

1997

Deregulation of Air Transport in Spain: E.E.C. Subsidies vs. Free Competition

Cynthia M. Costas-Centivany

Recommended Citation

Cynthia M. Costas-Centivany, *Deregulation of Air Transport in Spain: E.E.C. Subsidies vs. Free Competition*, 62 J. AIR L. & COM. 767 (1997)
<https://scholar.smu.edu/jalc/vol62/iss3/9>

This Comment is brought to you for free and open access by the Law Journals at SMU Scholar. It has been accepted for inclusion in Journal of Air Law and Commerce by an authorized administrator of SMU Scholar. For more information, please visit <http://digitalrepository.smu.edu>.

DEREGULATION OF AIR TRANSPORT IN SPAIN: E.E.C. SUBSIDIES VS. FREE COMPETITION

CYNTHIA M. COSTAS-CENTIVANY*

TABLE OF CONTENTS

I. INTRODUCTION—HIGHLIGHTED AIR TRANSPORT ISSUES IN SPAIN	767
II. ECONOMIC REGULATION OF AIR TRANSPORT	771
A. PUBLIC PROPERTY AND MONOPOLIES	771
B. MARKET COMPETITION	772
C. REGULATION AND SUBSIDIES.....	773
D. FOSTERING COMPETITION	773
III. DEREGULATION OF THE AIR TRANSPORT INDUSTRY.....	774
A. THE INFLUENCE OF DEREGULATION IN THE UNITED STATES	774
B. AIR TRANSPORT DEREGULATION IN EUROPE	776
1. <i>Tariffs: A Key to Competition</i>	780
2. <i>European Community's Stance on Competition</i> .	782
IV. THE CASE OF SPAIN: IBERIA AS A NATIONAL FLAG CARRIER.....	784
A. IBERIA'S SHORTCOMINGS	785
B. IBERIA'S STRATEGIES IN THE WAKE OF EUROPEAN DEREGULATION	787
V. CONCLUSION.....	788

I. INTRODUCTION—HIGHLIGHTED AIR TRANSPORT ISSUES IN SPAIN

IBERIA AIRLINES CURRENTLY finds itself in dire economic straits. According to some analysts, the company is under the

* The author wishes to thank Dr. Gaspar Ariño Ortíz, Director of the Programa de Estudios de Regulación Económica, Universidad Autónoma de Madrid, for research funding support.

risk of bankruptcy.¹ Spain's leading national carrier claims its financial difficulties have been ones not experienced by other European airlines. The difficulties were emphasized in 1995 when Iberia made efforts to renegotiate the European Commission's second grant of state aid. The outcome of that renegotiation was not as successful as Iberia had projected. The Commission granted only 87 billion of the requested 130 billion pesetas in aid.² Moreover, the Commission may add a future injection of 20 billion pesetas on the condition that Iberia meet its plan to achieve economic viability and improved competitiveness.³ The Commission also obliges Iberia to sell its assets in Aerolíneas Argentinas and Ladeco, two of its Latin American affiliates, for 15 billion pesetas.⁴

Iberia faces economic pressure from several sources. It must contend with the rapid proliferation of private airline competitors, the consequent loss of passenger load on those national air routes served by these lower fare competitors, and the obligation to lower its own fares in order to compete. Added to these pressures is the proposal of Iberia's airline pilots union (SEPLA) to study the possibility of establishing their own air carrier.⁵ Iberia's president responded by threatening to take the matter to court if a conflict of interest arose.⁶

This Essay will discuss the economic and deregulation factors shaping Iberia's competitive position. Important management and investment decisions that Iberia has made in recent years and which have influenced its current economic state will also be discussed. Challenges faced by Iberia offer useful lessons to those national carriers which are contemplating possible advancements under the free market competition promised by air transport liberalization in general, and in particular, by that liberalization to be effective in Europe by April 1997.

Iberia has a history of seeking financial support from the European Commission. September 1995 marked the European

¹ Julian González & Carlos Segovia, *Juan Sáez reconoce que la última huelga de pilotos deja Iberia "al borde de la quiebra,"* EL MUNDO, Nov. 8, 1995, at 65. Even Iberia's president, Juan Sáez, recognized that the company was "on the verge of bankruptcy" after a series of pilot strikes in November 1995. *Id.*

² Walter Oppenheimer, *La Comisión Europea aprueba hoy la ampliación del capital de Iberia en 87.000 millones de pesetas,* EL PAÍS, Jan. 31, 1996, at 45.

³ *Id.*

⁴ *Id.*

⁵ *El SEPLA decide estudiar la creación de una compañía aérea sin haberse cerrado el conflicto con Iberia,* EL PAÍS, Jan. 24, 1996, at 45.

⁶ *Competencia en las nubes,* EL PAÍS, Jan. 28, 1996, at 1, 2.

Commission's rejection of Iberia's second request for a cash reinjection totalling 130 billion pesetas (U.S. \$1 billion), to be used to overcome Iberia's crippling debt and embark on a new restructuring plan.⁷ Two years before, the Commission applied its "one time, last time" rule on granting Iberia an injection of 120 billion pesetas to help finance a restructuring plan which was to restore the flag carrier to economic health and profitability.⁸ On Iberia's approved, initial petition, competing airlines such as British Airways, which have managed to turn a profit without relying on state aid, complained that the grant amounted to unfair competition.⁹ In spite of these complaints during Iberia's first petition for aid, the Commission extended Iberia 120 billion pesetas in aid.¹⁰

When Iberia submitted its second petition for aid, the state-run carrier justified its request by qualifying its circumstances as "exceptional," described as the existence of fewer travelers after the Gulf War, currency fluctuations, and the world recession.¹¹ While exceptional circumstances are required for supplemental grants of Commission aid, the Commission and the general opinion has been that the exceptional circumstances described by Iberia have been common to all European airlines and not to the petitioner alone.

