement or on the way in which the state influences the operation of the Bilateral. Another inefficiency arises from the obligatory provision of facilities for some governmental functions, like customs or border control. These facilities have to be provided free of charge, and their use is based more on budgetary and political objectives than on market


The national airport is Schiphol airport. The regional airports are Rotterdam, Maastricht, Groningen, Eindhoven and Twente.

The Bilateral can mention the airport, not as a separate party, but as a point of destination. An exception is the annex to the second Bermuda agreement (infra, p. 85), which led to a specific regulation on airport charges combining revenue from aviation and non-aviation activities in establishing airport charges (single till). The regulation is still applied in the United Kingdom (MMC, 1996), although the requirement to maintain a single till approach has been abolished (Starkie, 1999: 10).
considerations. Regulations used by the state often limit the flexibility that airports need to create an efficient operation.

As is true of airlines, Schiphol airport strives for continuity, which means that its objective is not fully consistent with the state’s air transport goal. Differences in objectives mean that alternative co-ordination tools are needed.

One such tool is the reward schedule. The schedule facing the airport shows a weak link between behaviour and pay-off. For instance, the state will almost always offer Schiphol as a destination in Bilateral negotiations as it is the only airport with ‘mainport’ status and the facilities needed to conduct elaborate transfer operations. A further tool is behaviour control, which has led the state to translate its selective network goal into a variety of behavioural requirements. In particular, the 1995 KEPD, apart from addressing financial aspects, lays down strict environmental conditions. They include requirements on emission levels allowed around the airport, a noise zone and a cap on passenger throughput annually by the year 2015. In 1996, the airfield designation of Schiphol airport was changed to include the noise zone and the passenger cap, thereby formally limiting the volume of passengers. A formal compliance system was introduced which imposed the obligation to produce an Operations Plan setting out the way in which the airport intended to conduct its operations within given the limits during the coming year. In the Operations Plan the airport was to specify the maximum number of aircraft movements per year, the preferred order of runways to be used, as well as measures that would be taken if the noise zone were to be breached. The airport was to be held accountable if established limits were exceeded. However, it did not have any instruments at its disposal to control the number of aircraft movements. This compliance problem led to the imposition in 1997 of slot co-ordination as an instrument to control the airport’s behaviour. Slot allocation has been in effect since April 199861 and the regulation requires that, twice a year, Schiphol airport gives a capacity declaration to the slot co-ordinator on the basis of the Operations Plan. The slot co-ordinator, which is an independent party, translates this capacity into slots, taking into account the volume of traffic and spread of flights through the day. Available slots are matched with the demand for slots at slot conferences organised by IATA62 on the basis of a procedure derived from IATA and EC rules. The use of the airport is subject to a monthly check of aircraft movements by a CAA department and the airport itself63. A ministerial order issued in July 1999 introduced additional monitoring and information requirements on aircraft movements in connection with safety64. Although slot co-ordination helps to control airport behaviour, it also limits the airport’s ability to make efficient use of its

62 Infra, p. 71.
63 Required on the basis of Article 25h of the Air Transport Act.
facilities. In general, landing and take-off slots are allocated according to a set of administrative principles. The principles underlying traditional (IATA) slot allocation are simple: fundamental is the concept of grandfather rights, which lays down that an airline using a slot in one traffic season is entitled to its use in the same traffic season the following year. Secondary criteria include such factors as aircraft size, curfews at other airports and the need for a mix of services. The EC Regulation that was needed because of the potential anti-competitive effect of the IATA rules, improves these rules by, for example, allowing new entrants to take up under-used slots or new slots via a 'use it or lose it' rule. However, it fails to allocate scarce capacity where it is valued most as slot transfer is prohibited (Button et al., 1998: 83-86). Moreover, the airport has no say in the allocation of slots and holds no property rights to them.

In 1998, the set of instruments was expanded by the introduction of a new regulation that the airport had to close a runway preventively (i.e. before breaching the noise zone) if it was in danger of exceeding official limits.

The discussion illustrates that, notwithstanding the extensive use of behaviour control and elaborate monitoring, the state-airport relationship is not well-designed. The airport's contribution to one element of the selective network goal could harm other elements, which in turn might reduce the airport's pay-off. The airport's pay-off may decrease as a result of its obligation to close a runway preventively, or because the Minister of Transport closes a runway in the event that the airport fails to act. The KE PD provisions may also give rise to conflict: strict environmental regulation could deter new business and so endanger financial opportunities. Neither the principles underlying the KE PD restrictions nor the relationship between these regulations and market developments have been completely worked out and growth trends in the air transport industry have generally been disregarded. Moreover, some critics believe that the number of passengers flown is not the right criterion for measuring noise pollution and that the focus should be on aircraft type, time of operation and load factors. In addition, existing instruments have not succeeded in confining airport operations to established limits and the state has been required to tolerate various noise overruns. In 1998, following an evaluation of the KE PD, a cap on the volume of aircraft movements was introduced as a new requirement. In the same year the government decided to allow an annual increase in aircraft

65 Infra, Section 4.4.
66 Although United States legislation denies the existence of any right of ownership in a slot itself, and the FAA may grant and withdraw slots, a transfer of allocated domestic slots is allowed at a few airports in the United States (Borenstein, 1997: 531). International slots cannot be transferred. Transfer is also prohibited under the Community structure. The ability to transfer slots does not seem to have affected congestion delays. (See also Haanappel, 1994: 201-202, Havel, 1997: 100, 212, Morrison and Winston, 1997: 494, note 32).
67 See, for example, Van der Vlist (1998). The criticisms have been taken into account in the integrated policy views ("Integrale Beleidsvisie", or 'IBV') on the future of air transport in the Netherlands. See also the coalition agreement and Dutch Cabinet Decisions of 18 December 1998 and 17 December 1999 (Ministry of Transport, 1998c, Ministry of Transport, 1999b).
movements of 20,000, simultaneously requiring a decrease in the number of houses affected by aircraft noise, until the year 2003 (letter from Cabinet to Parliament of 6 March 1998), in preparation of the new fifth runway. At the same time it was decided to revise methods of computation, zoning and enforcing compliance with environmental policy, taking into account environmental, physical and other restrictions and thus achieve a better use of existing infrastructure. The measures developed to achieve this aim are part of the Optimisation strategy. The new system is scheduled to apply as of 2003. In the meantime the current system will continue to apply with slight adjustments, such as the annual growth in aircraft movements.

