

Liberalizing Air Transport Regulation in the People's Republic of China

by

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ABSTRACT

Through a comparative study of the aviation policies in the principal countries of North America (the United States) and Europe (Germany), this thesis will examine China's aviation policy and its situation in the trend toward liberalization, placing special emphasis on bilateral agreements.

This thesis will describe the historic evolution of the economic regulation in civil air transport that laid the foundation for bilateral air transport service agreements and the Open Skies regime. Moreover, the development of bilateral air services agreements, from the Bermuda Agreements to the U.S.'s "Open Skies" Policy, is addressed. Then, a study of the ICAO actions toward liberalization is undertaken.

An analysis from the deregulation, privatization in the American and E.U.'s aviation market to the reform in the Chinese civil aviation is conducted. Under the impact of the global liberalization trend, the Chinese aviation industry is creating a "deepen, widen" reform. Specifically, China Southern's imminent entrance into *SkyTeam* will significantly push the Chinese aviation policy toward liberalization. A detailed comparative study of bilateral air transport agreements between China, the United States, and Germany will show the recent progress of the Chinese aviation policy.

Finally, an argument for the separation of air cargo from air passengers in the liberalization process, especially for China's negotiation of bilateral agreements, is presented.

RÉSUMÉ

Par le biais d'une étude comparative des politiques de transport aérien d'un pays nord-américain – les États-Unis – et d'un pays européen – l'Allemagne, le présent mémoire passe en revue la politique de transport aérien de la République populaire de Chine et la place dans la perspective des tendances actuelles de libéralisation, mettant particulièrement l'accent sur les accords bilatéraux de transport aérien.

Ce mémoire retrace l'évolution historique de la régulation économique du transport aérien civil, sur laquelle repose les divers accords bilatéraux relatifs aux services aériens, de même que le régime de « ciel ouvert ». Le développement des accords bilatéraux relatifs aux services aériens, depuis le premier Accord des Bermudes (*Bermuda I*) jusqu'à la politique étasunienne de « ciel ouvert », est également étudié. Suit une analyse des démarches entreprises par l'OACI en vue de libéraliser le transport aérien.

L'auteur examine les impacts des mouvements de libéralisation et de privatisation, constatés aux États-Unis et dans l'Union européenne, sur le processus de réforme de l'aviation civile chinoise. Sous l'impulsion de la tendance mondiale de libéralisation, l'industrie chinoise du transport aérien se dirige vers une réforme « large et profonde » de son environnement concurrentiel. Plus particulièrement, l'avènement prochain de la ligne aérienne China Southern au sein de l'alliance SkyTeam est susceptible d'infléchir

significativement la politique chinoise de transport en faveur de la libéralisation. La comparaison des accords bilatéraux conclus entre la Chine, les États-Unis et l'Allemagne démontre les progrès récemment accomplis par la Chine à cet égard.

Enfin, ce mémoire propose, dans une perspective de libéralisation, la distinction des activités de transport de fret de celles du transport de passagers, tout spécialement en ce qui concerne la négociation par la Chine d'accords bilatéraux.

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INTRODUCTION

The Wright Brothers, who, more than a hundred years ago, were the first men to fly in a heavier-than-air vehicle, could not have understood the impact their invention would have on the world. Humankind developed the technology of the Wright Brothers' 38.9 km journey¹ to soar mightily across large continents, high mountains, and vast oceans.

The boom of the world's industry has drastically altered our lives. More than half a century ago, students who wished to travel from China to study in North America were confined to ships for the months-long trek across the ocean. Today, the same trip takes a mere 13 hours² on a Boeing 747.

The culture and science of government regulations contribute to the advancement of the knowledge and development of society. The government is the entity who makes the decision and who supervises it in the practice for all the industries. It shows that the government plays an important role in the development of every modern industry, including air transport industry.

Meanwhile, we should realize that the government regulation in any country is not changeless. There is no all-inclusive law or regulation that can cover the endless facts and details that affect every situation. Therefore, we should examine the issues about government regulation on air transport based on current practices and look ahead, especially when we study Chinese regulations.³

¹ In October 1905, they made the longest flight of the year covering 38.9 km in 38 minutes and terminated by a lack of gasoline. See Benjamin Freudenthal, "Back to Kitty Hawk-1900 and 1903, The Wright brothers and their Contemporaries" online: <http://www.flyanddrive.com/wright02.htm> (Last visited on November 28, 2004)

² Nonstop flight from Beijing, China to New York City, the U.S.

³ When we study Chinese regulations, we should have some basic knowledge about the current Chinese government's dominant theory—"DengXiaoping Theory." The Communist Party of China decided to hold

According to Chinese government's dominant theory⁴, although governments are the decision-makers and the regulatory authorities, they must make decisions according to the market oriented economic theory—the government is not the only actor in a free market economy; without private/cooperative/commercialized companies, the financial market would lose its vigor.⁵

In the air transport regulation system, on one hand, governments use the “ownership and control” clause to link airlines and governments; on the other hand, airlines themselves build alliances in order to maximize their gains and expect the realization of liberalization. The liberalization trend is allowing the aviation industry to reach its true potential, however, governments are often inherently conservative in matters of international relations.⁶ Since historical reasons, the conservative attitude was

the banner of DengXiaoping Theory high on her 15th National Congress in 1978, considering Deng Theory the only one that can solve the future and testing of socialism. Such theory is the direction for the development of all the industry in China in the recent decade years.

The idea used in this paragraph is that “comment on an issue based on current practices, to be practical and realistic.” It also emphasizes the principle of “the development is everlasting truth.” The meaning of such principles is that: the current Chinese society is under reformation; through reformation, the whole Chinese society will develop to be a strong nation in the world; development is the objective order, which is unavoidable; the difficulties and disorderly situation are temporary, while development will be reached at the end of Chinese reformation.

⁴ Chinese industries withhold DengXiaoping Theory and the important theory of “Three Represents” as their guidance all along.

⁵ This is the main idea of Mr. DengXiaoping's “modern market oriented economy theory.” This theory is the direction for the reform and development of all the industries in China. It introduces a competitive mechanism, breaks monopolization system, and positively advances the separation between power plant and grid, and competition on the market. All the industries should draw up and apply “Management by Objective, Supervision and Execution, Organization and Ordination, Right and Responsibility in Position” as their Management Policy; “Safety Production as the Foundation, Economic benefits as the Heart, Marketing-oriented Development, Mechanism Innovation as the Driving Force” as Operation Policy; “Staff is most important, Team Spirit, Post Responsibility, Healthy Environment” as Cultural Concepts; “Unyielding Integrity, Commitment to Performance that reflects and enterprise or individual's value and is the basis to assess or praise, Standardized management, Embrace Change” as Enterprise Value Viewpoint; “Self-pressurized Liability Spirit, Team Spirit, Contribution Spirit, Innovative Spirit” as Enterprise Spirits.

⁶ “The fact that governments are inherently conservative in matters of international relations, and the fact that aviation's true potential was just being realized, it is not surprising that there was a convergence of governmental interests in creating an international air transport system premised on creating, requiring and protecting national airlines.” See Milan A. Racic, *The Evolution of Global Airlines*, (LL.M. Thesis, McGill University, 1996) [unpublished], at 23.

expressed stronger in China than the western countries.⁷

Nevertheless, the most complex relationships are not between governments and airlines, but rather between different governments. Bilateral negotiation in the aviation field began with Bermuda I and has not stopped since. By analyzing the bilateral air transport agreements, we can ascertain the contracting parties' economic development, political position, history, and cultural background. For example, when we examine the bilateral agreements signed by China, we should realize that the conservative attitude of Chinese government is based on Chinese air transport industry's undeveloped economic basis. The slow developing process of bilateral relations between China and foreign countries is because China just began to adopt "the Open and Reformation Policy" in 1978.⁸

Liberalization has been a hot topic in international air transport regulation. The saturation of the developed countries' national aviation markets has left the developing countries as the biggest emerging potential aviation market. The relative degree of saturation has an important impact on the future demand for air transport in some markets. "On the basis of per capita travel measured in RPMs (revenue per passenger miles), North America appears to be the most mature market, with 1,740 RPMs per capita in 1990 compared to 475 in Europe and only 75 in the Asia-Pacific region."⁹ This data shows that the U.S. market was closer to saturation more than ten years ago, while the Asia-Pacific market still appears to have the potential for rapid growth.

⁷ Looking back to the history of China, there was a "Close door" Policy used both before the P. R. China government and in a long period of the R. R. China government. Actually, "the Open and Reformation Policy" of Deng Xiaoping Theory, just began to practice in China from the end of 1970s.

⁸ See *supra* note 3,4,5,7.

⁹ Wolfgang Michalski, Michel Andrieu & Barrie Stevens, "New Policy Approaches to International Air Transport: Main Issues and Summary of the Discussion" (1993) in the Book: Organisation for Economic Co-operation and Development, *International Air Transport: The Challenges Ahead* (France: OECD, 1993) at 11.

The analysis in this thesis will focus on liberalizing civil aviation regulation from a global perspective, with special emphasis on bilateral agreements in China, Asia's largest country.

This study proposes to study China's aviation policy in the context of global liberalization. Indeed, China has shifted from deciding whether to liberalize to deciphering how to liberalize. This analysis will be developed in four chapters.

Chapter I will present the basic structure of international air transport regulations. This chapter aims to outline the manner in which the legal background has influenced the global aviation industry's development. It includes a discussion of the Chicago Conference's *1944 Convention of International Civil Aviation* and how its basic provisions impact the emergence and development of bilateral agreement; a review of the history of Bermuda I and II and Open Skies bilateral agreements; an analysis of future development; and a description of the ICAO's actions toward liberalization.

Chapter II will examine deregulation and privatization, the main milestones in the road toward liberalization. After a review of the ownership and control principle and the development of deregulation in civil aviation, particularly in the United States and the European Union (EU), the core of Chapter II will focus on Chinese air transportation reform. This analysis will address the entrance of Chinese airlines into global airline alliances and will try to predict the future of Chinese airlines.