At this writing, Iberia and its affiliates are struggling financially against the effects of a more than seventeen day SEPLA strike during November and December 1995, with daily losses of approximately 700 million pesetas on cancellation of some 340 flights per strike day, more than half of the estimated 608 daily scheduled flights.¹² The pilots union demanded that Iberia management follow through on a 1994 proposed restructuring plan which included revamping directorship strategies and personnel. In support of its position, SEPLA proposed an outside consultant's analysis by Barclays Zoete-Wedd.¹³ Barclays' evalua-

⁷ *Spain's Subsidy Glutton*, WALL ST. J. EUR., Sept. 1, 1995, at 6.

⁸ *Id.*

⁹ *Id.*

¹⁰ *Id.*

¹¹ *Id.*

¹² *Los pilotos de Iberia y Aviaco mantienen la huelga sin que haya acercamiento con las empresas*, EL PAÍS, Nov. 7, 1995, at 60. The *International Herald Tribune* reported Iberia's total losses from the inception of the strike until November 8, 1995, its reporting date, as 2.46 billion pesetas (U.S. \$20 million). *Iberia Sees No Relief on Pilots' Strike*, INT'L HERALD TRIB., Nov. 8, 1995, at 2.

¹³ *Iberia necesita una ampliación de capital de 100.000 millones como mínimo, según Barclays*, EL PAÍS, Nov. 7, 1995, at 61.

tion¹⁴ concluded that, in light of the carrier's 93.7 million peseta debt, Iberia needed added capital amounting to 100 billion pesetas, an amount independent of the possible indebtedness of its affiliates.¹⁵

The president of Iberia, meanwhile, presented to Spain's parliamentary members an optimistic view of the company's circumstances by claiming that Iberia's losses through October 1995 exceeded 9 billion pesetas, over 5 billion pesetas less than the anticipated losses for the same period.¹⁶ He also stressed that fulfillment of pilot demands would lead Iberia and its affiliates to bankruptcy.¹⁷ The pilots union claims that Iberia's management has faltered in meeting terms and conditions in its original 1994 agreement, including failing to: (1) regain financial stability by the agreed date; (2) reorganize the company's business activities; (3) cut company costs through transparent information sharing and negotiations with the appropriate workers' unions; (4) renew the company's aircraft fleet as required; (5) improve management's dealings in labor relations with Iberia workers; (6) permit pilots' union voting/stock-own-

¹⁴ The Barclays de Zoete Wedd report, issued in the summer of 1995, made the following suggestions for Iberia's improvement:

- strengthening management toward more independent decision-making;
- improvement of organizational structure;
- need to develop a long-range global strategy plan for the company and its affiliates;
- permanent revision of its business plan;
- detailed analysis of company costs and improvement of financial flows and reporting systems;
- improvement of investment evaluation and decision-making processes;
- urgent rationalization and renovation of aircraft fleet;
- detailed evaluation of all company activities and how each contributes to business objectives and investment opportunities;
- urgent evaluation of all investments made in Latin American affiliates;
- outline a plan for handling activities which takes into account the effects of liberalization, and consider the creation of one or several independent affiliates so as to increase transparency and eventually contemplate opportunities to divest; and
- clearly define the competitive advantages of maintenance services as well as consider subcontracting in this area.

Id.

¹⁵ *Id.*

¹⁶ *Iberia pierde hasta octubre 9.035 millones, 5.171 menos de lo previsto*, EL PAÍS, Nov. 8, 1995, at 59.

¹⁷ *Id.*

ing representation within the company board of directors; (7) create and work consistently with a commission to oversee Iberia's restructuring plan; and (8) honor the results of the Barclays-Zoete Wedd evaluation.¹⁸ The Spanish government's reaction has been to redirect its Minister of Industry to European Commission officials in the hope of renegotiating the Commission's latest refusal to grant the full amount of aid requested on second petition by Iberia.¹⁹

II. ECONOMIC REGULATION OF AIR TRANSPORT

The industry organization of air transport may take the form of a publicly owned company which meets the market demand by monopolistic behavior.²⁰ Another form of regulation is that of systematic concessions granted to those bidding companies that commit themselves to provide a given service during a specified period in the most efficient and cost-effective manner.²¹ Yet another method of regulation is that emitted by an administrative body which has the authority to grant a limited number of licenses to various air carriers which are to provide a specified service in a given area or route and under agreed conditions in exchange for a direct subsidy.²² At the other end of the regulatory spectrum, a market may function under the impetus of competition having no restrictions on market entry.²³ This section will analyze the positive and negative repercussions of each of these approaches.

A. PUBLIC PROPERTY AND MONOPOLIES

Public monopolistic industries arise in instances where competition is not possible, where it is not desirable, or where important external factors necessitate their existence.²⁴ In air transportation, it is frequently the case that the relationship between the minimal size and indivisibility of the unit of production and level of market demand is such that a natural monopoly exists.²⁵ Moreover, when economies of scale do not

¹⁸ *Iberia y el Sepla, enfrentados por un plan*, EXPANSIÓN, Sept. 26, 1995, at 4.

¹⁹ *Id.*

²⁰ JOSÉ C. CARBAJO & GINÉS DE RUS, LA DESREGULACIÓN DEL TRANSPORTE EN ESPAÑA, TEORÍA Y EVIDENCIA 3 (FIES Working Paper No. 78 (1991)).