These adjustments do not eliminate the compliance problems confronting the airport. It still has to accept all traffic, which makes it dependent on airline operations. If the airport complies with the requirements imposed by the state, the state may be in breach of its obligations under existing Bilaterals. This might happen if the airport is closed because it has violated the noise zone. Another state might invoke its Bilateral rights, claiming that the Bilateral implies a right to transport and that this right has been unduly harmed. Such a claim has been made with success by some United States carriers as a threat to obtain slots. One case is US Airways, which requested access to Schiphol airport for daily flights from Philadelphia in January 1999. Initial access was denied due to a lack of slots at Schiphol. US Airways then considered asking the United States government not to renew the anti-trust immunity enjoyed by the alliance between KLM and Northwest Airlines. Eventually slots were made available. The compliance mechanism facing the airport relies heavily on formal sources of compliance, and legal enforcement is frequently used by environmentalists as well as by the state.

In the early years of air transport, the state and airport had largely overlapping interests. For the Netherlands, where there was only one national airport, where the state’s aim was to acquire transport rights to support the network, and where there were no infrastructural or environmental capacity constraints, opportunities to harmonise interests were substantial and reinforced through ownership relations. Schiphol airport was part of the local governmental organisation, namely the municipality of Amsterdam. When it was turned into a limited liability company in 1957, its shares continued to be fully owned by public authorities and the supervisory board was strongly influenced by the state. Schiphol airport in turn took shares in three of the other significant Dutch civil airports. In the past, the airport usually refrained from actively participating in marketing opportunities and for a long time accepted a

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68 See, for example, Staatscourant 22-10-98 (202) 'KLM en “Open Skies”’, p. 3.
70 The state put 5 directors on the supervisory board, representing the national government (2 directors), and the municipalities of Amsterdam (2) and Rotterdam (1).
71 Rotterdam Airport, N.V. Luchthaven Lelystad and N.V. Eindhoven Airport. The latter is a military airport with civil co-use.
facilitating role as an infrastructure provider. This included an administrative rather than market-based mechanism for allocating capacity. Even if the market indicated that services by new or expanding carriers were the most efficient (as shown by the price that carriers would be willing to pay for using airport capacity), there were only limited ways of gaining access. Consequently, the airport did not strive for any active involvement in Bilateral negotiations.

An overlap of interests also characterised the airport’s relationship with the home carriers. These relationships were not formalised. There were agreements for the rental of office space, but they did not include a specific airline-airport element. In the United States, many airlines owned and operated airport terminals and contracts between airlines and airports covering the use of facilities and timing of investments were common practice (Air Transport Association, 1998). In the Netherlands and in Europe generally, no such formal relations existed. In the Netherlands there was a fiction, based on private law, that an agreement was created as soon as an aircraft landed on the premises of the airport. Payment for airside facilities (such as aircraft, handling and fuel charges) was derived from this agreement. Formally the airport did not differentiate between foreign and domestic airlines, as this was prohibited under the Chicago Convention. However, loyalty and a strong mutual dependence between the home carriers and the airport created special ties between these parties. The home carriers were the primary users of the airport’s facilities and this sometimes led to substantial transaction-specific investments. Sometimes special arrangements existed, such as preferential use agreements and charging policies. The specific investments, along with the nationality requirement and dependence on the state for market access, forced airlines to maintain their home base at the airport and forged a long-lasting bond with the home airport.

Changing market conditions, such as liberalisation and high air traffic growth rates, have influenced the airport’s position in the air transport system. Liberalisation has intensified competition between airlines, which among other things has increased the importance of transport networks. The ability to realise economies via a network type of operation has made ‘hub-and-spoke systems’ a central feature in the market. Not only airlines but passengers, too, may benefit from greater flight frequency, easier connections and more non-stop flights. The airport plays an essential role in developing and maintaining such networks, if it can meet the demand for capacity and punctuality. The greater traffic volume and long lead time of investments have further increased the importance of those airports endowed with an abundance of space in the air as well as on the ground. Liberalisation has also increased the

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72 Article 15 Chicago Convention. These arrangements may further be in conflict with EC competition law. Infra, Chapter IV.
73 These transport systems use a central airport (a ‘hub’) to consolidate traffic flows from surrounding airports into one traffic flow to another hub. They have a long history in Europe due to a concentration of the flag carrier at a domestic home base but have not been operated as true hub-and-spoke systems until recently (Button et al., 1998: 21).
airport’s marketing opportunities. Concurrent with these developments, some countries are experiencing a shift in attitudes towards recognising the importance of the environment. A growing perception that air transport harms the environment has gradually meant a more critical stance towards air transport (OECD, 1997: 98). The industry, however, has no incentive to incorporate environmental damage into its own cost calculations. This has ushered in new airport regulations. Collectively these factors are increasing the extent of interest divergence and hence the risk of conflict between the airport and state. Opportunism, in the form of inadequate reporting or insufficient investment, has become a real issue. At the same time new requirements, introduced by the Optimisation strategy, have intensified relationships and increased the interdependence between the airport and the state.\textsuperscript{74}

In conclusion, the state relies on a growing body of legislation to specify the airport’s rights. It carefully monitors airport behaviour but, rather than alleviating certain agency problems, behaviour control seriously restricts the airport’s freedom of operation and may encourage opportunism. In Bilateralism, any agency problems in state-airport relations may still be limited because of a substantial overlap in interests. This may not last, however, as current developments, such as infrastructural capacity constraints and environmental concerns are reducing the extent of interest harmonisation.

3.3.4 - International organisations

For a complete picture, something must be said about the international organisations which from the beginning have played an important role in Bilateralism. These are ICAO, ECAC and IATA.\textsuperscript{75} None of these organisations has formal regulatory powers, which would of course not be consistent with the fundamental sovereignty of states. ICAO does have some regulatory powers in technical matters.

ICAO is a specialised agency of the United Nations. Its purpose is to ensure the safe and orderly growth of international civil air transport, to encourage the development of airways, airports and navigation facilities, to prevent economic waste caused by unfair competition and to ensure that the rights of contracting states are fully respected and that every contracting state has a fair opportunity to operate international airlines.\textsuperscript{76} ICAO’s powers are primarily in

\textsuperscript{74} Schiphol airport, the home carriers and ATC have started a project called ‘Project Optimisatie Schiphol’. The project studies the scope for improvements in the current system, which are to enter into force in 2003, as well as the ability to accommodate the yearly growth in aircraft movements until 2003.

\textsuperscript{75} ‘ICAO’: International Civil Aviation Organization, established by the Chicago Convention on 4 April 1947. ‘ECAC’: European Civil Aviation Conference, established by ICAO recommendation in November 1955 and ‘IATA’: International Air Transport Association, established on 18 December 1945 as a continuation of the International Traffic Association, formed in 1919. One other very important organisation, namely the European Community, will be dealt with in Chapter IV.