Chapter III will study, in detail, bilateral air transport agreements, which form the link between nations. "Even today, international flights only operate where authorized by a treaty between the nations served"¹⁰ or some other agreements. Among the huge number

¹⁰ Gabriel S. Meyer, "U.S.-China Aviation Relations: Flight Path Toward Open Skies?", *Cornell Int'l L. J.* 427 35 (2001-2002) at 428. Also see n. 6, Gerald L. Baliles, *Fear of Flying: Aviation Protectionism and*

of such agreements, this thesis highlights those between China and the U.S., China and Germany, and the U.S. and Germany in order to perform a comparative study of the bilateral aviation relations between China and America/Europe. Europe and America together easily account for well over half of the world's air traffic. According to the Economist, "If Europe and America can shed the rules and completely liberalize the airspace, the rest of the world will be forced to follow. ...Global takeover will then be possible, leading to consolidation and economies of scale. From this, a handful of mega-airlines could come to rule the skies."¹¹ The negotiation situation improved the air transport relations between China and these two regions and demonstrated their developing progress towards liberalization.

Due to the special characters of air cargo as opposed to passengers, Chapter IV will focus on china considering separate "Open Skies" agreements for cargo and passenger. This is based on the fact that the author believes that air cargo services will finally go to a separate negotiation table in the liberalization process.

Finally, the conclusion submits that globalization has been an overriding trend in the global market economy, as well as in the aviation industry. Liberalization has resulted in stronger air links to global markets, an important goal for export-oriented economies. In the light of continued deregulation and liberalization of air services, advanced communication and information technology, the globalization of markets, the international alliances, and the privatization of airlines, the airports and air traffic control services that are the main factors challenging civil aviation authorities, airlines, and airports, Chinese civil aviation will fall into step with the rest of the world for its own

Global Growth, Foreign Affairs, May/June 1997, at 8.

¹¹ "Open Skies and Flights of Fancy", *The Economist* (4 October 2003) 65.

national and public interest. Indeed, the Chinese aviation market is an indispensable part of the world market. The development of Chinese aviation policy will impact not only the Asia-Pacific area, but also the whole world.

Chapter I: The Basic Structure of International Air Transport Regulations

1. The Chicago System: Sovereignty and Freedom are the Pillars of the Bilateral Agreement

International aviation has been shaped by the Chicago Convention of 1944 and, thereafter, by the emergence of Bilateral Air Transport Agreements. Any analysis of government regulation of the aviation industry must include a short presentation of how this legal background influenced the thinking of the global aviation industry. Bilateral negotiation is, in essence, the bargaining of Freedoms based on the equalities and sovereignties of different countries; therefore, this chapter focuses on the principle of air sovereignty and Freedoms.

1.1 The Principle of Sovereignty over the Air Space

The recognition of the complete and exclusive sovereignty of any State over the airspace above its territory constitutes a well-established principle. From customary law to Article I of the Paris Convention of 1919¹² and Article I of the Chicago Convention of 1944¹³, the principle of air sovereignty is repeated and endorsed.

Article 6 of the Chicago Convention adds, “No scheduled international air service

¹² *Convention Portant Réglementation de la Navigation Aérienne (Convention Relating to the Regulation of Aerial Navigation)*, Paris, October 13, 1919, 11L.N.T.S. 173.

¹³ *Convention on International Civil Aviation*, 7 December 1944, 15 U.N.T.S. 295, ICAO Doc. 7300/6, ann.7. [hereinafter: *Chicago Convention*] Article I: “The contracting States recognize that every State has complete and exclusive sovereignty over the airspace above its territory.”

may be operated over or into the territory of a contracting state except with the special permission or authorization of that state,” thus denying scheduled international service the basic ‘right to fly.’ Article 6 requires that carriers must get special permission or authorization from the country over or into which it wants to fly; however, the Article does not provide any definition or detailed explanation of such special authorization. In practice, bilateral agreements between countries are concluded to address such matters. Article 6, the “Charter for Bilateralism”¹⁴, is deemed a monument to the 1944 Chicago Conference’s failure to reach any consensus by any party on air transport matters in general and the granting of traffic rights via multilateral exchange specifically.¹⁵ In this way, this Article 6 enshrines the bilateral system of the exchange of traffic rights to a greater extent than does Article 1 of the 1944 Chicago Convention.

“The fundamental underlying principle” that “all States should be able to participate in air transportation on a basis of equality”¹⁶ render these Articles the status as the pillars of the Chicago Convention, as they insist that no international air transport activity can be conducted by any State or by nationals of any State to or from the territory of another State without the latter’s consent. As observed by Bin Cheng, “the now firmly established rule of international law that each State possesses complete and exclusive sovereignty over the airspace above its territory means that international civil aviation today rests on the tacit acquiescence or express agreement of the States flown over.”¹⁷

These Articles have created a system in which the exchange of traffic rights between States is done on a bilateral basis via Bilateral Air Transport Agreements. The Chicago

¹⁴ Yoshinori Ide, *Liberalization of International Air Transport In the Japan-US Market*, (LL.M. Thesis, McGill University, 1998) [unpublished] at 5.

¹⁵ See N.M. Matte, *Treatise on Air-Aeronautical Law* (Toronto: Carswell, 1981) at 141, n. 49.

¹⁶ I. Diedriks-Verschoor, *An Introduction to Air Law* (The Hague: Kluwer, 1997) at 11.

¹⁷ Bin Cheng, *The law of International Air Transport*, (New York: Oceana Publications, 1962) at 3.

Convention failed to globally organize the economic regulation of air transport. Still, in terms of regulation, the sovereignty principle contributed to the emergence of the bilateral agreements, or, by extension, regional multilateral agreements, by which air transport should be governed.

Politically, the air sovereignty principle ensured that national governments would play a dominant role in the economic and political development of international civil aviation.¹⁸ As was demonstrated in the Chicago Convention, sovereignty remains a powerful concept that colours attitudes to many aspects of international air transport in the minds of regulators. "It is the national governments that give the definition of transit and landing rights for airlines, which want to operate in or above their territory."¹⁹ This principle, however, is also under great pressure to adjust to new realities.

The economic consequence of the sovereignty principle is that it excludes access to foreign markets unless it is specifically granted by the State concerned. In other words, any State can forbid international air commerce in its airspace. "However, the practical co-operation of States, the integration of their economies and of their political institutions gradually permit a less rigid and more co-operative understanding and application of the concept of complete and exclusive sovereignty. It is a sovereign right of a State to freely accept a restriction on its own sovereign rights for mutual benefit."²⁰ The Chicago Conference tried to reach a multilateral understanding between States regarding the exchange of commercial aviation rights at the level of traffic freedom rights.

¹⁸ See P.S. Dempsey, *Law and Foreign Policy in International Aviation* (New York: Transnational Publishers, Inc., 1987), at 8.

¹⁹ *Ibid.* at 8. See also O. Lissitzyn, *International Air Transport and Policy* (New York: Council on foreign relations, 1942) at 365.

²⁰ Michael Milde, "The Chicago Convention – are major amendments necessary or desirable 50 years later?" (1994) 19 *Ann. Air and Space Law*. 401.

1.2 Freedoms

The irony of liberalization in today's airline industry is that almost every airline remains imprisoned in terms labeled as Freedoms, which are in reality, restrictions. It embodies one of the "Limited" factors of the "Partial" Open skies.²¹ Such concepts could go back to the Chicago Conference of 1944.

1.2.1. Five Freedoms in International Agreements

The Chicago Convention guarantees no universal freedom to fly. Article 5 offers some leeway in that it allows a Freedom for non-scheduled flights; however, it offers no Freedom in which scheduled flights can be conducted. The multilateral International Air Transport Agreement²² makes explicit the possibility of allowing greater freedom of movement. Through this agreement, the States grant each other five categories of traffic rights.²³

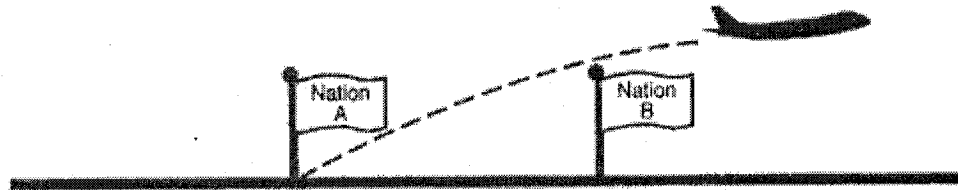
²¹ "The ever ubiquitous U.S. open skies policy should be relabeled limited or partial open skies because there are six areas in which it falls short of a fully liberalized aviation market, to wit: Foreign ownership restriction, Right of Establishment restriction, Seventh Freedom Rights Restrictions, Prohibition on cabotage traffic, Fly American Act, Wet leasing restrictions." See Roberto C. O. Lim, "Beyond Open Skies is True Open Skies" Paper presented to the Worldwide Conference on Current Challenges in International Aviation (September 2004) [2004].

²² *International Air Transport Agreement*, 7 December 1944, 171 U.N.T.S. 387, US Department of State Publication 2282. As of 30 June 2004, 121 Contracting States are parties to the Air Transport Agreement.

²³ The first two Freedoms are the right to land for technical purposes without picking up or letting off revenue traffic.

- 1) The right to fly across the territory of another State without landing.²⁴

First Freedom



- 2) The right to land in another State for non-traffic/technical purposes.

Second Freedom



- 3) The right to carry revenue traffic from its own country of registry to another country.

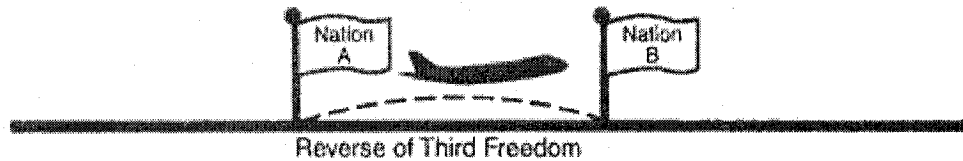
Third Freedom



²⁴ See Adrianus D. Groenewege, *Compendium of International Civil Aviation*, 2nd ed. (Montreal, Quebec: International Aviation Development Corporation, 1998) at 47-48, for the figs of Eight Freedoms and more explanation.

- 4) The right to carry revenue traffic from another country to its own country of registry.

Fourth Freedom



- 5) The right to carry revenue traffic between two countries outside its own country of registry as long as the flight originates or terminates in its own country of registry.

Fifth Freedom



The majority of the nations at the Chicago Conference agreed that a certain amount of Fifth-Freedom traffic was essential to the profitability of many international air routes; however, the nations represented at Chicago were unable to reach an agreement about the economic structure of postwar civil aviation.²⁵ Very few countries adopted the

²⁵ The U.S. viewed a multilateral granting of all five Freedoms with no capacity or frequency restrictions as being consistent with its stated goal of open competition in the marketplace. The U.K. maintained that such a system would confer upon the U.S. a near-monopoly on a number of major international routes. The Europeans feared that a multilateral granting of Fifth-Freedom rights with no limitations on capacity would

International Air Transport Agreement in 1944, and the five commercial rights did not gain universal recognition.