²¹ *Id.*

²² *Id.*

²³ *Id.*

²⁴ *Id.*

²⁵ *Id.*

have a significant impact, regulatory authorities frequently consider that the duplication of services would cause such a loss of resources that they will permit the creation of a publicly or privately managed monopoly through a system of granted concessions.²⁶ This is the case of Iberia in Spain, where the regular (as opposed to charter) transportation of passengers is a public service rendered by a national monopoly.²⁷ One of the salient characteristics of such monopolies is their disposition to practice tariff discrimination, where for the same service, different consumers are charged different prices—for example, early ticket purchase versus last minute ticket purchase priced differently for the same travel route.²⁸ The justification and social benefit of such discrimination is that of achieving higher company output when fare discrimination is practiced than when all consumers pay the same fare.²⁹ Where restrictions on the entry of competitors exist, it is advisable that possible increments in output over time be recognized so that public subsidies may be conditioned on uniform or multi-tariff price-fixing schemes.³⁰

B. MARKET COMPETITION

One of the drawbacks of natural monopolies is the inability to take the greatest advantage of economies of scale by a single company without creating monopolistic power.³¹ One regulatory solution against this result is to create market competition by allowing market entry to various operators so that they may compete to become the most efficient, and consequently, only server of the market.³² In most cases, a market entry concession is granted when the selected company commits to rendering a service for the lowest price or the best quality relative to price.³³ Nonetheless, a system of regulated concessions granted to new market entrants does not always work favorably, especially in light of the inherent dangers of collusive pricing among a reduced number of entrants or the existence of bidders that stand

²⁶ *Id.*

²⁷ *Id.*

²⁸ *Id.* at 4.

²⁹ *Id.*

³⁰ *Id.* at 7.

³¹ *Id.* at 8.

³² *Id.* at 8-9.

³³ *Id.* at 9.

at such an advantage before other companies that they, in effect, have no competitors.³⁴

C. REGULATION AND SUBSIDIES

Where an industry requires large start-up investments and provides a service that is of public benefit, such as air transport, public subsidies are granted to assure that the service is maintained under a scheme of regulated fares or other conditions.³⁵ The source of financing of some subsidies can come out of a highly profitable service area to a less profitable service area that is to be maintained in the same sector.³⁶ On the other hand, there are also public subsidies which arise as direct, one-shot contributions to assist a company in surviving otherwise unanticipated market dynamics, but which, if allocated intelligently, must ensure that the derived benefits compensate for the possible negative effects on the costs involved.³⁷ It may be argued that the indirect subsidy from a more to less profitable service can lead to a lessening of public benefit and economic losses for a company.³⁸ While the more profitable service is supporting the less profitable one, the former is often not able to expand to maximum levels of output and the costs of providing the less profitable service is undervalued by the consumer.³⁹

D. FOSTERING COMPETITION

Regulation which fosters market competition takes the form of prohibiting anti-competitive practices, for example, collusive agreements between companies to fix prices.⁴⁰ Another approach is to dismantle any barriers to entering the market. Eliminating any quantitative limits on the number of permissible operators in a given market is an example of this.⁴¹

The latter form of fostering market competition is known as deregulation.⁴² Deregulation provides two advantages: (1) it improves the internal managerial efficiency of companies under the disciplinary pressure of market competition; and (2) it en-

³⁴ *Id.* at 8-9.

³⁵ *Id.* at 13.

³⁶ *Id.*

³⁷ *Id.*

³⁸ *Id.* at 14.

³⁹ *Id.*

⁴⁰ *Id.*

⁴¹ *Id.*

⁴² *Id.*

courages innovation as a response to rival companies introducing new products, services, or price structures.⁴³ The theory of contestable markets was applied in the deregulation of the air transport industry in the United States, whereby operators which serve a given market must function at maximum efficiency or else new competitors will be able to enter the market and threaten their replacement.⁴⁴ The most frequent argument made against deregulation is that free entry of all operators will unnecessarily engender a duplication of certain fixed costs and thus fails to maximize the desired public benefit.⁴⁵

III. DEREGULATION OF THE AIR TRANSPORT INDUSTRY

A. THE INFLUENCE OF DEREGULATION IN THE UNITED STATES

Motivating reasons which edged the United States toward deregulating domestic air transport were expressed clearly in the 1975 Report of the Civil Aeronautic Board Special Staff on Regulatory Reform.⁴⁶ Those reasons included:

- (1) *de facto* exclusion of new airlines from long-haul trunkline markets; (2) protection of the relatively inefficient carriers; (3) unduly high labour costs and unduly high-cost type of service; and (4) lack of emphasis on price competition and on variations in the price/quality mix in response to consumer preference.⁴⁷

Between 1975 and 1978, the government applied various intermediate measures to relax Civil Aeronautic Board (CAB) control over the industry and progressively recognized special offer fares initiated by Texas International and American Airlines.⁴⁸ In February 1977, President Carter proposed a new bill to Congress that was designed to allow greater competition in the airline industry.⁴⁹ This legislation, the Airline Deregulation Act, was signed into law in October 1978.⁵⁰ The Act eliminated most restrictions on air fares and new competitors entering the mar-

⁴³ *Id.* at 15.

⁴⁴ *Id.* at 16.

⁴⁵ *Id.* at 15.

⁴⁶ RIGAS DOGANIS, *FLYING OFF COURSE: THE ECONOMICS OF INTERNATIONAL AIRLINES* 51 (2d ed. 1991).

⁴⁷ *Id.* (citing CIVIL AERONAUTICS BOARD, *REPORT OF THE CAB SPECIAL STAFF ON REGULATORY REFORM* (1975)).

⁴⁸ DOGANIS, *supra* note 46, at 52.

⁴⁹ *Id.*

⁵⁰ *Id.*

ket. The Act also provided for complete elimination of the CAB regulatory body by 1985.⁵¹

Looking back on the history of United States airline regulation, it is of little surprise that the ultimate result would be one of deregulation. Air transport regulation in the United States began in 1938 to regulate interstate air travel fares and control market entry. It also provided subsidies for the promotion of what was then a nascent industry.⁵² The government's purpose was to provide financial incentives for the industry to innovate, grow, and continue offering a public benefit at affordable costs.⁵³ But it is not evident, even at that time, that price and market entry regulation was necessary in order to offer continued public benefits at affordable costs. Perhaps public safety was and continues to be a more persuasive basis for airline regulation. Nevertheless, the industry was not a natural monopoly given that its infrastructure was publicly financed, unrecoverable costs (sunk costs) were relatively low, and economies of scale were modest.⁵⁴

It is evident that regulation per se did not successfully achieve the CAB's general objectives.⁵⁵ Those objectives were to: foster competition; ensure that industry operators offer adequate services at efficient and reasonable prices; prevent unjustified price discrimination; and promote "healthy economic conditions" for the industry.⁵⁶ In reality, the CAB suppressed competition by limiting market entry and eliminating the possibility of rival pricing measures.⁵⁷ As a result, the possibility of furthering innovation and the price-quality balance of existing carriers and new market entrants to the industry was diminished significantly.⁵⁸ Between 1950 and 1974, the CAB received approximately eighty new air carrier applications to enter the market; the CAB rejected each of them under the premise of giving greater importance to protecting existing competitors than to promoting the innovation that can come with competitive pressures of new entrants to the market.⁵⁹

⁵¹ CARBAJO & DE RUS, *supra* note 20, at 22.