\textsuperscript{76} Article 44 Chicago Convention.
the technical field, although it can issue advice on economic matters and is also a party to environmental discussions, for instance on the phasing out of noisy aircraft or global restrictions on emissions. It tries to harmonise rules and procedures through standardisation (‘Standards’ and ‘Recommended Practices’). After reaching general agreement, ICAO submits a new rule or procedure to the member states. It will be applicable three months later, without separate ratification, unless at that time a majority of the member states have informed the council of their dissent. Apart from harmonisation, ICAO’s most important function is offering a forum for discussion and guaranteeing a common interpretation of the provisions of the Chicago Convention. Some Bilaterals give the ICAO council a role as an arbitrator in the resolution of disputes. However, because of the problems surrounding arbitration between states and the fact that ICAO is made up of representatives of member states, which essentially makes it a political organ (Dempsey, 1987: 300-302), this role is seldom invoked.

ECAC is a European organisation of air traffic authorities that was established following discussions on co-operation in air transport matters in the Council of Europe (Bin Cheng, 1962: 56-57, Havel, 1997: 124). ECAC was established in November 1955 by an ICAO recommendation of 19 Western European states. The organisation deals with the development of European civil air transport through co-ordination and co-operation. ECAC issues resolutions and policy statements, which may be incorporated into the domestic legislation of each member state. It can further act as a forum for discussions with other states. An example of this function is the negotiations with the United States on the subject of non-scheduled air transport over the Atlantic, which resulted in a multilateral agreement in 1975. ECAC is an inter-governmental organisation. It enables states to act as one forum, yet binds a state only to those negotiation resolutions and results that have been explicitly accepted through a separate domestic approval process. At best, agreement in ECAC gives rise to a political or moral commitment to start such a process. This makes it an expensive and time-consuming form of co-operation.

IATA (Chuang, 1972, Brancker, 1977, Havel, 1997: 119-123) is a world-wide non-governmental organisation of airlines. Strictly speaking, it is a private organisation, but it is very much influenced by state interests, partly because of government control and interference in air transport (e.g. ownership of airlines). In a sense, IATA fills the gap left by the states after the second world war regarding the creation of a multilateral regime to exchange traffic and transport rights. The purpose of IATA is to promote the safe, regular and efficient use of air transport and the investigation of related issues. From the moment its tariff-setting procedures were accepted in the Bermuda I Bilateral, the organisation has had an enormous influence.

77 The plans of Sforza, Van de Kieft and Bonnefous. 78 The EC seems to have reduced the role of ECAC, because of restrictions on the powers of member states. See, however, infra, p. 118.
Apart from tariffs, conditions of traffic are negotiated at the conferences. These are primarily aimed at facilitating interlining. IATA operates the ‘Clearing House’, a central facility used by airlines to clear payments for the common use of tickets, interlining and other services. The Clearing House obviates the need for bipartite agreements between carriers, which would be very difficult and time-consuming because airline services are often not comparable, while cost structures vary. IATA also facilitates slot co-ordination.

IATA helps airlines create a coherent, global structure of interlinked tariffs and conditions as well as uniform standards and procedures in such areas as ground handling and conditions of carriage. This reduces uncertainty and stimulates the development of air transport. A disadvantage is IATA’s rigid structure and the consequent stiffening effect on the industry. Prior to 1978, the rules made it impossible to experiment with tariffs or service levels, despite a demand for such flexibility due to a growing acceptance of air transport, coupled with the marginal results of the industry. This gap on the demand side was partly filled by charter carriers. Another development was liberalisation, which led to a more flexible bilateral tariff regime and thus a diminishing need for IATA’s facilitating role. These developments pressured IATA into eliminating some rules and processes, while maintaining trade organisation activities, such as the facilitation of slot co-ordination. Despite a reduction in formal powers, IATA continues to be influential.

Finally, there are several types of non-governmental institutions that exert influence. These include trade associations and lobbying organisations (for example, the airport organisation ‘Airports Council International’ or ‘ACI’) that monitor government legislation and other relevant issues. Through persuasion of parliament, legislative aides and other persons considered influential, they try to obtain the best possible operating conditions for their member corporations. General and air transport media also exercise some influence. News reports can stimulate public interest in legislative inquiries into various air transport practices, while editorials and other forms of advocacy journalism may promote regulatory changes.

3.4 - The object of the exchange and property rights

Section 3.2 explained that states hold the property rights to the airspace. The market is closed and access is given through a bilateral exchange of air transport rights. In these exchanges, the conditions of access are also regulated. At first sight, it might seem odd to regard the air as ‘property’. It does not seem possible to create, hold or enforce property rights with respect to airspace. A more careful look, however, shows that it is possible to create excludability and

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79 Agreements authorising carriers to sell each other’s services.
80 A further factor was the anti-competitive nature of some procedures. In 1978, IATA had to prove why its procedures should continue to have immunity from US anti-trust laws.
81 Recall from Section 2.2 that property rights capture the right to use an asset, to capture benefits from the asset, to alter the asset and to transfer all or some of these rights.
prevent people from using airspace. Foreign aircraft, for example, can effectively be banned from the air. Furthermore, the use of airspace can be measured by dividing airspace into individual units, using registrations by Air Traffic Control authorities. Thus, the state may use the airspace, capture the benefits from this use, alter the rights to use airspace and transfer these rights to other states. The property rights to use the airspace and capture the resulting benefits are divided into eight different (freedom) rights: two traffic rights and six transport rights. Following Bin Cheng (1962: 9-16), the following rights can be identified:

1. the right to fly and carry traffic non-stop over the territory of the grantor state,
2. the right to fly and carry traffic over the territory of the grantor state and to make one or more stops for non-traffic purposes,
3. the right to fly into the territory of the grantor state and there discharge traffic coming from the flag state of the carrier,
4. the right to fly into the territory of the grantor state and there take on traffic destined for the flag state of the carrier,
5. the right to fly into the territory of the grantor state for the purpose of taking on, or discharging, traffic destined for, or coming from, third states,
6. the right to fly into the territory of the grantor state and there discharge, or take on, traffic ostensibly coming from, or destined for, the flag state of the carrier, which the carrier has either brought to the flag state from a third state on a different service or is carrying from the flag state to a third state on a different service,
7. the right of a carrier, operating entirely outside the territory of the flag state, to fly into the territory of the grantor state and there discharge, or take on, traffic coming from, or destined for, a third state or third states and
8. the right to carry traffic from one point in the territory of a state to another point in the same state (also known as ‘cabotage’).