Another multilateral agreement, the International Air Services Transit Agreement,²⁶ was drawn up at the same time. This Agreement granted the first two Freedoms; most States became signatories. Ultimately, of the five proposed Freedoms, the majority of the States attending the Chicago Conference only adopted the first two.

From that point forward, bilateral systems comprise the same Freedoms that were set out in the bilateral air service agreements. Certain traffic rights were granted to various airlines from each side. Generally, the Third and Fourth Freedom rights are present in almost all bilateral air service agreements. The Fifth Freedom is being exchanged in an increasing number of agreements.

1.2.2. The Sixth, Seventh, and Eighth Freedoms

The Freedoms do not stop with the abovementioned Five. Currently, although there is no official recognition, the Sixth, Seventh, and Eighth Freedoms receive more attention than the traditional ones:

The Sixth Freedom can be regarded as a combination of Third and Fourth Freedoms.

It is the right of one State to carry traffic between two foreign States via its own country

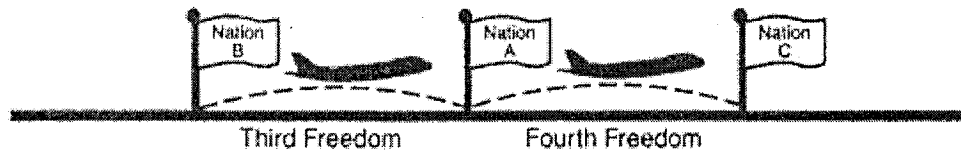
provide U.S. carriers with unlimited access to the European carriers' most valuable traffic. See Dempsey, *supra* note 18, at 12.

The Chicago Convention did not establish measures of the economic regulation of international transport and disagreed on principles pertaining to international air traffic rights, allocation of routes, capacity and frequency of services, as well as the establishment of international fares and rates. The Chicago Conference therefore agreed that the old IATA (established in 1919) should be reinstated as a worldwide organization of airlines operating scheduled services under a different name. The revisioned IATA was given the responsibility of establishing fares, rates, and charges for the carriage of passengers, baggage, and cargo (air mail was not included because of assigned role of UPU).

²⁶ *International Air Services Transit Agreement*, 7 December 1944, 84 U.N.T.S. 389, ICAO Doc. 7500. As of 30 June 2004, only 11 Contracting States were parties to the Air Services Agreement.

of registry.

Sixth Freedom (Combination of Third & Fourth Freedoms)



The Sixth can also be seen as a special form of the Fifth Freedom, because both the points of origin and of destination of the traffic are outside of the country of registry. In this way, the restrictions that apply to the Fifth Freedom should also apply to the Sixth. However, as a combination of the Third and Fourth Freedoms, the Sixth Freedom would be more easily attainable by developing countries under the Open Skies regime. For example, China's traffic rights only include the first five Freedoms. It would be easier to encourage China to accept the Sixth Freedom if it were presented not as an advanced Freedom, but rather as an extension of the Third and Fourth Freedoms, which are already included in almost all of the agreements signed by China. The contention surrounding the Sixth Freedom ceases to exist under the Open Skies regime, as it imposes no restrictions on the Third, Fourth, and Fifth Freedoms.

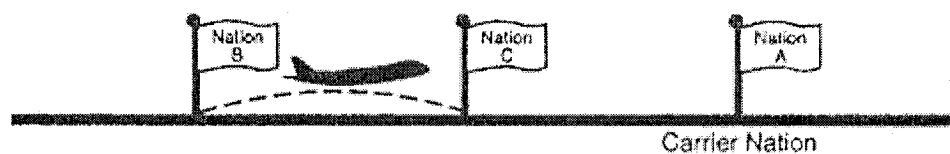
Geographically, the Sixth Freedom right might confer on some small States or special cities the advantages of being international hubs.²⁷ In such places where the domestic market is limited, (e.g., the Netherlands, Singapore), the prospect of opening the domestic market in favour of gaining an international one is a good trade-off. The major airports of such optimal locations become international hubs at which the local airlines

²⁷ See Hong Hu, *Open Skies and Its Recent Impact on the Asia-Pacific Region*, (LL.M. Thesis, McGill University, 1997) [unpublished] at 24.

can attract a larger volume of traffic to, from, and through their country. Furthermore, they can achieve the means to strengthen their air carriers. Singapore, the first Asian country to sign an Open Skies agreement with the U.S., is one such example, as its geographical situation makes it possible to enjoy the benefits of the Sixth Freedom exchange.²⁸ However, since China is a large country of 9600,000- km.² territory and it has a pretty broad domestic market, she will not have the same rationale as Singapore does towards the Sixth Freedom right. Until now, China has not granted the Sixth Freedom right to any country.

The Seventh Freedom concerns airlines whose operations take place entirely outside of their countries of registry. It assures the right to fly into another country to discharge or take on traffic that is coming from or destined for a third country.

Seventh Freedom



The Seventh Freedom can be seen as the Fifth or Sixth Freedom without the stop in the country of registry. The absence of a link with the Third and Fourth Freedom and the lack of a requirement for a plane to connect to its home country will enable the foreign carrier to save the network costs of operating services between foreign countries. Nevertheless, the Seventh Freedom seldom appears in the bilateral agreements.²⁹ There

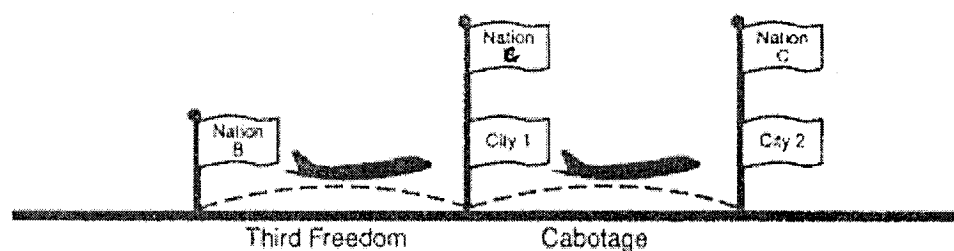
²⁸ *Ibid.*

²⁹ The ICAO has reported that only 50 bilateral agreements grant the Seventh Freedom for all cargo services. See ICAO Working Paper (Worldwide Air Transport Conference: Challenges and Opportunities of Liberalization) No. AT Conf/5-WP/21 (3 March 03).

are some legal and economic reasons for the exclusion. In Asia, for example, the ASEAN Action Plan has no program to offer the Seventh Freedom to ASEAN or non-ASEAN carriers, because “a liberal foreign investment policy together with a principal place of business test are more attractive strategies to bring significant investment and employment benefit in the aviation sector.”³⁰

The Eighth Freedom is cabotage. “In international law, cabotage was originally held to apply to a State that reserves itself the right to restrict all coastal navigation between two points within its territory for the exclusive use of its own subjects.”³¹ Aerial cabotage “applies to air transport between any two points in the same political unit, that is to say, in the territory of a State as the term is used in air law.”³² “Most bilateral air transport agreements dealing with the matter of cabotage reserve the carriage of domestic traffic to national airlines.”³³ The objective of the Eighth Freedom is to protect the State’s own domestic air transport participant.

Cabotage (Eighth Freedom)



³⁰ Lim, *supra* note 21, at 8.

³¹ I. Diedriks-Verschoor, *supra* note 16, at 18.

³² Bin Cheng, *supra* note 17, at 314.

³³ Peter P.C. Haanappel, *Pricing and Capacity Determination in International Air Transport* (Boston: Kluwer Law and Taxation Publishers, 1984) at 12.

This concept of Eighth Traffic Freedom was broadly interpreted in Article 7 of the *Chicago Convention*:

Each contracting State shall have the right to refuse permission to the aircraft of other contracting States to take on in its territory passengers, mail and cargo carried for remuneration or hire and destined for another point within its territory. Each contracting State undertakes not to enter into any arrangements which specifically grant any such privilege on an exclusive basis to any other State or an airline of any other State, and not to obtain any such exclusive privilege from any other State.³⁴

In terms of commerce, the first sentence of Article 7 is merely a restatement of the sovereignty principle. States may refuse to give cabotage traffic rights to airlines belonging to other contracting States. The second sentence of Article 7 can be deemed as a sort of Most Favored Nation clause, in that the State granting the right to one State would have to do the same for every other State.³⁵ If a State permits cabotage, it cannot do so on an exclusive basis; therefore, cabotage was deemed an obstacle to free aviation.³⁶

Due to the lack of consent at the Chicago Convention on the manner in which traffic

³⁴ *Chicago Convention*, *supra* note 13, art. 7.

³⁵ It prohibits States from specifically granting exclusive cabotage rights to any other State or any airline of another State. The "specific" granting of the privilege on an "exclusive" basis, means that other States cannot ask for more than that specific route with exactly the same frequency. See P. Mendes de Leon, *Cabotage in Air Transport Regulation* (London: Martinus Nijhoff Publishers, 1992) at 37-53. See also Douglas R. Lewis, "Air Cabotage: Historical And Modern-Day Perspectives" (1979-1980) 45 J. Air L. & Com. 1064.

³⁶ See e.g. D. Goedhuis, "The Cabotage Concept in Aviation" (1952) 1 Review of the World Aviation. 41. & (1952) 2 Review of the World Aviation. 97.; W.M. Sheehan, "Air Cabotage and the Chicago Convention" (1980) Vol Harvard Law Review. 1157.; L. Lewis, "Air Cabotage: Historical and Modern-day Perspectives" [1980] J.A.L.C. 1059.

rights, routes, and capacity should be allocated and in which the fares should be fixed, the commercial regulation of international aviation was left to the bilateral interests of individual States. The word “commercial” should be stressed, inasmuch as, at Chicago, there was no doubt that the air would not be free in the political sense.³⁷ Since then, States have used bilateral agreements to exchange “commercial” traffic rights with other States.

2. The Development of Bilateral Air Services Agreements

2.1 The Bermuda Agreements

Traffic rights are exchanged through bilateral agreements, which may be defined as “international trade agreements in which governmental authorities of two sovereign States attempt to regulate the performance of air services between their respective territories and beyond.”³⁸ The first major agreement was concluded in 1946 between the U.S. and the U.K. “Bermuda I”³⁹ resulted in a certain structure and pattern of how States could achieve their rights.

The Bermuda I Agreement represented an essential compromise between the world’s two leading civil aviation powers,⁴⁰ a compromise between the liberalization of the U.S. and the virtual protectionism of the U.K. It was typified by its restrictive pricing regime and its liberal capacity arrangements and route descriptions. For instance, it determined that capacity should bear a strong and close relationship to the requirements

³⁷ See Lim, *supra* note 21, at 10.