⁵² *Id.* at 20.

⁵³ *Id.* at 21.

⁵⁴ *Id.* at 20.

⁵⁵ *Id.* at 21.

⁵⁶ *Id.*

⁵⁷ *Id.*

⁵⁸ *Id.*

⁵⁹ *Id.*

The CAB's air fare regulations led to inefficiency and losses. Airlines tended to increase the number of flights per route because of the CAB regulations.⁶⁰ This substantially reduced the number of passengers per flight thereby resulting in inefficient operations and losses.⁶¹ Moreover, existing airline companies, severely restricted from serving new travel routes, limited their search for the most profitable operations.⁶²

Deregulation allowed airlines to renovate the industry. At the threshold of U.S. deregulation in 1982, new entrants were allowed into any market or route they were willing and able to operate, leading to the "hub-spoke system".⁶³ In addition to routing, deregulation significantly improved other practices in the industry. For example, airlines introduced air fare discrimination and innovated computerized air reservation systems.⁶⁴

Yet, while Spain and Europe as a whole look to these favorable effects of deregulation, other less favorable aspects can be observed. As a result of deregulation in the United States, air traffic has increased significantly without the accompanied growth of airport infrastructures, thus causing congestion in airports, increased flight delays, and a need for greater security measures. Additionally, prices have increased within those markets where the demand for services is most concentrated.⁶⁵ On balance, however, deregulation has brought with it lower air fare prices which more closely reflect actual costs, a greater range of consumer choices in which quality-price factors are considered, and increased efficiency of operations in the industry as a whole.⁶⁶

B. AIR TRANSPORT DEREGULATION IN EUROPE

A key distinction made in the regulation of air transport in Europe is that of regular and charter flight services. Each of these services have different markets operating under distinctly different conditions and controls. Charter carriers have a lower cost of market entry, limited product line, and sell passenger seats or travel package deals through intermediary travel

⁶⁰ *Id.*

⁶¹ *Id.*

⁶² *Id.* at 21-22.

⁶³ *Id.* at 23.

⁶⁴ *Id.*

⁶⁵ *Id.*

⁶⁶ *Id.*

agents.⁶⁷ This ensures that at least a minimum capacity of each flight is filled.⁶⁸

Regular flight services are subject to the conditions of bilateral agreements which must be approved by the governments of the respective countries in which a flight route is serviced.⁶⁹ These agreements specify permissible routes to be served between countries, the particular carriers to do so, and their passenger capacity on such routes, in addition to a ceiling or structure for air fares.⁷⁰ Air carriers are known to complement these bilateral agreements with confidential agreements that modify the terms of the original agreement and specify requirements for passenger capacity, income distribution, and costs covered.⁷¹ These requirements ultimately impose limits on air tariff prices and special travel offers which can be extended by either carrier in the confidential agreement as well as by new entrants seeking to serve the same market.⁷²

These regulatory approaches have resulted in inefficiency and limited air travel options to consumers in Europe. As a result, the European Economic Community (E.E.C.) put in place its multilateral and bilateral initiatives to deregulate air transport in Europe, effective as of 1997.⁷³ A primary basis for its initiatives was the application of Treaty of Rome Articles 85 and 86 to the air transport sector.⁷⁴ Article 85 "prohibits and makes unenforceable anti-competitive agreements, decisions and concerted practices which eliminate, reduce or distort competition unless specific exemptions have been granted."⁷⁵ Article 86 "prohibits an abuse of a dominant position within the Community or any part of it so as to affect trade between EEC member states."⁷⁶

While the E.E.C. did not specify particular agreements to be prohibited, it was evident that capacity-sharing agreements, tariff-fixing, and revenue pooling were anti-competitive under Article 85 and thus unacceptable.⁷⁷ Nonetheless, the European Commission was given the power to grant exemptions to such

⁶⁷ *Id.* at 32.

⁶⁸ *Id.*

⁶⁹ *Id.*

⁷⁰ *Id.*

⁷¹ *Id.* at 33.

⁷² *Id.*

⁷³ *Id.* at 35.

⁷⁴ DOGANIS, *supra* note 46, at 84.

⁷⁵ *Id.*

⁷⁶ *Id.*

⁷⁷ *Id.*

agreements so long as the exemptions involved only intra-European carriers and did not concern a non-Community carrier.⁷⁸

The application of Article 86 presented greater complications because of the difficulties in defining what constitutes a "dominant position" within the E.E.C. It is generally recognized that a dominant position consists of holding over forty percent of the market share and retaining advantages not shared by competitors, such as economies of scale and scope.⁷⁹ As enforced by the European Commission and European Court of Justice, the clear prohibitions under Article 86 are that airlines may not:

- enter restrictive fare agreements;
- create exclusive dealings with travel agents by offering the agents commissions;
- use computer reservation systems to obtain an undue advantage over their competitors;
- restrict the purchase of supplies only to suppliers of their own nationality;
- refuse to accept interline traffic from another airline without sufficient justification;
- artificially create disadvantages for their competitors, such as by tying up more terminal facilities or runway slots than necessary; and
- use "predatory pricing" to force competitors out of a market.⁸⁰

The European Commission is perhaps the least supportive of deregulation because its representatives must defend the government interests of their respective Member States. As early as mid-1987, the Commission proposed and was prepared to approve measures which represented a global agreement on the application of the Treaty of Rome to air transport in the Community.⁸¹ But Spain vetoed the proposal because the Commission refused to accept Gibraltar in the network of proposed routes.⁸² By mid 1987, the Commission adopted measures in conformity with the competition laws under the Treaty of Rome, as they are applied to regular air transportation.⁸³ The meas-

⁷⁸ *Id.*

⁷⁹ *Id.*

⁸⁰ *Id.* at 85.