The first five rights are part of the Air Transport Agreement, yet are explicitly included in every Bilateral, reflecting the wish on the part of states to strictly regulate access to their airspace. The first two rights, i.e. the traffic rights, are essential to the right to transport, but usually no compensation is involved in their exchange. An exception is made by Russia for routes over Russian territory. Russia is not a party to the Air Services Transit Agreement and takes the position that the right of overflight takes away income that would be obtained in the event of a landing so that a payment is in order. The right of overflight has to be specifically arranged with the Russians and payments are made because of the tremendous financial

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82 Some authors, including Mendes de Leon (1992, annex), distinguish nine freedoms. In this categorisation, the eighth freedom is the same as the seventh but is combined with a third or fourth freedom right.
83 In this listing, the carrier’s state of origin is called ‘flag state’, referring to the fact that the carrier’s aircraft
consequences of having to bypass the Russian airspace.

The third, fourth and fifth freedom rights form the core of a traditional Bilateral. The sixth and seventh freedom rights are developed in practice and, not being formally laid down, are referred to as ‘so-called freedoms’. The eighth freedom right, namely cabotage, is laid down in the Chicago Convention, but granting it can be problematic. The Chicago Convention formulates the principle that a state is not allowed to offer cabotage on an exclusive basis. Some interpret these words as containing a most-favoured-nation clause, with states fearing that, once they grant it, they will be forced to allow domestic transport by an airline from a state with whom they want only limited contact. Others believe that a de facto exclusivity is allowed, but that a refusal cannot be upheld by exclusivity (among others: Fennes, 1997: 74).

Uncertainty surrounding cabotage has meant that this right is not frequently granted.

The Chicago Convention grants its member states separate rights according to the origin or destination of traffic instead of a single right to take on and discharge international traffic, which motivates the concept of the ownership of traffic (among others: Mendes de Leon, 1992: 101). Traffic potential is thus seen as an ‘estate’, a notion which is also present in the ‘Ferreira doctrine’. Wassenbergh (1957: 104) ties the concept to a state’s responsibility for the welfare of its economy and consequent requirement to make optimum use of its economic resources. The rights to traffic potential constitute a central feature of the Bermuda I Bilaterals, which grant the right to transport originating from a state primarily to carriers from that state. Traffic potential also forms the basis for establishing capacity in Bilateral negotiations. This limits the efficient development of air transport because it implies that the state with the smallest third freedom potential acts as a ceiling on the total amount of traffic allowed. Although some leeway can be created by a liberal interpretation of the fair and equal opportunity requirement or by exploiting fifth freedom rights, these options are risky. To give an example, no state accepts the magnitude of fifth freedom rights outweighing the amount of third freedom traffic. If the amount of fifth freedom traffic becomes too large, the state of embarkment or of final destination may refuse further traffic because its own third and fourth freedom traffic suffers (see, for example, De Murias, 1989: 120, Havel, 1997: 186-187).

bear the flag of that country. The ‘grantor state’ is the trading partner, i.e. the state allowing the transport.

84 The payments are part of a commercial arrangement between foreign carriers and the Russian carrier Aeroflot. The imposition, their size and different treatment given to European, Asian and US carriers have led the EC member states to take the matter to an international level. It was discussed during an ECAC meeting in Paris in March 1999. The issue is also part of the (technical) ICAO discussion on ATC (air traffic control) capacity. In addition, the Association of European Airlines (‘AEA’) has suggested creating a specific fund for these payments, which could be linked to the TACIS programme (‘Technical Assistance for the Commonwealth of Independent States’), a technical assistance programme run by the EC, to help Russia move towards a market economy and a democratic society. So far every effort to reach a solution has failed.

85 The SAS consortium is an exception because it involves the granting of cabotage rights to each of the participating states. The rights are not exclusive, but will cease to be in effect if and when a third state claims cabotage.

86 See Article 44 (f) Chicago Convention.
These limits became increasingly apparent when technological innovations enabled states to attract traffic not originating from, or destined for, their own territory. This opportunity was of great value to the Netherlands, especially, given its limited potential of originating and destination traffic. Routes (links) were created by combining third and fourth freedom segments. Here too, it would have been possible to classify the traffic as fifth freedom traffic, but the previous discussion suggests that this option was risky. Pool agreements were also insufficient and new concepts were created. The first was the ‘sixth freedom’. This was - according to the states that benefitted from it - no more than a combination of third and fourth freedom rights, to which they were already entitled (ICAO, 1994: 14, Dierikx, 1999: 149-156). Through this interpretation, the transport became ‘primary’. While such reasoning is accepted in practice, it may lead to problems when there is a need to increase the capacity allowed under a Bilateral. Again, the state of origin or destination could refuse an increase or tie approval to a monetary payment, because of the effect of sixth freedom traffic on its own traffic potential. This sum can vary from a reasonable sum to ‘a dollar for a dollar’. Sixth freedom rights are not formally recognised in Bilaterals, although several Memoranda make implicit reference to them, especially when dealing with capacity issues (Doganis, 1991: 347). Another concept developed in practice is the ‘seventh freedom’, which is a combination of third and fourth freedom rights outside the flag state. The eighth freedom right is cabotage. The seventh and eighth freedom rights are always explicitly mentioned in Bilateral agreements but seldom granted. With the maturing of the air transport industry, accessory provisions, i.e. soft rights, have gained importance. Initially, these rights were not part of Bilateral agreements, which generated uncertainty about their future exploitation. As the financial importance of soft rights has grown, so has the call for greater certainty. Some efforts have now been made to include soft rights in Bilaterals (Fennes, 1997: 383-384). Three soft rights, namely ground handling, line maintenance and the use of computerised reservation systems, have been included in the 1993 General Agreement on the Trade of Services (‘GATS’).

Until they were defined, the freedom rights and soft rights rested in the public domain. They were created only when expected benefits exceeded the costs of defining, negotiating and executing the rights (Barzel, 1989: 64-65). The expected benefits have increased through both technological developments and changes in travel habits. Technological developments, for instance, have helped to exploit traffic potential by linking route parts, thus creating the opportunity to realise scale-related economies (see Section 5.2.2). Technological factors have

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87 Dierikx (ibid.: 154-156) describes the complex air transport relations between the Netherlands and the US in early years. The main problem was KLM’s sixth freedom operations, which compromised the principle of reciprocal exchange. The states concluded their first Bilateral in 1957.

88 Final act of the MTN/UR of 15 December 1993 MTN/FA II-A1B (UR-93-0246). Negotiations covering air transport services took place during the Uruguay round and focused on traffic rights. It was, however, not possible to come to an agreement on the governance of these rights.
also reduced the cost of supervising the exercise of freedom rights, further motivating an explicit formulation of these rights. On the demand side, there has been a stronger need to differentiate services. An additional reason for an explicit formulation is the fact that Bilateralism is based on specific approvals.