³⁸ Peter. P. C. Haanappel, “Bilateral Air Transport Agreements: 1913-1980” (1979) 5 Int’l Trade L.J. 241 at 241.

³⁹ *Agreement between the United Kingdom and the United States*, 11 February 1946, 3 U.N.T.S. 253, 60 Stat. 1499, T.I.A.S. No. 1507 [hereinafter *Bermuda I*].

⁴⁰ Dempsey, *supra* note 18, at 57.

of the public for air transport,⁴¹ but called for *ex post facto* review rather than predetermination of capacity.

Bermuda I reinforced the role of national governments in formulating international civil aviation policy. Although the task of tariff-setting was given to the International Air Transport Association (IATA), the tariff-setting clause gave governments a basis upon which they could formulate their own civil aviation policies. At times, this led to a State's adoption of an unduly restrictive stance on its sovereignty in airspace, thus prompting frequent State withdrawals of the air traffic rights that were being enjoyed by airlines. This was deemed a shortcoming of Bermuda I.⁴² For example, in 1975, the United Kingdom Government refused to grant the United States-flag carrier TWA the right to add London to its beyond-point service.⁴³ Similarly, in the 1970s, despite the existence of a valid and effective bilateral between Australia and Sri Lanka, Australia refused Air Lanka market access and entry into the country, arguing that there was no justifiable and predetermined traffic potential between the two countries. Sri Lanka did the same to Jordan.⁴⁴

Nevertheless, over the next thirty years, Bermuda I became the prototype for bilateral air transport service agreements worldwide.⁴⁵ In the years following WWII, many new States with largely underdeveloped aviation industries sought to protect their

⁴¹“Under the agreement, while the U.S. compromised by withdrawing its opposition to the international regulation of fares, and agreed that primary fare-setting functions should devolve upon the International Air Transport Association (IATA), the U.K. agreed to retract its earlier position that capacity should be regulated, and recognized that airlines should be allowed to regulate capacity by determining their frequency on a given route, provided that governments were the ultimate arbiters of the control of capacity on the routes that were relevant to their territories.” See Ruwantissa I.R. Abeyratne, *Emergent Commercial Trends and Aviation Safety* (London: Ashgate Publishing Ltd., 1999) at 13.

⁴² *Ibid.*

⁴³ See Bin Cheng, *supra* note 17, at 386-389.

⁴⁴ Email from Mr. Abeyratne (29 October 2004).

⁴⁵ Dempsey, *supra* note 18, at 57. See also Peter. P. C. Haanappel, *supra* note 30.

airlines from competition by insisting on the equal sharing of traffic rights.⁴⁶ The 'predetermination of capacity' system in their bilateral agreements⁴⁷ replaced the Bermuda I capacity provisions.

Britain denounced the Bermuda Agreement in 1976, and, in 1977, signed the new "Bermuda II"⁴⁸ Agreement with the United States. Bermuda II contained a system of multiple designations of airlines by one State and other liberal provisions, which toned down the harshness of the capacity and route designations of its predecessor. The Agreement's "primary objective" is Third and Fourth Freedom traffic, while limiting that of the Fifth Freedom.⁴⁹ The Agreement was of the "predetermination" type, for it limited the airlines to adjusting their capacity or operations only within the Freedom predetermined by the Agreement.⁵⁰ Senate Commerce Committee Chairman Howard Cannon described Bermuda II as "the greatest step backward in forty years of attempting to bring market-oriented competition to international aviation."⁵¹

In conclusion, neither Bermuda I nor Bermuda II became a "model" for modern-day bilateral air transport agreements. Despite the existing prototype of bilateral air transport service agreements, no two agreements are exactly alike; each reflects the level of development of each country's aviation industry and aviation policy.⁵² At present, air

⁴⁶ B. Cheng, *supra* note 17, at 241.

⁴⁷ Peter. P. C. Haanappel, *supra* note 33, at 35.

⁴⁸ *Agreement Between the Government of the Kingdom of Great Britain and Northern Ireland and the Government of the United States of America Concerning Air Services*, 23 July 1977, 28 U.S.T. 5367, T.I.A.S. No. 8641 [hereinafter *Bermuda II*].

⁴⁹ See Sean McGonigle, *Comparative regulation of air transport in the Asia-Pacific region* (LL.M. Thesis, McGill University, 2003) [unpublished] at 15. See also P. Mendes de Leon, "Before and After the Tenth Anniversary of the Open Skies Agreement Netherlands – US of 1992" (2002) 28 *Air & Space L.* 281.

⁵⁰ *Ibid.*

⁵¹ P. S. Dempsey, "Turbulence in the "Open Skies": The Deregulation of International Air Transport" (1987) 15 *Trans. L. J.* 332.

⁵² Professor P. S. Dempsey mentioned, "As we have seen, national governments have played a dominant role in the development of international civil aviation. But as in so many areas which directly affect national interests, governments have, for the most part, failed to agree upon a uniform and comprehensive policy for

traffic rights are negotiated by States bilaterally and in some cases multilaterally⁵³, with an attempt by some to introduce an ‘Open Skies’ policy. Through the free exchange of air traffic rights between the carriers of consenting States, this policy would allow the market to determine prices, routes, and scheduling.⁵⁴

2.2 The U.S. “Open Skies” Policy

“Open Skies” largely focuses on the routes, capacity, and pricing, as well as traffic aspects of the aviation industry, and differs from previous bilateral agreements in its significant move toward the liberalization of trade in aviation services. The U.S. is the first State to promulgate a new initiative to adopt this concept,⁵⁵ based on which the U.S. attempted to persuade other nations to open their air transport markets.

In the Department of Transportation (DOT)’s “Order Requesting Comments” on Open Skies,⁵⁶ the basic elements of the Open Skies definition were listed as follows:

international aviation. Thus, although there are basic concepts and provisions common to nearly all bilaterals, no two agreements are exactly alike. Each reflects the aviation policies and negotiating postures of the signatory nations; their specific provisions have often been agreed upon only after long and exhaustive negotiation.” See Dempsey, *supra* note 18, at 47. See also B. Gidwitz, *The Politics of International Air Transport* (Lexington, Mass. : Lexington Books; 1980), at 32, 72-73, 156.

Further discussion of this opinion will be found from the comparative analysis of the bilateral agreement between China, the U.S. and Germany in Chapter III, below.

⁵³ In November 2000 the United States, New Zealand, Singapore, Brunei and Chile concluded the Multilateral Agreement on the Liberalization of International Air Transportation to replace the bilateral agreements between them. The Multilateral Agreement was signed on May 1, 2001 in Washington, DC. Peru and Samoa have also acceded to the agreement.

⁵⁴ See Chapter I. 2.2 below, for more on “Open Skies” Policy.

⁵⁵ On 31 March 1992, the U.S. Department of Transportation (DOT) adopted the “Open Skies” policy. The DOT replaced the CAB [the Civil Aeronautics Board] in 1985.

⁵⁶ Department of Transport, *Order Defining “Open Skies” and Requesting Comments*, Order 92-4-53, 57 Feb. Reg. 19323-01 (5 May 1992). Department of Transport, *Final Order Defining “Open Skies”* Order 92-8-13, 1992 DOT Av. LEXIS 568 (5 August 1992).

See also P. S. Dempsey & Laurence Gesell, “Air Transportation—Foundations for the 21st Century” (New York: Coast Aire Publications L.L.C., 1997) at 305.

- (1) Open entry on all routes (no limit on number of carriers);
- (2) Unrestricted capacity and frequency on all routes;
- (3) Unrestricted route and traffic rights that would allow “the right to operate service between any point in the United States and any point in the European country, including no restrictions as to intermediate and beyond points, ... or the rights to carry fifth-freedom traffic[;]”
- (4) Double-disapproval pricing in third and fourth-freedom markets (which would allow disapproval of tariffs originating out of one state only if the other state also assents to the disapproval as well);
- (5) Liberal charter rules arrangements (the least restrictive charter regulations of the two governments would apply, regardless of the origin of the flight);
- (6) Liberal cargo regime (criteria as comprehensive as those defined for the combination carriers);
- (7) Conversion and remittance arrangement (carriers would be able to convert earnings and remit in hard currency promptly and without restriction);
- (8) Open code-sharing opportunities;
- (9) Self-handling provisions (right of a carrier to perform/control its airport functions going to support its operations);
- (10) Procompetitive provisions on commercial opportunities, user charges, fair competition and intermodal rights;
- (11) Explicit commitment for nondiscriminatory operation of and success for computer reservation systems.

According to the above liberal allowances, an “Open Skies” agreement would allow an airline to enjoy unrestricted traffic rights between any point in the country of origin and any point, intermediate, destination, or beyond, within the confines of the participating country. Such an “Open Skies” agreement would ensure more liberalization than the rigid, pre-negotiated routing rights in the bilateral agreements.

Although the U.S. incorporated many traditional elements of the bilateral agreement into its definition of Open Skies, matters of ownership/control and cabotage were addressed on a case-by-case basis. This limitation was dubbed “the United States protectionist policy” and was criticized in later air transport negotiations.⁵⁷

Several European countries accepted the U.S. definition on “Open Skies;” however, the concept has not achieved worldwide acceptance. Further, the process of negotiation failed to create an environment where “Open Skies” enjoyed a universally accepted definition. Moreover, ICAO makes it clear that the “Open Skies” agreement is not uniformly defined:

“A type of agreement which, while not uniformly defined by its various advocates, would created a regulatory regime that relies chiefly on sustained market competition for the achievement of its air service goals and is largely or entirely devoid of a priori governmental management of access rights, capacity and pricing, and has safeguards appropriate to maintaining the minimum regulation necessary to achieve the goals of the agreement.”⁵⁸

⁵⁷ See G.L.H. Goo, “Deregulation and Liberalization of Air Transport in the Pacific Rim: Are They Ready for America’s ‘Open Skies’?” (1996) 18:1 Univ. Hawaii L. Rev. 550. 551, quoted from Department of Transport, *Order Defining “Open Skies” and Requesting Comments*, Order 92-4-53, 57 Feb. Reg. 19323-01 (5 May 1992). Department of Transport, *Final Order Defining “Open Skies”*, *ibid.*

⁵⁸ ICAO, *Manual on the Regulation of International Air Transport*, ICAO Doc. 9626 (1996) at 2.2-2.