⁸¹ CARBAJO & DE RUS, *supra* note 20, at 38.

⁸² *Id.*

⁸³ *Id.*; see also DOGANIS, *supra* note 46, at 84.

ures covered air fares of regular air travel, as well as capacity designation and market access:⁸⁴

a) Member States may approve operator air fares so long as they are reasonably related to long-term global costs. A proposed tariff being lower than that of another carrier operating on the same route is not sufficient justification to reject the proposal.

b) Establishment of two flexible air fare pricing zones: one zone of reduced tariffs which includes fares from 90% to more than 65% of the reference price; and another zone of highly reduced tariffs which comprises fares from 65% to 45% of the reference price;

c) Abandonment of the traditional methods in distributing capacity (50-50%), and establishment of a 55-45% capacity distribution until October 1989, with a 60-40% capacity distribution to apply from that time onward, notwithstanding an exceptions clause which permits a Member State to request a waiver of the 60-40% rule in cases in which it can show that its national flag carrier has suffered "serious economic prejudice"; and

d) establishment of new market entry opportunities within travel routes with more than 250,000 passengers.⁸⁵

While Europe proceeds to relax its restrictions on competition, and gradually comes closer to deregulating air transport, the United States experience suggests several lessons. It is advisable for Europe to make efforts to expand airport ground facilities and to augment security measures in order to accommodate increases in passenger flow caused by deregulation. While analyzing the U.S. experience, it is useful to bear in mind that Europe's economy and transport systems are different. Average income levels in Europe are lower than in the U.S., with the effect that Europeans travel less by air.⁸⁶ Fuel in Europe is more expensive and subject to higher taxes than in the U.S., thus heightening the cost of air travel in Europe.⁸⁷ People in Europe travel by rail more frequently than in the U.S. because it is less expensive than air travel and because geographical distances in Europe are shorter.⁸⁸ When they do fly, it is usually because ground travel permits less speedy or convenient crossings such as those of the British Channel, the Alps, or the Baltic Sea.⁸⁹

⁸⁴ Council Regulation 3976/87 of 14 December 1987, On the Application of Competition Rules, 1987 O.J. (L374) 9-11.

⁸⁵ CARBAJO & DE RUS, *supra* note 20, at 39.

⁸⁶ *Id.* at 23 n.1.

⁸⁷ *Id.*

⁸⁸ *Id.*

⁸⁹ *Id.*

Deregulation inevitably leads to the failure of less efficient carriers unable to withstand competitive pressures and their subsequent acquisition or merger by more competitive carriers. These mergers have had both negative and positive results: on the one hand, the public loses because fares on certain routes have increased, while on the other hand, there are gains for consumers in the range of destinations and variety of special air travel offers, such as accumulated mileage points.⁹⁰ Carrier mergers can cut back on some of the gains of deregulation, but to counteract this, special measures have been applied. For example, the monopoly of airport ground facilities and space by certain companies is now subject to special taxing structures as an incentive for carriers to curtail airport congestion.⁹¹ Certain travel promotion programs are also taxed so as to balance with those carriers not in a position to offer similar programs.⁹² International air carriers now may require reciprocal access to the airport facilities in the respective countries of the companies involved.⁹³ In light of these consequences, government needs to exercise antitrust policing powers in order to prevent anti-competitive violations such as collusive pricing and market dominance.

1. *Tariffs: A Key to Competition*

In order to combat a recent and significant downturn in the number of passengers, a first-time price war has begun at the initiative of Aviaco, an Iberia affiliate.⁹⁴ For the moment, the dramatic slashing of fares by almost fifty percent, with no adjustments for costs, is limited to Aviaco's national flights.⁹⁵ Per Lufthansa Airlines President's suggestion that Iberia would do well to reduce its prices, a discussion follows on developing fair and competitive tariffs in which important consideration is given to costs.

Under the existing competitive fare conditions of the air transport market, "the key to successful revenue generation is market knowledge, cost awareness and yield management."⁹⁶ In

⁹⁰ *Id.* at 28-29; see also DOGANIS, *supra* note 46, at 78.

⁹¹ CARBAJO & DE RUS, *supra* note 20, at 29.

⁹² *Id.*

⁹³ *Id.*

⁹⁴ G. González & R. Árbol, *Aviaco desata una guerra de precios para parar su caída en tráfico nacional*, CINCO DÍAS, Nov. 23, 1995, at 5.

⁹⁵ *Id.*

⁹⁶ DOGANIS, *supra* note 46, at 288.

order to know their market, airline companies are obliged to fully understand the market segments and the requirements in each of their markets.⁹⁷ As to cost awareness, airlines must ensure that costs are covered fully within each traffic category they carry, whether passengers or freight. Moreover, the feasibility of investments in aircraft, new routes, and different products should force an evaluation process of investment opportunities which would lead to developing a sound pricing strategy according to the demands of evolving market conditions.⁹⁸ Yield management is also essential to competitive tariff-setting because airlines under certain circumstances will decide to set prices according to costs or according to the market, and in either case yield managers must carefully evaluate costs and market evolutions to properly project fair and competitive tariffs.⁹⁹