The object of the exchange has now been defined. The next section takes a closer look at the transaction process. The description follows Noteboom (see Section 2.3) and addresses in turn the contact phase, contract phase and execution phase. Part of the execution phase, namely compliance and enforcement, will be dealt with separately as the sovereign nature of states has implications for these issues.

3.5 - The transaction process

3.5.1 - Contact phase

Any transaction presupposes a need. In air transport, this need is often voiced by the airline, which usually has a good feel for new opportunities. In the Netherlands, the transaction might be initiated as follows. On the basis of a request by an airline, the CAA might decide to initiate a preparatory meeting of representatives of KLM and possibly other carriers, Schiphol airport and the Ministry of Foreign Affairs. The purpose of the meeting is to identify the parties’ objectives via the exchange of information. The Ministry of Foreign Affairs provides information on any factors that could influence the transaction. These include the political or economic situation in the country with which the transaction is to be concluded, the existence of other Bilaterals and conditions in the air transport industry (e.g. market potential, capacity effects, presence of other carriers, competition). The ministry is in a good position to provide information because its representatives are stationed in the country concerned. These information gathering and processing activities are continuous, if only because air transport relationships are one element of the permanent relationships between states. Industry players also provide information. The airport might provide information supporting a preference for a particular airline or time of operation. The airlines will often share their private information in order to maximise the chance of a successful negotiation outcome. They will also support their demands with business plans or other means. The actual exchange of information starts at the initial domestic positioning. At first, it might not be clear whether KLM is interested in operating the rights and hence whether other carriers are eligible to submit their business plans, but this will become clear at an early stage. Frequently, contacts between carriers from the two states have by this stage already led to a tentative commercial accord. Additional sources of information include internal research material and data from manufacturing companies, while
organisations such as ICAO, IATA and the World Travel and Tourism Council also provide material. Thus, some information may already be available, particularly if the states maintain close relations or have negotiated Bilateral agreements before.

There will be an attempt to calculate the value of the transaction, although bounded rationality makes this difficult. The Bermuda I Bilaterals base the value of the transaction directly on the anticipated potential of third and fourth freedom traffic but, depending on domestic air transport policy, other factors will also be included in the calculation. For example, in the case of the Dutch state, the contribution to the selective network is the correct measure, which implies that environmental factors should be included. This means that assumptions about the use of equipment or, more generally, about the state’s attitude towards environmental issues need to be made. In determining the value of the transaction, the foreign state’s environmental views of and, if negotiations also cover fifth freedom traffic, the position of third states need to be taken into account. After one or more meetings, an internal position might be established. This usually covers the full range of acceptable negotiation outcomes as well as the choice of an airline. The position is not put into writing because the CAA wants to retain flexibility in its negotiations with the other state.

Having established an internal position, the state forms a delegation. The delegation is made up of airline representatives, the Ministry of Foreign Affairs and the CAA and is led by the CAA. The airport seldom participates. The participation of the airline is not formalised but is based on custom, its status as one of the main beneficiaries of the rights to be acquired, as well as its ability to provide valuable information. Negotiations are initiated following one of two main approaches. The state wishing to initiate negotiations may approach the appropriate agency of the other state. In other instances, negotiations may be opened (or renewed) according to provisions of an existing Bilateral, such as a provision requiring a periodic review.

3.5.2 - Contract phase

Despite an initial need for a transaction, it may not come to a negotiation. The state will weigh the chance of succeeding and any potential benefits against the costs of creating or amending a Bilateral. These costs derive from gathering, providing and processing information, negotiating, drafting and so on. There are also costs associated with attempts to influence preferences and secure a position favourable to lowering ex post transaction costs, such as the costs of organising a system through which compliance can be checked (Bokkes, 1989: 44-46). If the expected benefits outweigh the costs, the state will initiate negotiations. These negotiations differ from negotiations between businessmen. They do not follow strict formal

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90 This depends on the services requested (scheduled or chartered) and designation policy (dual or single).
91 One exception is the participation of the Commercial Director of Schiphol airport in the negotiation of the 1992 Open Skies Bilateral with the United States.
rules but take place through consultation, which is essentially a diplomatic process based on credit, confidence, consideration and compromise. There is no time frame and an agreement need not be reached in a single negotiation round: states can stop and restart negotiations as they see fit (ICAO, 1994: §2.1).

The unlimited duration of Bilateral agreements, and the need to preserve state relationships more generally, make it very important that states reach an agreement that is favourable with regard to the substance as well as process of the transaction. The agreement will, of course, never be complete and unequivocal and parties will anticipate this fact. They will view it as both a problem and an opportunity. Neither party knows whether an exchange will turn out advantageous, nor how the costs and benefits will be allocated. Much depends on any contingencies and the states’ response to these contingencies. But incompleteness and equivocality also open up possibilities to interpret the agreement opportunistically. Each party will try to negotiate a position that gives it the greatest potential to exploit such possibilities. As the actual implications of an agreement will only unfold after the close of negotiations, each party’s say in decisions to be made during the execution phase is crucial. The ‘trick’ is to get competence without countervailing responsibility. A party will thus try to get as much clarity as possible regarding its own competence and the other party’s responsibilities, while inclining towards vagueness about its own responsibilities and the other party’s competence. At first sight, this reasoning does not seem to apply to interstate relations in Bilateralism, because of such factors as explicit approvals and the reciprocity requirement. There seems to be little room for leaving issues unaddressed or creating unequal outcomes. However, Bilateralism is also based relational contracting and diplomacy so that the agreement will not detail every contingency. Furthermore, the states will always choose to leave certain matters unaddressed, because the costs of negotiating and drafting agreements and the costs associated with potential inflexibilities deter complete contracting (Lyons, 1998: 302). As an example, Bilateral agreements do not cover sixth freedom services, although states increasingly include soft rights. The states will weigh the risk associated with leaving matters unspecified against the risk of not reaching agreement. In their decisions, the extent to which states trust their respective trading partners plays a role.

In some situations a party will be confident that, whatever the formal agreement may be, it is assured of the lion’s share of decision-making power. It may, for instance, have access to superior information during the execution phase. Under these circumstances, the party may try to minimise its formal competence in exchange for less responsibility (Noorderhaven, 1997: 121-122). This seems to apply to the relationship between the state and airline. The airline’s say in the decision-making process is secured essentially through its information advantage. By creating a position where its formal competence is limited (as is the case under designation),
favourable events can be exploited and unfavourable events passed on to the state.