2.3 Future Development

Almost half a century of sustained and orderly growth in international aviation proves the beneficial nature and retention of bilateralism. The airline industry has exhibited significant growth under bilateralism. Furthermore, in practical terms, airlines as well as modern airports have sprung up in almost all areas of the world. International tourist figures reveal the fruit of consumerism under the bilateral regime. "Bilateralism has not stalled the international business world. On the contrary, international travel is now reasonably swift."⁵⁹

The future might seek a different regulatory structure for the international exchange of traffic rights to either replace or supplement the bilateral system. Some believe that the elimination of tariff and non-tariff barriers will encourage free trade, thus allowing the law of comparative advantages to dictate which nations are best suited for producing various commodities and services.⁶⁰ If air services come to be considered a trade in service, they will have to be brought within the purview of the General Agreement on Trade in Service (GATS) under the umbrella of the World Trade Organization (WTO). In such a case, however, the present bilateral regime/regional multilateral regime will prove inadequate for serving the current needs of commercial aviation, thus necessitating the development of a true universal framework. The real meaning of "Open Skies," the absence of any restrictions on foreign airlines of any nationality to operate anywhere in the world, might then be achieved. Still, considering national security, economic, and political interests, no State will happily abandon its right to bargain.

⁵⁹ B. D. K. Henaku, *Regionalism In International Air Transport Regulation* (Leiden: Koma Publishers Foundation, 1993) at 15.

⁶⁰ Dempsey, *supra* note 18, at 10.

3. ICAO Actions Toward Liberalization

International aviation has been entrusted to the International Civil Aviation Organization (ICAO), a specialized agency of the UN. The Chicago Convention assigns the ICAO the role of “foster[ing] the development of international air transport so as to meet the needs of the peoples of the world for safe, regular, efficient, and economical air transport.”⁶¹ ICAO’s jurisdiction has been limited so that it deals primarily with aspects of aviation related to technology and safety. Professor Michael Milde points out that the Chicago Convention established ICAO as “an international organization with wide quasi-legislative and executive powers in the technical regulatory field and with only consultative and advisory functions in the economic sphere.”⁶²

Today, in an effort to form a global consensus on the further liberalization of the airline industry, the ICAO has taken actions to develop a new set of policy objectives for distribution to its member nations.

The 5th Worldwide Air Transport Conference on “the Challenges and Opportunities of Liberalization” was held at the ICAO’s Montreal Headquarters between 24-29 March 2003. The objectives of the Conference were “to develop a framework for the progressive liberalization of international air transport with safeguards to ensure fair competition, safety and security and including measures to ensure the effective and sustained participation of developing countries.”⁶³

Despite the hovering storm clouds of SARS and the conflict in Iraq, nearly 800 delegates and observers from 145 of the Organization’s 188 Contracting States, as well as

⁶¹ *Chicago Convention*, *supra* note 13, Article 44.

⁶² Michael Milde, “The Chicago Convention – After Forty years,” (1983) 9 Ann. Air & Space Law, 119.

⁶³ ICAO Working Paper, *supra* note 29, at 6.

26 observer organizations, participated in the conference. Key issues on the agenda included ownership and control, market access, dispute settlement, and consumer affairs. The global attendance and ensuing consensus on all issues signaled the widespread desire to advance the liberalization process in international air transport.

As the global aviation forum, the ICAO represents the collective view of the international aviation community. Its conferences set the tone for the future developments in the global aviation industry. ICAO tried to show States how best to advance the liberalization agenda toward a more open but highly safeguarded regulatory environment. With widespread support for “gradual, progressive and safeguarded liberalization,”⁶⁴ the 2003 Conference did not focus on whether the industry should liberalize, as had the previous one; rather, it focused on how to liberalize. Meanwhile, the interrelationships between safety, security, and liberalization were emphasized by ICAO.

Furthermore, as a key issue facing the Conference, expansion of the concept of air carrier ownership and control was set as the first of the key regulatory issues in liberalization.⁶⁵ Firstly, the past experience of liberalization in ownership and control affirmed that regulatory modernization with respect to conditions for air carrier designation and authorization, which will further benefit the liberalization of air carrier ownership and control provisions, can take place without conflicting with the obligations of the parties under the Chicago Convention and without undermining the nature of international air transport.⁶⁶ The liberalization of provisions governing air carrier designation and authorization is widely supported by States.⁶⁷ Secondly, during the

⁶⁴ *Ibid.* at 6.

⁶⁵ See Agenda Item 2.1: Air Carrier ownership and control, *Ibid.* at 16-24. In the practice, ‘ownership and control’ means barrier to international airline mergers. See later in Chapter II for more detailed analysis of ‘ownership and control’.

⁶⁶ See Agenda Item 2.1.3.1 a), *Ibid.* at 19.

⁶⁷ See Agenda Item 2.1.3.1 b), *Ibid.*

gradual reduction of specified proportions of national ownership, the national right to self-determination was highly respected. Without needing to change their existing laws or regulations, States may follow their own chosen approach at their own pace.⁶⁸ Thirdly, there are some conditions for air carrier designation and authorization (e.g., the guarantee of safety and security, properly addressing the economic and social impact, and considering all the potential risks).⁶⁹ Finally, possible alternatives are addressed; as States may take more positive approaches in the short term to facilitating liberalization, States may choose to liberalize air carrier ownership and control on several bases (such as unilateral, bilateral, regional, plurilateral, or multilateral bases).⁷⁰ This was expressed in the model clause that the Conference suggested States consider as an option to use at their discretion in air services agreements, as follows:⁷¹

“Article X: Designation and Authorization

1. Each Party shall have the right to designate in writing to the other Party [an airline] [one or more airlines] [as many airlines as it wishes] to operate the agreed services [in accordance with this Agreement] and to withdraw or alter such designation.
2. On receipt of such a designation, and of application from the designated airline, in the form and manner prescribed for operating authorization [and technical permission,] each Party shall grant the appropriate operating authorization with minimum procedural delay, provided that:

⁶⁸ See Agenda Item 2.1.3.1 c) and f), *Ibid.* at 20.

⁶⁹ See Agenda Item 2.1.3.1 d) and e), *Ibid.*

⁷⁰ See Agenda Item 2.1.3.1 g) and h), *Ibid.*

⁷¹ They are also reaffirmed in the Recommendation, See *ibid.* at 22-23.

- a) the designated airline has its principal place of business [and permanent residence] in the territory of the designating Party;
 - b) the Party designating the airline has and maintains effective regulatory control of the airline;
 - c) the Party designating the airline is in compliance with the provisions set forth in Article___ (Safety) and Article___ (Aviation security); and
 - d) the designated airline is qualified to meet other conditions prescribed under the laws and regulations normally applied to the operation of international air transport services by the Party receiving the designation.
3. On receipt of the operating authorization of paragraph 2, a designated airline may at any time begin to operate the agreed services for which it is so designated, provided that the airline complies with the applicable provisions of this Agreement.”⁷²

In addition, the recommendation of Agenda Item 4.1⁷³ addressed the ICAO’s future role in economic liberalization and its relationship with the World Trade Organization, whose policy on trade in services has an impact on the partial trade regime of the coverage of international air transport. It provided that ICAO should focus specifically on promoting the liberalization process through its work; however, this promotion must remain limited to policy guidance and assistance in the evolving globalized and liberalized air transport marketplace. States would have the right to choose the manner in which they developed their own air transport, in terms of ensuring safety and security. As

⁷² *Ibid.* at 21.

⁷³ *Ibid.* at 57.

it had in the 4th ICAO Worldwide Air Transport Conference, the 5th ICAO Worldwide Air Transport Conference endorsed neither the bilateral nor the multilateral system as the preferred one. The different experiences, economies, and cultures of the various countries and regions shape their views in choosing the optimal route to liberalization. The different views are totally dependant on the wishes of the contracting parties.⁷⁴

In its relationships with organizations, such as the WTO, the ICAO should cooperate to reach a common interest or involvement in global regulatory matters, and to ensure that its mandate and role in the aviation community are taken into account. At the global level, this cooperation will promote harmony and prevent duplication.

Of course, the ICAO aims only to “seek balance in the reform process;”⁷⁵ however, its leading role in regulatory matters will centre the focus of the ICAO on the promotion and implementation of liberalization.

⁷⁴ The 5th ICAO Worldwide Conference that took place in 2003 concluded that: “(b) Experience in the past decade has confirmed that the existing bilateral, regional, and multilateral regulatory regimes based on the Chicago Convention can and do co-exist and can each accommodate different approaches to air transport regulation. These regimes continue to provide a viable and flexible platform for States in pursuing liberalization according to their specific needs, objectives, and circumstances. The number of open-skies and other liberal agreements are evidence that these regimes have been very effective in increasing liberalization, and the momentum should be maintained...”

“e) While multilateralism in commercial rights, to the greatest extent possible, continues to be an objective of the Organization, conditions are not ripe at this stage for a global multilateral agreement for the exchange of traffic rights, States should continue to pursue liberalization in this regard at their own choice and own pace, using bilateral, regional and/or multilateral avenues as appropriate. The proposed ICAO Template Air Services Agreements (TASAs) provide detailed guidance on liberalization options and approaches.” See ICAO Consolidated Conclusions, Model Clauses, Recommendations and Declaration, AT Conf/5 31.3.03 at 6.

The ICAO Declaration of Bilateral Principles for the Liberalization of International Air Transport also declared: “4.4 Each State will determine its own path and own pace of change in international air transport regulation, in a flexible way and using bilateral, sub-regional, regional, plurilateral or global avenues according to circumstances.”

See also Lim, *supra* note 21, at 3.

⁷⁵ Dr. Assad Kotaite, Address (Lecture by the President of the Council of the International Civil Aviation Organization (ICAO) presented to the Fifth Worldwide Air Transport Conference, (March 2003) [unpublished].

Chapter II: The Effect of Global Air Transportation Deregulation and Liberalization on Chinese Air Transportation Reform

1. Airlines Come to be Independent Actors in the Economic Market

1.1 Substantial Ownership and Effective Control

There are no universally accepted definitions for the term “substantial ownership and effective control.” “Ownership is usually expressed in a percentage of voting shares. Any percentage above 50% is generally perceived as meeting the criterion ‘substantial’. Majority ownership is substantial, whether in government or in national private hands.”⁷⁶ “Effective control” “has nothing to do with the numbers but rather who actually controls the airlines.”⁷⁷

1.1.1 The Development of the “Substantial Ownership and Effective Control” Principle

After the Chicago Conference, many States proceeded to sign bilateral agreements that regulated the remaining commercial rights. Such agreements required that airlines of

⁷⁶ IATA, Government and Industry Affairs Department, *Report of the Ownership & Control Think Tank World Aviation Regulatory Monitor*, IATA doc. Prepared by P. van Fenema (7 September 2000) at 13.