There are three categories of costs borne by airlines: variable direct operating costs, fixed or standing direct costs, and indirect operating costs.¹⁰⁰ Variable costs are those avoided by not servicing a flight route, such as "fuel costs, variable flight and cabin crew costs, landing and en route charges."¹⁰¹ Direct maintenance costs fall in this category and are the most difficult to estimate because they can depend on the number of "block hours flown on each route or a combination of block hours and number of landings" on each route.¹⁰² Fixed or standing costs include "depreciation and insurance, the fixed annual flight and cabin crew costs, and engineering overhead costs," which are often calculated according to costs per block hour for each aircraft type and route.¹⁰³ Indirect operating costs include ground station and service costs, passenger insurance and their ground services, ticketing, sales and promotion costs, and general administrative overheads.¹⁰⁴

The need to maximize short term revenues and the low marginal costs of carrying additional passengers have led airlines to develop a variety of different pricing strategies.¹⁰⁵ Once costs are established, airlines are in a better position to create tariff

⁹⁷ *Id.*

⁹⁸ *Id.*

⁹⁹ *Id.*

¹⁰⁰ *Id.*

¹⁰¹ *Id.* at 289.

¹⁰² *Id.*

¹⁰³ *Id.*

¹⁰⁴ *Id.*

¹⁰⁵ *Id.* at 291.

systems that they can adapt to the demands of their various market segments; for example, off-peak rates for the non-business class segment, separate rates for first class and business segments, economy and excursion fares for the tourist segment as distinguished from charter rates, as well as advanced purchase, on demand, and stand-by fares.¹⁰⁶ The role of yield managers is to create marketing strategies which will ensure that the passengers willing to pay the higher rates will not switch to lower fare categories, and to prevent excess bookings at low fares, thus maximizing the total revenue per flight.¹⁰⁷

Sometimes competitor's lower airline fares can be misleading if "the competitor has lower unit costs [per passenger] or is heavily subsidized by its government."¹⁰⁸ Thus, marketing and yield managers must carefully evaluate how to maximize revenues even when faced with such competitors, and must remember that, regardless of the lower unit costs borne by a competitor and their lower fares, an airline has the first and foremost obligation to cover its own costs, maximize its revenues, and meet its corporate objectives.¹⁰⁹

2. *European Community's Stance on Competition*

As discussed in Part III.B. above, the fare pricing zones established under the 1987 E.E.C. measures have been used by few airline companies, with an almost imperceptible effect in countries such as Great Britain, Belgium, Luxembourg, Holland, and Ireland, which had implemented greater pricing flexibility through bilateral agreements.¹¹⁰ Moreover, little visible change from what was true of previous years was apparent in passenger capacity distribution.¹¹¹ In the end, air tariffs were less affected by the 1987 E.E.C. measures than by a 1989 decision of the European Court of Justice in the case of Ahmed Saeed Flugreisen.¹¹²

The issue presented by the case was whether national authorities had the right to enforce price fare limits on flights which

¹⁰⁶ *Id.*

¹⁰⁷ *Id.* at 293.

¹⁰⁸ *Id.* at 295.

¹⁰⁹ *Id.* at 296.

¹¹⁰ CARBAJO & DE RUS, *supra* note 20, at 40.

¹¹¹ *Id.*

¹¹² Case 66/86, Ahmed Saeed Flugreisen v. Zentrale zur Bekämpfung unlauteren Wettbewerbs, 1989 E.C.R. 803.

either originated or were destined to the country in question.¹¹³ In this case, air tickets were being sold in countries where currency values were low, whereby a transatlantic fare with a stop-over in Germany ended up to be cheaper than if the ticket was purchased in and the flight originated from Germany. The court held that the E.E.C. measures referred to only international intra-European flights and that the applicable competition rules applied to all other carriers fall under the rubric of Articles 88 and 89 of the Treaty of Rome.¹¹⁴ Thus, the decision was far-reaching in that for the first time the court contemplated jurisdiction over non-Community carriers that were subject to the competition rules under the Treaty of Rome.

A second package of regulatory measures was adopted by the European Commission in June 1990. The most significant effect of these measures was giving full support to abolish all bilateral limits on capacity shares and intra-Community fares by January 1, 1993. Moreover, by July 1992, each Member State subject to these measures was required to formulate a licensing scheme that fostered the market entry of new airlines that met the licensing requirements, thereby opening access to that country's air routes by other Community airline companies.

The liberalization of air transport in Europe has been initiated at a gradual pace. The importance of outsider competition that eventually will enter the Community market is a reality which cannot be underestimated. Already, EFTA and East European countries, not to mention Asian and North American competitors, are defining a role for themselves through multilateral alliances and global routing cooperatives with selected European Community carriers. The European Commission is increasingly adopting interventionist measures to protect consumer interests as well. Quite different from what took place in the United States, small European carriers are not merging to compete against their more established counterparts. Moreover, there are few newly created carriers in Europe that present any real competition for established airline companies. If there is to be any competition in Europe's liberalization process, it is to be among the existing airline companies. Yet given the alliances being formed among European and non-European countries, it is doubtful that carriers in a given alliance will compete

¹¹³ *Id.* at 806.

¹¹⁴ *Id.* at 814; see also CARBAJO & DE RUS, *supra* note 20, at 40 (discussing significance of the case); DOGANIS, *supra* note 46, at 90.

against each other. It is apparent that the scale of competition has evolved to take hold between transnational alliances and global markets, not between lone air carriers.

IV. THE CASE OF SPAIN: IBERIA AS A NATIONAL FLAG CARRIER

The law which founded Iberia as Spain's national air carrier is dated June 7, 1940. Subsequent regulations of 1942 and 1944 expanded on this law, with the essential groundwork establishing exclusive air transport service to the Iberian peninsula, its territories, and protectorates. Law 48/1960 of July 21, 1960 implicitly expressed the concept that regular national flights were a public service reserved to national companies.¹¹⁵ Regular and international flights are subject to the reciprocity of international agreements, thus allowing foreign companies to offer their services in Spain.¹¹⁶ The exclusivity of national service to satisfy national demand used to be an especially common characteristic of most, if not all, national transportation systems that fulfilled an essential public service. This philosophy underlying current economic regulation and liberalization has changed considerably, to the extent that the concept of exclusivity goes against the free market competition that is being fostered today.