In air service negotiations, the Netherlands are almost always the requesting party, due to the strong position of KLM (relative to its captive market) and a relatively small potential of third and fourth freedom capacity on the Netherlands’ side. The country’s small traffic potential makes it difficult to meet the requirement of a fair and equal opportunity but has also made Dutch negotiators very creative. To compensate for the lack of air transport reciprocity, they have at times resorted to threats on non-air transport issues. For example, the Netherlands have threatened to withhold contributions to NATO until the United States granted specific concessions to KLM, and support for Israel in negotiations with the European Community unless Israel granted KLM additional frequencies on the Amsterdam-Tel Aviv route. Such a negotiation tool is known as a ‘non-aviation quid pro quo’. While seldom acknowledged publicly, any quid pro quo is formalised in the Memorandum. Examples given by Gidwitz (1980: 148) and De Murias (1989: 120) illustrate that this method is certainly not exclusively Dutch.

After one or more negotiation rounds, which might take as long as several years, the negotiators might reach agreement. Depending on the status of the agreement (i.e. a Memorandum, a new Bilateral or an amendment to an existing Bilateral), it will be implemented in accordance with domestic rules. Once agreement is reached, the state will designate an airline.

3.5.3 - Execution phase
The Bilateral will enter into force on the date specified in the agreement, again subject to domestic rules. These rules can differ substantially between states. In the Netherlands, for example, Bilaterals are formal treaties that have to be approved by parliament. In the United States, a Bilateral is an ‘executive agreement’ that can be entered into by the president without the advice and consent of the US Senate (Havel, 1997: 40). It should be mentioned that in foreign affairs - especially when concluding treaties - parliamentary influence is often limited (Klabbers, 1996: 132). In the Netherlands, the approval procedure for treaties on air transport is neither difficult nor time-consuming. The ease of approval can partly be attributed to secrecy. Although the ratification process does provide some information, on the whole, there is a lack of publicly available material. Parliament is therefore unable to formulate an opinion or take a position.

The Dutch model Air Services Agreement provides that the agreement will apply provisio-

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91 For instance, the suspension of a service.
92 Negotiations may in fact be permanent, with states meeting each other on air transport issues at regular intervals. Examples are the Bilateral negotiations with South Korea, as well as Japan. Separate negotiation rounds may only lead to piecemeal results. The Dutch state has, for instance, spent over 20 years trying to increase its rights on the route to Tokyo. By contrast, when Nagoya airport was opened, reaching agreement took only one negotiation round.
93 Supra, p. 49.
nally from the thirtieth day after signature and formally after domestic requirements have been met. Most states, including the Netherlands, agree that, pending the outcome of the constitutional process and depending on that outcome, the designated carriers are allowed to start operations on the basis of a permit. At the same time, entry into force of the agreement does not mean that every right will be used immediately (Rekenkamer, 1998: 53) nor that state involvement stops. The state remains involved to protect the interests of its carrier (Dempsey, 1987: 168, Havel, 1997: 157). Often, the total frequency allowed is not fully exploited, or only one of the carriers operates the rights, sometimes on the basis of a pool agreement. In all cases the rights exchanged can only be used after designation by each flag state. The grantor state has to accept every designation and issue an operational permit to the foreign carrier. The ECAC Standard Clauses (see Section 3.2) consider this acceptance and the issue of a permit an obligation, provided that the nationality requirement is met and the carrier can be expected to adhere to the rules of the grantor state. Although authorisation can be seen as an implicit consequence of the exchange of rights, it is not automatic. Fennes (1997: 121-123) describes a conflict between the Netherlands and Israel in which the Netherlands wanted to use a wet-leased aircraft94 from Southern Air Transport, an American cargo carrier. Israel refused to issue a permit on the grounds of the nationality requirement. Some states further require that, when a permit is issued, a statement should be made regarding the welfare effects of the transport. In discussing the United States’ practice, Havel (1997: 164 note 191) lists some criteria used by the DOT, namely any implications for market structure, fare and service proposals and the effect on competition in the domestic industry. Furthermore, the DOT has at times linked the determination of the statutory public interest issues to the conclusion of an Open Skies agreement between the United States and the foreign carrier’s home state95. Bin Cheng (1962: 360-364) observes that this situation might even result in a reopening of negotiations, but many authors (for instance, Dempsey, 1987: 123, Havel, 1997: 166) consider this unlikely to happen.

Before starting a new service, the airline will have to incur costs. These are partly incurred in the destination country and consist of surveying local conditions, including relevant legislation, organising housing and ground handling, acquiring slots and adjusting timetables. Additional costs may arise from co-operative arrangements. The largest component of these investments consists of arranging aircraft capacity. The airline has to free aircraft previously used on other routes, lease aircraft or even acquire new aircraft. Like the costs incurred during the contract phase, these costs are partly sunk. The operation of the rights exchanged means additional income for the designated airline in the form of operating revenues minus tax. The airport will also experience an additional use of its premises. The increase in its pay-off is

94 ‘Wet lease’ is the leasing of an aircraft including crew.
95 This strategy is not exclusively American, infra Section 5.2.2.
composed of aircraft charges, handling and fuel charges, property income and revenues from duty-free shopping.

The pay-off to the state is the contribution to the selective network of services to, from and via the Netherlands. Section 3.3.1 explained that the potential benefits of this goal are partly financial. The state can also use Bilaterals as an instrument in its relations with other states. Realising these benefits may, however, be difficult. For example, the airline’s behaviour during the execution phase influences the state’s reputation. The state generally has little information on whether the airline is making a serious attempt to attain the state’s goals (see Section 3.3.2), primarily relying on interest harmonisation. To realise a selective network, the state further requires the timely availability of airport facilities. It uses an elaborate set of instruments and mechanisms to control the airport’s behaviour including extensive performance monitoring. Yet, these measures are not very effective ways of motivating the airport to make appropriate investments or use its facilities efficiently. Again, interest harmonisation is important.

Any change in the conditions underlying the agreement, any breach of these conditions, or any new market developments may lead to a new contact phase. At this point, it is worth recalling that Bilateral agreements do not have expiration dates and in practice tend to be long-term. A long-term agreement may be difficult to amend if there are no procedures governing change. The problem is particularly acute in a transaction-specific bilateral structure, where interdependencies between transaction parties make any amendment of the agreement very costly (see Section 2.7.3.1). The severity of the problem depends on the nature of the change. In general, a change resulting from exogenous events, such as an increase in traffic volume caused by changing patterns of travel, is easier to accomplish than a change resulting from opportunistic behaviour (e.g. change in the time of operation). Even if there are procedures structuring a change, negotiations may still be complex. The level of complexity can be reduced through the use of an objective change mechanism. An example of such a mechanism is the inclusion in the agreement of a general index clause that will become applicable once an easily verifiable exogenous event takes place, such as the ex post facto review clause in air transport. Practice shows that the use of this mechanism is declining. An alternative way of amending Bilateral agreements is the Memorandum, but this method does not meet the standard of objectivity.