⁷⁷ Isabelle Lelieur, *Law and Policy of Substantial Ownership and Effective Control of Airlines: Prospects for Change*, (McGill LL.M. Thesis, 2002), at 4.

each nation be substantially owned and effectively controlled by its citizens.⁷⁸ Since then, the requirement for substantial ownership and effective control has been the backbone of the bilateral system.

In fact, the nationality of airlines was not addressed in the Chicago Convention itself.⁷⁹ The only multilateral international agreement that actually addresses the issue of airline ownership restrictions is the *International Air Services Transit Agreement*.⁸⁰ Article 1, Section 5, provides that,

[e]ach Contracting State reserves the right to withhold or revoke a certificate or permit to an air transport enterprise of another State in any case where it is not satisfied that substantial ownership and effective control are vested in nationals of a Contracting State, or in case of failure of such air transport enterprise to comply with the laws of the State over which it operates, or to perform its obligations under this Agreement.

Why these ownership restrictions were include in the *International Air Services Transit Agreement*, the bilateral agreements, and national laws? The reasons are complex, including: (1) National security;⁸¹ (2) Economic security;⁸² (3) Safety;⁸³ (4) Competition

⁷⁸ Peter. P. C. Haanapel, "Multilateralism and Economic Bloc Forming in International Air Transport" (1994) 19 Ann. Air and Space Law. 211.

⁷⁹ In 1994, examination of the issue by the ICAO Worldwide Air Transport Conference showed that there is no single agreed-upon definition of what is meant by substantial ownership and effective control. See ICAO, Working Paper (Worldwide Air Transport Conference on International Air Transport Regulation, Present, Future) AT Conf/4-WP47 at 3. See also Lim, *supra* note 21, at 10.

⁸⁰ *International Air Services Transit Agreement*, *supra* note 26, also reproduced in ICAO Doc. 9587. *The International Air Services Transit Agreement* has been ratified, as of 4 October 2000, by 118 States. *The International Air transport Agreement*, *supra* note 22, in its Article 1 § 6, addresses the same issue; however, as only a very small number of States has signed the Agreement, it is not entered into force.

⁸¹ "Governments have argued that foreign ownership of airlines could compromise national security, since civilian aircraft capacity may be widely used by the military, particularly in times of national emergency.

issues;⁸⁴ (5) Bilateral issues;⁸⁵ and (6) Other legal issues.⁸⁶

Bilateral aviation agreements often require the substantial ownership and effective control of a partner country's qualifying airlines by a citizen of the partner country. If negotiating countries were unwilling to amend the "substantial ownership and effective control" clause, the negotiating process may be thrown into stalemate.⁸⁷ If the foreign-owned airline is permitted to exercise its rights, this could result in the airline gaining access to a country by the backdoor, and third countries may obtain the negotiated privileges through the back door, as might occur in preferential trading agreements.⁸⁸ This is the reason why when some governments, particularly the U.S., suggest to relax the "substantial ownership and control" principle, they require some prior conditions, "namely that the foreign entity seeking to own a U.S. carrier must come from a country

Foreign owners, it is said, could not be counted on to supply this capacity." Commission on Air Transport, "Foreign in Airlines: An ICC view", (November 8, 1994), online:

<http://www.iccwbo.org/home/statements_rules/statements/1994/foreign_investment.asp> (last visited on December 5, 2004)

⁸² "Both governments and labour union representatives have raised economic objections to foreign ownership. Some governments, particularly in countries largely dependent on tourism, argue that it would be unwise to turn over the nation's principal earner of foreign exchange into foreign hands. They are also concerned that in difficult economic times, foreign owners would be tempted to discontinue vital air links, leaving the country vulnerable to a serious disruption in the availability of air transport services. Labour's principal concern is that job losses will follow once foreign owners take control of an airline. Union officials have also questioned whether the terms and conditions of their employment would be governed by foreign, rather than domestic labour laws." *Ibid.*

⁸³ "Some interests, particularly pilots' organisations, have raised the possibility that foreign ownership could result in weakening of safety standards. These claims are frequently coupled with concerns that foreign-owned carriers which have their aircraft registered in other countries could be subject to less strict safety tests than airlines having aircraft registered in the country of designation. By extension, it is argued, there will be a move towards creating "flag of convenience" airlines in the same way that flag of convenience shipping operates in maritime transport." *Ibid.*

⁸⁴ Ownership restrictions have become a means of protecting national airlines from foreign competition and of ensuring their survival in the domestic market.

"Some government officials have expressed doubts about confidentiality and the willingness of airlines to compete vigorously with one another when they have overlapping ownership and boards of directors." *Ibid.*

⁸⁵ This is will be explained in next paragraph. Because this is the related issues to this thesis.

⁸⁶ "A final argument made by some governments is that there must be a clearly identifiable locus of responsibility for the safety, security and economic integrity of airline companies. Their reasoning is that if a carrier is owned by nationals who are not citizens of the designating country it may be difficult to demonstrate the designating government's continuing competence in the technical aspects of airline and aircraft certification." *Supra* note 81.

⁸⁷ *Supra* note 81.

⁸⁸ *Ibid.*

that maintains a pro-competitive, private sector-run regime governed by equitable and transparent rules and regulations.”⁸⁹ This is a requirement for a *quid pro quo* negotiation, which means that the liberal rules should be established only in return for other features of a liberal bilateral agreement.

In the current global economic scheme, however, the principle of the national ‘substantial ownership and effective control’ of airlines is one of the biggest growth impediments to the air transport industry. Bilateral agreements hamper the free market by restricting the ability of airlines to consolidate with foreign carriers through equity transfers. To circumvent such barriers, airlines must enter into more indirect forms of cooperation, such as code sharing and joint marketing arrangements.⁹⁰ However, the proliferation of foreign investments between airlines arguably highlights the need to remove national restrictions.⁹¹

“In early 2001, more than 57 carriers reportedly held shares in foreign airlines, and over 160 airlines have foreign equity ownership.”⁹² This showed the development of further deviations and exceptions to the principle of ‘substantial ownership and effective control’ have been developed. The removal of some national limitations on foreign ownership was regarded as a “positive first step” to the “free circulation of capital between international industries” and “the globalization in the air transport industry.”⁹³ Similar pressure also comes from heightened competition, reduced cost, airline privatization, globalization and consolidation, the successes of low-cost carriers, and so

⁸⁹ *Ibid.*

⁹⁰ Cary Clyde Hufbauer & Christopher Findlay, eds. *Flying high: Liberalizing Civil Aviation in the Asia Pacific*, (Washington, DC: Institute for International Economics, 1996) at 21.

⁹¹ See Isabelle Lelieur, *supra* note 77, at 8-9.

⁹² WTO, Note on Developments in the Air Transport sector Since the Conclusion of the Uruguay Round, Part Five. WTO Doc. S/C/W/163/Add.4 (2001) at 4. See also *ibid.* at 9.

⁹³ *Ibid.* at 52.

on.

Coincident with the financial losses and bankruptcies in the airline industry resulting from the events of September 11, 2001, at the World Trade Center in New York, the Iraq War, and the SARS outbreak⁹⁴, the liberalization of airline ownership and the control principle becomes more important for the regulators in airline industry.⁹⁵ Mr. R. Doganis observed: "In the first decade of the third millennium, it is the ownership and investment rules that are the most likely to be liberalized. For it is on this issue that the economic and political pressures for change are greatest. This is because while there are strong economic forces pushing the airline industry towards concentration and the creation of competing global alliances, the existing bilateral regime clearly constrains airlines' freedom of action and their ability to maximize the potential benefits of scale and of global network. Moreover, relaxing the ownership rules would also make it unnecessary any longer to safeguard domestic or Seventh Freedom rights. Once airlines are no longer owned by nationals of a particular state, there is little point in that state protecting to air traffic rights or assiduously as in the past."⁹⁶ Therefore, the principle of "substantial ownership and effective control" has become the heart of bilateral agreements.

⁹⁴ P. S. Dempsey, "The Cyclical Crisis in Commercial Aviation: Causes and Potential Cures", 28 (2003) Ann. of Air and Sp. L. 1.

⁹⁵ Also in the final conclusion of AT/Conf. 5, the ICAO Declaration of Global Principles For the Liberalization of international Air Transport called for flexibility in the field of ownership and control policy: "States should give consideration to accommodating other States in their efforts, to move towards expanded transporter ownership and control of air carriers, and/or towards designation of air carriers, based on principal place of business, provided that clear responsibility and control of regulatory safety and security oversight is maintained." See *supra* note 29.

⁹⁶ R. Doganis, *The Airline Business in the 21st Century*, (New York: Routledge, 2001) at 147.

1.1.2 Erosion of the “Substantial Ownership and Effective Control” Principle

There are many deviations to the “substantial ownership and effective control” principle which are developed by the changing of national laws or by airline industry itself.

First, foreign investment lays the foundation for the changes that the “substantial ownership and effective control” principle will usher in. Some developing countries are amending the legal regimes that govern foreign ownership of their domestic air carriers and thereby breaking down the system of national restrictions. For example, “in the 1990s, Brazil raised its ceiling on foreign ownership from 20% to 49.5%, Korea raised its cap from 20% to 49%, Thailand went from 30% to 49%, and Peru upped its limit to 70%. Bangladesh even went so far as to permit operation of its domestic carriers by joint ventures and unlimited foreign ownership of its cargo airlines. Then again, other countries have eliminated national restrictions altogether and have allowed 100% foreign capital investment in their airlines due primarily to their geographical setting. For example, with the emergence of Singapore as a major transit hub in the Asian-Pacific region, the Singaporean government saw fit to abolish ownership restrictions that had limited foreign investment in its national airline, Singapore International Airline (SIA) to 27.5%, so that foreign investors could now hold 100% of SIA.”⁹⁷

From the above practice, it showed that the changes in national airline ownership regimes have departed from the traditional ownership and control requirement. “The removal of some national limitations on foreign ownership is positive first step, since restrictions represent the biggest impediment to free circulation capital between

⁹⁷ Isabelle Lelieur, *supra* note 77, at 49-50.

international industries and are a major reason for the lack of globalization in the air transport industry.”⁹⁸

Second, the creation of multi-national airlines⁹⁹ is a deviation from the “substantial ownership and effective control” principle. For example, “Scandinavian Airlines System (SAS) is a joint operating organization of the national airlines of Norway, Sweden, and Denmark, which was created in 1951. Each of the SAS component airlines is substantially owned and controlled by nationals of the countries concerned. However, SAS is appointed as the designated airline and, thus, the holder of traffic rights in each of the three bilateral agreements concluded with third countries.”¹⁰⁰

Third, a multilateral Open-Skies agreement concluded by the U.S. and four State Parties to the Asia Pacific Economic Cooperation (APEC) Agreement (Brunei, Chile, New Zealand, and Singapore) in 2000, “did away with the traditional requirement that an airline must also be “substantially owned” by nationals of the designated country.”¹⁰¹ “While the APEC Open-Skies agreement retains the Bermuda I-type requirement that an airline be “effectively controlled” by nationals of the State whose government designates the airline to receive traffic rights, the “substantial ownership” requirement is replaced by a requirement that the designated airline simply be incorporated in that State and have its principal place of business there. By eliminating the “substantial ownership” requirement, this multilateral Open-Skies agreement could open the door to increased cross-border investment for domestic airlines that have historically been forced to rely almost

⁹⁸ *Ibid.*, at 52.