We have entered a period in economic and legal history in which fostering market competition is believed to engender improved customer services, greater innovation, increased cost-effectiveness, and more attractive pricing. More recently, airline companies are encouraging international company linkages, by which worldwide routing systems are jointly formed to increase access to and coverage of global markets. Hence, the concept of exclusive national service no longer exists, to the benefit of "essential transport facilities" consumers who increasingly demand greater routing flexibility and choice.

Iberia's efforts to achieve global expansion have taken the form of investing in shares of the following airline companies in Latin America: Aerolíneas Argentinas, Ledeco (Chile), and Viasa (Venezuela). Iberia has also been in negotiations with these airlines, trying to realize some of the same objectives as in the negotiations held with Dominicana.¹¹⁷ However, upon peti-

¹¹⁵ LEY DE NAVEGACION AEREA [L.N.A.] arts. 71, 73, 74, and 83 (Esp.).

¹¹⁶ *Id.* art. 88.

¹¹⁷ In September 1993, Iberia closed its flight distributor hub in the Dominican Republic, resulting in the closure of its Miami hub, discontinuation of flights

tioning a second injection of 130 trillion pesetas in state aid from the European Commission, the Commission's response was to grant only 48 billion, of which 36 billion pesetas was destined to finance the social benefits agreement for workers and 12 billion pesetas were to compensate for the restoration and reduction of aircraft equipment.¹¹⁸ With few alternatives, Iberia at one point projected turning to the following sources for added financing: 40 billion pesetas resulting from the sale of Aerolíneas Argentinas, and 10 billion pesetas from the sale of Austral, a subsidiary of Aerolíneas Argentinas.¹¹⁹ In case of an added need for financing, Iberia would also consider selling shares of Viasa Airlines, even though these have proven to be less marketable than shares of its other acquisitions.¹²⁰

A. IBERIA'S SHORTCOMINGS

Evidently, Iberia faces reversing its position from an airline aspiring to expand its global market to one which reverts to selling its recent acquisitions in order to survive.¹²¹ Jürgen Weber, President of Lufthansa, commented that in considering an alliance with Iberia unlikely, the Spanish flag carrier would do well to avoid state aid by reducing its size, and any resulting financing should be used, not to restructure the company, but to reduce its prices.¹²² A reduction in prices necessarily will oblige the carrier to stand on a more competitive ground with those international carriers that access Iberia's consumer markets.

to Los Angeles, and a reduction of the frequency in connecting flights from the Buenos Aires hub. Antonio Ruiz del Árbol, *Iberia clausura su centro aéreo de Santo Domingo y reduce vuelos en Buenos Aires*, CINCO DÍAS, Sept. 28, 1993, at 8. Airline financial losses in Central America, the United States, and Japan reached 8 billion pesetas. *Id.* At the same time, the intercontinental activities were projected to experience a loss of at least 23.5 billion pesetas. *Id.*

¹¹⁸ Xavier Vidal-Folch, *Iberia rebaja a 100.000 millones la inyección de capital necesaria para su plan de viabilidad*, EL PAÍS, Oct. 15, 1995, at 53.

¹¹⁹ *Id.*

¹²⁰ *Id.*

¹²¹ One of the important conditions to a second extension of aid by the E.E.C. is that of obliging Iberia to agree either to repurchasing sold shares of Aerolíneas Argentinas or totally separating itself from the airline at the end of a two year period from the date of receiving aid. *Iberia pierde hasta octubre 9.035 millones, 5.171 menos de lo previsto*, EL PAÍS, Nov. 8, 1995, at 59.

¹²² Belén Cebrián, *Los Gobiernos tienen que privatizar las compañías aéreas*, EL PAÍS, Sept. 3, 1995, at 46 (interview with Jürgen Weber).

In a comparative survey, Iberia is cited to be one of the least productive airlines in the world.¹²³ Some comparative figures on productivity rates follow:

TABLE 1. AIRLINE COMPANY PRODUCTIVITY¹²⁴

Company	Income Gains U.S. Dollars \$(000)	Transported Passengers/kil.	Personnel	Productivity (ratio TPK/pers.) (000)
JAL	\$7,930,000	53,328	21,142	2,539
CONT'L.	\$4,944,223	63,618	32,011	1,988
TWA	\$4,507,348	56,572	29,815	1,950
NORTHW.	\$6,554,000	75,863	40,000	1,896
PANAM	\$3,561,000	47,729	28,784	1,704
DELTA	\$8,571,709	95,509	65,099	1,724
AMERICAN	\$10,479,600	118,288	75,089	1,577
AIRCANADA	\$3,091,200	26,195	21,022	1,247
BRITISH	\$7,726,000	61,038	50,959	1,220
KLM	\$3,338,100	24,960	25,000	998
AIRFRANCE	\$5,470,828	36,846	39,111	944
LUFTHANSA	\$6,700,000	36,173	43,565	841
SWISSAIR	\$2,931,259	15,459	20,471	772
SAS	\$4,570,000	15,316	20,471	765
IBERIA	\$2,984,967	21,119	29,001	728
SAUDIA		16,238	24,064	676
VARIG	\$1,862,136	16,191	24,638	674
ALITALIA	\$3,413,000	17,920	29,197	617

One observes in Table 1 that in terms of income gains, Iberia is most comparable with Swissair, at \$2,984,967 and \$2,931,259 (U.S.). But, while Swissair shows a lower figure for transported passengers per kilometer, Iberia has more personnel and a lower productive mileage rating than Swissair. One important indication exhibited by these figures is that 9,000 extra Iberia personnel over the Swissair figure may be in excess of actual company needs. This is not the first time a suggestion has been made that Iberia could reduce the number of its employees in order to cut excess company costs.¹²⁵ But there are other areas

¹²³ *Iberia es una de las líneas aéreas menos productivas del mundo*, LA GACETA, Sept. 24, 1990, at 8 (publishing a 1990 Instituto de Transporte Aéreo (Spain) Study).