3.5.4 - Compliance and enforcement

The long duration of the agreement and limited opportunity for change once the agreement has

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96 An example of an opposite situation is given by Havel (1997: 187). Northwest complained that the Australian government had imposed strict numerical limitations on its fifth freedom rights. Qantas, being confronted with the risk of retaliatory countermeasures, contended that it was not part of the Australian government and should
been concluded can lead to disputes during the execution phase when the terms of the agreement no longer reflect economic conditions. Havel (1997: 86-87, note 276) gives some examples of the discriminatory treatment of foreign carriers such as sudden changes in arrival or departure times at a destination airport, the refusal of fares, or assignment to inconvenient airport-terminal locations. In creating a dispute, a state will take into account the risk of disrupting relations with the foreign state. It will be less inclined to run such a risk if the foreign state is politically or economically important. In the event that a foreign state or carrier breaches the agreement, the state may choose to retaliate. In air transport, most states take the position that, in case of a dispute, they have the right to protect their position and preserve the benefits derived from the agreement until the dispute is resolved. Thus, a state might restrict the operation of a foreign airline if it determines that the rights under the agreement are being infringed by that airline’s national government (Kasper, 1988: 105, Havel, 1997: 161, 167). Because the airline’s transport rights are frequently part of a complicated route network, suspension of a service will have serious effects on other services. Likewise, the inconvenience caused to the public (the voters), the effect on future relations with the state concerned and any third state, as well as the high level of political visibility inherent in retaliatory exchanges increase the cost of deviating and create strong incentives for states to comply with the terms of the agreement and to resolve any dispute rapidly (Axelrod, 1984: 179). Although the strength of these factors and hence the degree of compliance will vary across states, practice shows that disputes mostly end prior to turning into real conflicts. In the event of a dispute, any method used to resolve it should take into account the following points:

1. state sovereignty,
2. mutuality,
3. economic interests,
4. efficiency and
5. (legal) vulnerability of the agreement, given that a Bilateral can be terminated at any time.

These factors seriously complicate the compliance mechanism in Bilateralism. The fact that several sovereign states are involved makes the Bilateral subject to at least two domestic regulatory systems as well as international law. The sources of international law are equally diverse with rules deriving from the Chicago Convention, Vienna Convention, as well as custom and case law. The multiplicity of rules creates problems for the states and the airlines.

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97 The list is based on Bin Cheng (1988: 18) but adds the sovereignty factor.
98 This point is largely academic since Bilaterals are rarely terminated. An exception is the termination of the Bermuda I Bilateral by the United Kingdom. Threats of termination do occur, however, and usually serve as a means of pressure or discipline (Dempsey, 1987: 37 and 176).
It is virtually impossible to learn all the relevant laws and regulations, while the rules of international law are often obscure. Yet, airlines, as agents of the state, are obliged to comply with these rules and can harm the state’s goals if they fail\textsuperscript{100}. A complicating factor is that the Bilateral agreement leaves certain items unspecified so that the state and the airline do not always know if they are in compliance. Furthermore, sovereignty makes the states very sensitive about their position and their status as equals and hence about any loss of control over the outcome of a dispute. Sovereignty generally rules out the feasibility of an external enforcement system, which is indeed the case in Bilateralism\textsuperscript{101}. Section 3.2 mentioned that relationships between states are managed by consultation and essentially governed by informal norms, such as morals and manners, and by political concerns. Consultation is indeed the method most commonly used in air transport to both prevent and resolve disputes. States can give consultation an exclusive role as a dispute resolution mechanism or they can make their choice of method dependent on the nature of the dispute. A specific procedure which applies consultation to disputes over tariffs and capacity was chosen in the second Bermuda agreement, concluded in 1977. Consultation often applies to disputes over the meaning of certain provisions or the application of an agreement. The Dutch model Bilateral, for instance, contains a consultation clause. As an alternative, the Dutch model Bilateral contains arbitration clauses, whereby parties undertake to comply with the decision of an arbitrator. These clauses do not contain any reference to applicable rules or procedures and parties are free to choose their own arbitrator. The clauses are an example of a general procedure. The principal advantage of consultation to resolve disputes is that it is a familiar method, usually engaging people who understand the issues, while states retain control over the outcome of the dispute. The principal disadvantage is that the only parties involved are those who are likely to have established views on the issues and are thus less likely to be sufficiently objective and flexible to resolve the dispute. This might lead to protracted discussions and seriously harm transport interests.

The compliance mechanisms in the agency relationships between the state on the one hand and airport and airline on the other seem less complicated. Firstly, there are opportunities for legal enforcement such as domestic courts. The applicable rules and procedures are known to those affected, thus reducing the level of uncertainty. In addition, the relationships between the state and industry players show mutual dependencies with opportunities for self-enforcement. Section 2.4.4 noted that whether any party to an agreement will resort to legal enforcement or rely on self-enforcement in case of a dispute depends on their relationship and relative strength. In the case of air transport, the airline, for example, has an information advantage during the

\textsuperscript{100} See, however, the example on page 80 where state actions harm the carrier’s operations.

\textsuperscript{101} One exception is the regulation of three soft rights in the context of GATS. Here, general and binding rules have been created, including a binding dispute resolution mechanism. Supra, p. 74.
execution phase, which often makes it stronger than the state. In its relations with the state the airline tends to rely on the strength of its position rather than immediately resort to legal remedies. The fact that in the Netherlands only one airline has ever invoked the opportunity offered by law to contest a designation supports the above statement. However, the position of the state is equally strong during the contact and contract phases, as the airline depends on the state for market access, while its relationship with the airline is generally close. Both parties will therefore be reluctant to turn to legal enforcement. The state-airport relationship is also close, but the distribution of power differs due to sizeable transaction-specific investments made by the airport. The high degree of asset specificity enables the airport to significantly influence the pay-off to the state and the state will more easily resort to legal enforcement in case of a conflict.