⁹⁹ “These multinationals are normally comprised of airlines from the same geographic region, grouped together in an effort to strengthen their respective markets through a common identity.” *Ibid.* at 48.

¹⁰⁰ See *ibid.*, at 47. See also IATA, Government and Industry Affairs Department, Report of the Ownership and Control Think Tank World Aviation Regulatory Monitor, IATA doc. Prepared by P.van Fenema (7 September 2000) at 20.

¹⁰¹ *Ibid.* at 48.

exclusively on domestic sources of investment capital.”¹⁰²

In summary, the countries have relaxed the national ownership requirement; and, with many deviations, the “substantial ownership and effective control” principle has been under erosion.

1.2 Deregulation and Liberalization

Deregulation and liberalization in the U.S. and in Europe have had an enormous impact on the birth of opportunities to liberalize air services around the world. As world leaders in the aviation industry, the activities of the U.S. and Europe influence air transport policy in the rest of the world.¹⁰³

1.2.1 The Deregulation of Airlines in the U.S.

In June 1977, President Jimmy Carter appointed Cornell University economist Alfred E. Kahn to the first pro-deregulation chairmanship of the Civil Aeronautics Board. A *de facto* pro-deregulation policy was immediately initiated. Meanwhile, Kahn managed to spearhead the drive from the political forum towards policy and legislative reform. Deregulation was embodied in the *Air Cargo Reform Act of 1977*,¹⁰⁴ and on a much larger

¹⁰² *Ibid.*. For more details about the *APEC Agreement*, see IATA doc. *Supra* note 101, at 21; WTO, *Note on Developments in the Air Transport sector Since the Conclusion of the Uruguay Round, Part Four*. WTO Doc. S/C/W/163/Add.3 (2001) 21, at 25; K. Knibb, “Bilater Accord Sparks Ownership Debate...as APEC Moves Towards Multilateral Open Skies” *Airline Bus*. (January 2001) 24

¹⁰³ “If Europe and America can shed the rules and completely liberalize the airspace, the rest of the world will be forced to follow. The two regions together account for well over half the world’s air traffic. Global takeover will then be possible, leading to consolidation and economies of scale. From this, a handful of mega-airlines could come to rule the skies.” See *supra* note 11.

¹⁰⁴ P.L. 95-163, Nov. 9, 1977, 91 Stat. 1284.

scale in the *Airline Deregulation Act of 1978 (Airline Deregulation Act)*.¹⁰⁵ “The goal of the Act was for encouraging, developing, and attaining an air transportation system which relied on competitive market forces to determine the quality, variety, and price of air service.”¹⁰⁶ *De jure* deregulation was achieved in the domestic field of air transport.¹⁰⁷

Based on the philosophy that competition is the best way to guarantee low-priced service¹⁰⁸ for consumers, the U.S.’s deregulation practices achieved initial success. In order to stimulate competition, many new airlines were encouraged to enter the market; therefore, an extensive selection of carriers was born. CAB maintained that a *laissez-faire* attitude would eliminate all the ineffective carriers and force the remaining ones to maintain greater pro-consumer prices and services.¹⁰⁹ By gradually dismantling the entry, price, and route regulations that had regulated U.S. carriers, market forces successfully compelled U.S. carriers to undergo changes. In this way, the current structure of the U.S. air transport industry was developed.

1.2.2 Regulation and Liberalization in Europe

Although regulatory reforms in the domestic airline sectors of the U.S., Canada, and other countries provide good insight as to the likely effects of the aviation policy in Europe, Europe has been a relatively late starter in terms of liberalizing its air

¹⁰⁵ P.L. 95-504, Oct. 24, 1978, 92 Stat. 1705.

¹⁰⁶ *Supra* note 49.

¹⁰⁷ In the international field, deregulation was initiated on March 31, 1978, when the U.S. signed its first “liberal” air transport agreement: a Protocol amending the existing 1957 U.S. –Netherlands agreement. See Peter. P. C. Haanappel, *supra* note 33, at 51.

¹⁰⁸ The service should satisfy the different requirements from customers. It includes low price, seat changing, check-in, boarding, good meal, and so on. In fact, low price is the one which customers’ pay more attention to.

¹⁰⁹ See P. S. Dempsey, *Airline Deregulation and Laissez-Faire Mythology* (Westport: Quorum Books, 1992) at 185.

transportation. Europe uses the term 'liberalization' rather than 'deregulation' because of the differences between the U.S. and European airline market.¹¹⁰

The European liberalization process is hampered by the vast number of countries and governments with their own ideas, air control systems, and languages. The first attempt to implement liberalization policies failed in 1979 and 1984 when the dominant European countries rejected the first two Commission memoranda, which wanted to apply the principles of the common market to intra-European aviation as well. The liberalization in Western Europe began when the European Court of Justice ruled, through the *Nouvelles Frontière* decision,¹¹¹ in April 1986, that the European Economic Community's antitrust laws applied to civil aviation matters.

In 1986, the European Council implemented the *Single European Act*,¹¹² which marked the first and most important step towards liberalization approved by the E.C. It aimed at reaching a "unified internal market" in E.U.¹¹³ To prepare for a single EC sky, the European Council implemented three packages as important steps on the road to liberalizing and securing an internal market for air transport.

The First Liberalization Package was implemented on 1 January 1988. It allowed scheduled intra-E.C. air services to adopt multiple designations, Fifth Freedom rights, the automatic approval of discount fares, and other such measures toward free market access. It also introduced new competition rules and applied the antitrust rules of the *EEC Treaty* to E.C. air transport.¹¹⁴ However, this First Package "caused negligible effects on

¹¹⁰ Dipendra Sinha's book details eight differences. See Dipendra Sinha, *Deregulation and Liberalisation of the Airline Industry* (Burlington: Ashgate, 2001) at 69-71.

¹¹¹ Joined Cases 209213/84, *Ministère Public v. Lucas Asjes*, 32 E.C.R. 1425 (1986) (known as the *Nouvelles Frontière* decision).

¹¹² See *Single European Act*, 28 February 1986, 2 C.M.L.R. 741, 25 I.L.M. 506.

¹¹³ P.S. Dempsey, "Competition in the Air: European Union Regulation of Commercial Aviation" (2000-2001) 66 J. Air L. & Comm. 979 1004.

¹¹⁴ See EEC, *Council Regulation of 14 December 1987 on the Application of Article 85 (3) of the Treaty to Certain Categories of Agreements and Concerted Practices in the Air Transport Sector*, OJ Legislation

competition in the European Community and resulted in only slight reductions in air fares.”¹¹⁵

The Second Package aimed to expand the liberalization granted in the First. It came into effect in 1990 and applied a double disapproval rule to full fares.¹¹⁶ The E.C. took further steps towards an integrated aviation market¹¹⁷ by implementing the Third Package, which is the most important of the three. It was implemented on 1 January 1993, “effectively creat[ing] a single EC airline market”¹¹⁸ by lifting pricing restrictions on all fares, abandoning the distinctions between chartered and scheduled carriers, and allowing full access to all routes, including cabotage ones for all Community air carriers, as defined by Regulations 2407/2408.¹¹⁹ In this way, a single aviation market was created although the E.C. retained the right to intervene against fares, predatory pricing, and dumping pricing.¹²⁰ In its effort to reach a multilateral open skies environment in air transport, the E.C. achieved success.

On 5 November 2002, the European Court of Justice rendered a decision that the Commission had not “exclusive external competence to negotiate air transport trade

¹¹⁵ S. M. Warner, “Liberalize Open Skies: Foreign Investment and Cabotage Restrictions Keep Non-citizens in Second Class” (1993) 43 Amer. Univ. L. Rev. 296.

¹¹⁶ “double disapproval rule” means “proposed fares would take effect unless both countries disapproved.” P. S. Dempsey, *European Aviation Law*, (the Netherlands: Kluwer Law International; 2004) at 43.

“The second package introduced a three-tier fare zone system: a normal zone (105-95% of the reference fare), a discount zone (94-80% of the reference fare) and a deep discount zone (79-30% of the reference fare). Within each zone, EU carriers could enjoy the flexibility to set their fares. Above 105% of the reference fare would be automatically effective unless both member countries were to disapprove of the fare.” Yoshinori Ide, *supra* note 14, at 12.

¹¹⁷ See EEC, *Council Regulation of 24 July 1990 on Fares for Scheduled Air Services*, OJ Legislation (1990) No. 2342; EEC, *Council Regulation of 24 July 1990 on Access for Air Carriers to Scheduled Intra-Community Air Service Routes and on the Sharing of Passenger Capacity between Air Carriers on Scheduled Air Services between Member States*, OJ Legislation (1990) No. 2343.

¹¹⁸ S. M. Warner, *supra* note 111, at 297.

¹¹⁹ See EEC, *Council Regulation of 23 July 1992 on Licensing of Air Carriers*, OJ Legislation (1992) no. 2407.