¹²⁴ Instituto de Transporte Aéreo (ITA) (Institute of AirTransport) (1990).

¹²⁵ In 1992, Iberia announced that top management salaries would be frozen. Antonio Ruiz del Árbol, *Iberia decide congelar los sueldos de sus altos cargos y directivos en 1993*, CINCO DÍAS, Nov. 5, 1992, at 12. In 1993, Iberia proceeded to freeze its employee salaries while simultaneously claiming that the salaries of its 1200 pilots, a minority of the company's total 26,500 employees, comprised the greatest percentage of the total salary figure paid to all employees, pilot salaries being the highest ranging from 7 to 20 million pesetas annually. Celedonio Sanz, *La conge-*

for cutting costs: diminishing or eliminating free travel benefits amounting to an estimated 430,000 air tickets or 10 billion pesetas annually, consumed by Iberia's 23,500 employees and their relatives, not to mention the added free flight benefits allocated to high level government officials and parliamentary members.¹²⁶ It is also important to note that in 1994 when Iberia management and employees signed a viability plan to avoid imminent bankruptcy, company workers accepted an average salary cut of 8.5% and a reduction of 3,500 employees in exchange for the terms and conditions Iberia promised to meet in re-vamping and restructuring its executive and board management and business activities.¹²⁷

B. IBERIA'S STRATEGIES IN THE WAKE OF EUROPEAN DEREGULATION

Domestic air tariffs in Spain are approved by the Ministry of Fiscal Affairs, while Iberia's possibilities to invest are controlled by the Ministry of Industry. This implies that in the absence of a single authority to decide both tariff and investment issues, it is often the case that such decisions are based on little coordination and may sometimes even contradict themselves. Hence, one suggested strategy for the carrier and its affiliates is to coordinate the decision-making powers affecting them within a single governmental or private authority.

lación salarial en Iberia marcará la línea al sector público, CINCO DÍAS, Feb. 25, 1993, at 6. By the end of the same year, Iberia management claimed that it was overstaffed by 132 pilots or 10% of their total number. Antonio Ruiz del Árbol, *Iberia dice a los sindicatos que le sobra el 10% de los pilotos*, CINCO DÍAS, Dec. 10, 1993, at 10. It may be questioned, however, whether reducing pilot staff alone, in light of their high salaries, is the soundest and most comprehensive restructuring standard to use given the following salary comparisons between Aviaco, an Iberia affiliate, and other airlines:

Pesetas (000,000)

	<u>Pilots</u>	<u>Flight Attendants</u>	<u>Land</u>
British Midland	10.4	3.31	4.07
Air U.K.	10.4	3.31	4.07
Lufthansa City Line	11.5	3.56	—
Aviaco	18.0	5.53	4.75

Germán Temprano, *Aviaco soporta un sobrecoste salarial de 7.000 millones sobre sus competidoras*, GACETA DE LOS NEGOCIOS, Nov. 27, 1995, at 5.

¹²⁶ Maribel Rodrigo, *Iberia: diez mil millones en billetes gratis*, EXPANSIÓN, Sept. 15, 1995, at 6.

¹²⁷ *¿Tiene sentido Iberia?*, EL PAÍS, Nov. 12, 1995, at 14.

Other strategies for success would reasonably focus on fully capturing the north-south European travel market, particularly that catering to tourism. Along the same principle, charter flights that cater to the same market will present Iberia with its greatest competition, especially since in 1988 more than 39 million passengers flown into Spain were transported by international flights, of which 72.8% were charter, non-regular flights.¹²⁸

At the national level, Iberia and its affiliates currently are the only carriers servicing regular travel demands. With the onset of air transport liberalization in Europe and its elimination of licensing concessions by Member States, increased competition is expected from newly established regional European carriers and from charter companies newly converted to serve regular travel markets. The more heavily traveled national routes will be affected first. Moreover, national rail, road, and air travel can be better coordinated through tax incentives and selective investments in these networks, in order to increase the efficient operation of Iberia and best meet consumer demands.

At the international level, Iberia's success will depend on the competitive cost structure it establishes relative to that of European and North American competitors. This will involve what is already apparent: the need to restructure the company and renegotiate salaries in order to lower operating costs. Airport handling activities, moreover, will change from exclusive control to open competition, thus obliging Iberia to ensure quality controls and innovate airport autohandling methods in order to continue servicing the desired market while recognizing the inevitable entry of competitors to this service area.¹²⁹

V. CONCLUSION

Having compared the distinct deregulation approaches between Europe and the United States, air transport liberalization in Europe cannot replicate the United States experience. Nonetheless, the progressive relaxation of competition rules by both the European Commission and bilateral agreements among Member States will have similar consequences to those experienced in the United States. Spain, along with other Member

¹²⁸ CARBAJO & DE RUS, *supra* note 20, at 45.

¹²⁹ Carlos Ocaña Pérez de Tudela, *Comentarios a las propuestas del Tribunal de Defensa de la Competencia para la liberalización de los servicios*, 86 CUADERNOS DE INFORMACIÓN ECONÓMICA 42 (1994).

States, will develop hub-spoke routing, increasingly competitive tariffs, and, as is permitted under the Commission's authority, an increase of company mergers to take place on the basis of purely economic, and not national protectionist, justifications. In the wake of these deregulation measures, the success of Iberia Airlines and its affiliates depends greatly on their ability to maintain a competitive tariff structure relative to costs, especially in relation to its closest competitors, including but not limited to charter companies that increasingly will service regular travel demands. Iberia's success will also depend on its ability and sustained flexibility over time to introduce new products into its markets, thus contributing to the European Economic Community. An eventual transnational alliance also promises to benefit global consumer groups, even if such an alliance is at this time a lesser priority than the urgency for Iberia to contain its costs and compete at maximum efficiency.