3.6 - Characterisation of the Bilateral structure

Section 2.7 classified governance structures into three categories. The description of the transaction process in Sections 3.4-3.6 shows that Bilateralism has traces of a transaction-specific structure. The frequency of negotiating and concluding Bilaterals is low, but the relationship between states creates permanent contacts. Further, the execution phase leads to permanent contacts between designated airlines, acting as agents for the states. The permanent interstate relationships and differences across these relationships (the relationship with the United States is very different from that with South Africa), the opportunities to use air transport as a foreign policy instrument, and state sovereignty all warrant the creation of a specific governance structure. Because of the importance attached to state sovereignty, the formation of a hierarchy or unified structure has not been feasible. Rather, a bilateral structure has been designed where states exchange rights through a form of procurement (barter). The various examples of how the value of the relationship affects the conditions attached to the provision of market access show that Bilateralism is based on relational contracting. One example is the applicability of the environmental provisions in the Dutch standard Bilateral, which varies depending, among other things, on the state with which the agreement is to be concluded. A state with few financial resources and hesitant about giving access to Dutch carriers will entice Dutch negotiators less than a state with substantial resources and similar views on the environment. Similarly, the Bilateral agreement is not detailed through extensive wording and, in case of a dispute, is not subject to a legalistic interpretation. Legally correct wording is unimportant, definitions are incomplete or vary across agreements and principles leave room for different interpretations (MacNeil, 1978: 890, appendix: 902-905). The fact that the Standard Clauses (see Section 3.2) only deal with technical-administrative matters supports the argument. Fennes (1997: 96) characterises the Bilateral as a ‘typical economic agreement’, whose primary aim is to deal with domestic political and economic concerns. In
contrast to traditional relational contracting, Bilateralism shows a high recognition of reciprocity in the exchange (e.g. the quid pro quo requirement) and places a strong emphasis on price (approval) and quantity variables at the formation stage.\textsuperscript{102}

The relationships between the state and its agents combine a transaction-specific structure and a semi-specific structure of regulation. The transaction-specific element is reflected in certain features resembling hierarchy (full state ownership of Schiphol airport and partial state ownership of KLM) and procurement (designation of airline and airport). Both relationships are governed by relational contracting, as evidenced by the absence of or limited attention to incentive systems, the absence of a careful selection process as well as the reluctance to use formal compliance mechanisms in the case of airlines. Regulation was defined in Section 2.7.2 as a very incomplete form of long-term contracting whereby the regulated are guaranteed a just return - for instance, in terms of a secure operating environment and a more efficient industry - in exchange for a successive introduction of changes. In the case of airlines, regulation governs the process of obtaining a permit and a designation to operate services. The permit and designation serve as a contract between the airlines and the state. The airfield designation and KEPD, which govern the state’s relationship with the airport, are also examples of regulation.

In conclusion, Bilateralism is a form of hybrid governance structure, consisting of a transaction-specific structure at the state level and a combination of a transaction-specific structure and a semi-specific structure of regulation at the state-industry level.

3.7 - Further developments

This chapter has described the traditional structure governing the exchange of air transport rights. The focus has been on the structure created by the Bermuda I Bilaterals. This structure comprises the Bilaterals, the accompanying principles, the provisions of the Chicago Convention, international law, domestic rules, as well as the rules of international organisations. The structure can be characterised as very rigid on the one hand, and very flexible on the other hand. Never meant to be permanent, it was subjected to severe criticism during the 1970s. In 1977, the United States saw the coming to power of the Carter administration. This presidency strongly believed in the benefits of greater competition and wanted to increase its share in international air transport (Dogalis, 1991: 53-54). In Texas and California, the deregulated interstate airline markets had shown an ability to generate costs substantially lower than the costs experienced by their regulated counterparts (Williams, 1994: 11). Termination by the United Kingdom of the Bermuda I Bilateral in 1976 (because the United Kingdom felt that its traffic share on the relevant route was too small) created an opportunity for the United States to incorporate the new policy into a new Bilateral, even

\textsuperscript{102} An exception to the emphasis on price and quantity in Bilateralism is the Open Skies Bilateral. Supra, p. 46. Note, however, the termination by Thailand of its Open Skies Bilateral with the US, mentioned in footnote 14.
though the various objectives had not been fully clarified at the time (Doganis, 1991: 157). The Bermuda II agreement concluded with the United Kingdom in 1977 was not a success. The agreement was much less liberal than the Bilaterals that followed shortly thereafter and in the United States was attacked within a year as being too protectionist (Havel, 1997: 46-48). The agreement concluded with the Netherlands in 1978 became a trend-setter for subsequent Bilaterals concluded by the United States. However, uniformity across Bilaterals generally diminished because, like the United States, many states were in the process of revising their transport policy. Furthermore, groups of states were embarking upon co-operation initiatives.

The criticisms of the Bilateral structure and its strict regulation have to be seen in the light of developments in economic theory. As early as the 1960s and early 1970s, the effectiveness of regulation was closely scrutinised (e.g. by the ‘Chicago School’). It was found that regulation frequently failed to benefit the public, among other things, because it enabled firms to appropriate the vast rents associated with their position, because it enabled the regulators to expand the reach of regulation to include ancillary activities (Williamson, 1976: 89) and because it failed to provide sufficient performance incentives. Some critics judged the air transport industry capable of generating adequate results without regulation, partly because there seemed to be enough potential competitors (see Section 5.2.4). In this environment, the United States domestic air transport market was deregulated in 1978. Industry performance improved, but there was also a restructuring of the domestic air transport industry and an increase in concentration.

During the 1980s, the air transport industry was in one of its worst recessions. The consequent pressure on revenue created strong incentives for carriers to obtain greater flexibility, both in their relations with the state and in IATA. These developments were influenced by events associated with general trade liberalisation (OECD, 1997: 116). Although the profitability of the airlines improved during the 1990s, the liberalisation trend continued both on a regional and on a global plane. Another factor typical of the 1990s was the concern for the environment, which was increasingly reflected in air transport regulation. In Europe, especially, these concerns continue to be considerable. Furthermore, the strict Bilateral regulations frequently prevent the airline and airport from using their facilities optimally. These factors have slowly undermined the Bilateral structure.

The ICAO conference of 1994, celebrating the 50th anniversary of the organisation, was used to discuss some fundamental proposals for change. However, it became apparent that at a global level no agreement could be reached on any radical reform of the governance structure.

103 Protocol, amending the 1957 Bilateral between the Netherlands and the United States.
104 Borenstein (1993) gives a good overview of these effects. See Havel (1997: § 3.3) for an overview of the United States’ international aviation policy.
The resistance from developing countries, which feared a cannibalising effect on their infant industry, was too strong. The hesitation at the global level does not reflect regional initiatives that are often part of more encompassing forms of co-operation. One example is the initiative taken by the European Community, which will be discussed in the following chapter.