¹²⁰ Hong Hu, *supra* note 27, at 15.

agreements on behalf of the 15 EU member governments.”¹²¹ But the EU was “exclusively competent on fares and rates on intra-EU routes, and CRSs.”¹²² “Further, four types of provisions in bilaterals are inconsistent with EU Law:

1. Nationality clauses (including establishment) – the ‘effective ownership and control’ provisions violate the right of establishment guaranteed under Article 43;
2. 2 Areas of exclusive Community competence, such as:
 - a. Air fares and rates on intra-Community routes – the so-called ‘fifth freedom’ pricing provisions;
 - b. Computer reservations systems; and
 - c. Airport slot allocations.”¹²³

The EU has already warned member states not to negotiate individually. EU Court of Justice decision empowered EU Commission to take the air transport negotiation on behalf of its members.¹²⁴ “There is precedent for the EU to negotiate air transport agreements with other governments. It has negotiated a bilateral air transports with Switzerland, a multilateral agreement with Norway and Sweden, and a multilateral as part of a larger agreement on a European Economic Area with Iceland and Norway. So it could begin negotiations with the other nations on areas in which it has been granted exclusive competence.”¹²⁵ “When a member state concludes arrangements that do not

¹²¹ Paul S. Dempsey, *European Aviation Law*, (the Netherlands: Kluwer Law International, 2004) at 88.

¹²² *Ibid.*

¹²³ *Ibid.* See also EU Press Release No. 89/02 (5 November, 2002). Other areas of exclusive Community competence in civil aviation are safety, security and the environment.

¹²⁴ “The ECJ decision make it clear that no EU Member State could lawfully enter into a bilateral air transport agreement that included an ‘effective ownership and control’ clause unless access to routes was open to all EU air carriers. But the court did not proclaim the existing bilaterals to be null and void.” *Ibid.* at 89.

¹²⁵ *Ibid.* at 89.

allow for the designation of EU airlines, an advisory committee (of the EC and member states) will consider whether the agreement would harm Europe's common transport policy.this may well provide a loophole...for France, which is carrying out bilateral negotiations with China.”¹²⁶

More recently, the E.U. seeks to surpass the U.S. model ‘open skies’ agreement¹²⁷ by aiming to eliminate all restrictions, except for those on technical and safety matters, in order to achieve truly open skies.¹²⁸ In pan-European cooperation with regards to aviation, the E.C. plans to extend its market by negotiating comprehensive Community aviation relations with its major aviation partners, including China.¹²⁹

1.3 Chinese Air Transport's Reform Under the Impact of the Liberalization Trend

As mentioned above, the experiences of the U.S. and Europe have influenced other countries in the aviation field, including China. As an influential country in Asia, China wishes to have the most developed aviation industry and make the fast progress in the liberalization process in Asia.¹³⁰ However, China is facing difficulties from both inside and outside. In Asia, the absence of a single Asian market, as a single Sky in Europe, is slowing the regional liberalization process.¹³¹ These bring the limitation of regional environment for the liberalization of Chinese air transport industry. In domestic market,

¹²⁶ Colin Baker & David Field, “UK-HK sign bilateral deal”, (January 1, 2004) *Airline Business*, (Lexis) (last visited on December 31, 2003.)

¹²⁷ *Supra* note 45.

¹²⁸ It contemplates the granting of the Seventh Freedom, cabotage, and the elimination of all restrictions on ownership and control within the area. See C. O. Lim's paper, *supra* note 14 at 14, n. 48.

¹²⁹ EU, Council Regulation 847/2004 on the Negotiation and Implementation of Air Service Agreements between (EU) Member States and Third Countries (2004) O.J.L. L-157/7. See also Lim, *supra* note 21, at 14.

¹³⁰ This is the wish of Chinese government to develop China's aviation industry to be the strongest in Asia.

¹³¹ This is a thinking to compare with the Single European Sky, in Asia, there is no such idea to build a Single Asian Sky.

the Chinese air transportation industry is facing many historical problems, such as the undeveloped management system and the burden of debt. China should deal with domestic reform in its aviation industry as it develops its regional or international relations.¹³² With the achievement of its internal reformation, Chinese air transport industry may be stronger in the international competition. Currently China is on the brink of creating a Free Trade Area with Japan and India.¹³³ This is a good beginning to develop Chinese aviation industry together with the other countries.

There are two main motivations on the reformation of Chinese air transport industry. First, China has become a member of the WTO. Although WTO does not have jurisdiction over airlines, its reform of other industries creates a highly liberal environment in which the airline industry can develop, thus indicating that China may further open its aviation market in the future.

Second, Airline alliance has been a worldwide trend in recent years. The competition between airlines has metamorphosed into a competition between alliances. The global aviation market recently has been divided by a few strong airline alliances. The increasing strength of the monopolizing trend of the global airline alliances forces the other international airlines to either join an alliance or try to make the most of the portion of the limited market the Alliances leave behind. Therefore, Chinese airlines' entry into the world alliance is one choice for them to meet the challenge from international competition.

Burgeoning growth in this industry has prompted important reforms. State-owned

¹³² This thinking to finish the Chinese domestic reformation first and then to seek advantage in the international competition is the general idea used in all the Chinese industries by Chinese government. They think that before the achievement of the domestic reformation, Chinese industries cannot be strong enough to join in the international competition.

¹³³ Beginning in 2005, China, Japan, and India are expected to create a Free Trade Area and implement transport cooperation programs. See Lim, *supra* note 21 at 15, n. 46.

airlines have been privatized and regulations have been eased.¹³⁴ Still, the liberalization of civil aviation in China has been uneven. The State remains the dominant shareholder in many recently privatized carriers. Regulations have been relaxed, but the State still routinely intervenes in the markets.

1.3.1 China Civil Aviation is Running to a “Deepen, Widen”¹³⁵ Reform

China has enjoyed robust growth in air passenger and air cargo transport over the past several years.¹³⁶ China’s challenge will be meeting this explosive demand with new and expanded airlines, airports, and aviation infrastructure.

In response to the globalization of market, Chinese government has undertaken a major restructuring of its airline, airport, and aviation industries.

In the early 1990s, many Asia-Pacific countries cut back on subsidies to their airlines in order to accelerate airline privatization.¹³⁷ China is one of this team. In July 2000, the Chinese government reorganized ten airlines under the direct control of the Civil Aviation Administration of China (CAAC) into three air transportation conglomerates: (1) Air China; (2) China Eastern; and (3) China Southern Group.

The biggest merger in Chinese Civil Aviation is the reorganization of China’s three airline conglomerates, officially launched on October 11, 2002, at a ceremony in Beijing’s Great Hall of the People. It brought together nine airlines under Air China in Beijing,

¹³⁴ See Chapter II. 1.3.3., below, for more on this topic.

¹³⁵ The words “Deepen, Widen” are the exact official translation by Chinese government. It express the reformation in China should be moving to a deeper level and a comprehensive scope.

¹³⁶ From 1989 to 2001, China’s civil aviation has maintained an average annual growth rate of 17.4 percent in air traffic turnover, 16 percent in air passenger traffic volume, and 15.3 percent in air cargo & mail traffic. See CAAC, *Statistical Data on Civil Aviation of China*, (China: CAAC, 2003).

¹³⁷ See Hong Hu, *supra* note 27, at 51.

China Eastern Airlines in Shanghai, and China Southern Airlines in Guangzhou. Air China merged with China Southwest Airlines and China National Aviation Corp.; China Eastern Airlines merged with China Northwest Airlines and Yunnan Airlines; and China Southern Airlines merged with China Northern Airlines and Xinjing Airlines.¹³⁸

In addition, three aviation service conglomerates were formed on the same day separately handling fuel, information, and materials.¹³⁹ The establishment of the six conglomerates was a key step in reorganizing Chinese civil aviation and aviation service. But it was not the end of reform; in reality, it was only the beginning.

Furthermore, the Civil Aviation Reorganization Plan adopted by the State Council, China's highest administrative authority, on January 23, 2002, changed the face of civil aviation after the reorganization. As the administration department in charge of the national aviation affair directly under the State Department, the CAAC would no longer act on behalf of the six conglomerates and airports as the owner of national assets. The CAAC would be mainly responsible for civil aviation safety and security management, market management, air traffic control, macro economic control, and foreign relationships. Based on this orientation, the CAAC actively changed its functions, reduced their administration examinations and approvals, and strengthened their statutes.¹⁴⁰

Meanwhile, under the same plan, 129 civil airports directly managed by the CAAC would all be transferred to local governments, with the exception of the Beijing International Capital Airport and the civil airports in Tibet. All airport assets, debts, and

¹³⁸ Ning Su, "China Civil Aviation Merger Formed with Six Groups Established" 22 (2002) China Civil Aviation 14.

¹³⁹ *Ibid.*

¹⁴⁰ Zane O. Gresham, Gang Xu, "China Moves to Increase Private and International Participation in Airports and Aviation" Online:

<<http://www.mofo.com/news/general.cfm?MCatID=9604&concentrationID=&ID=1247&Type=5>>
(last visited on January 3, 2005)

personnel would be transferred to local governments.¹⁴¹

1.3.2 The Reform Process: Advantages and Disadvantages

A. Restructuring Creates Opportunity

Restructuring is one way for Chinese air transport enterprises to strengthen their completion ability. Through restructuring, the airlines can deal with the structural problems in capital, debt, routes, and aircrafts that have long been present, and can satisfy their production and operation needs. Meanwhile, they could achieve lower costs. Of course, restructuring is an excellent way to strengthen Chinese airlines, a goal that became increasingly important when China wants to benefit from international competition. The improvement in the operation and management of Chinese airlines and the building of modern cooperation systems could also turn weakness into strength.

B. The Problems in the International Market

When the three big conglomerates divided China's civil aviation market, concerns arose as to whether their conflicts in domestic market would be transferred into their new conflicts in the international market. The effects of the division remain unclear. The original aim of reform was to create a united Chinese pressure in the international market; however, the drive for individual benefits may break this tenuous balance at any time. Reasonably dividing the business scopes of the three conglomerates is therefore the most

¹⁴¹ *Ibid.*

effective way to prevent dissension. It would require the three conglomerates to focus on different fields (e.g., one conglomerate focus on international routes, domestic routes, or air cargo); based on the fair competition, each conglomerate would have its own special category, which could be business passengers, leisure passengers, or cargo.

The size of the airlines makes evident another problem. After the restructuring, each conglomerate is much bigger than the individual airlines they consolidated; however, big does not necessarily mean strong or viable. If airlines cannot absorb their partner airlines' advantages and make up their shortcomings, they probably would take on a much heavier burden of debt after the reform than before. Theoretically, the scale of an enterprise is decided based on the balance of its business costs and its operation costs.¹⁴² Generally, only when the benefits, brought by the "economy of scale"¹⁴³, outweigh the increased management costs, born from the expansion of the enterprise, is it possible for the civil aviation enterprise to continue to develop. Economy of scale is the most direct means of improving the enterprise's operational efficiency. Thus, based on the concept of economy of scale, the air transport industry can function smoothly and profitably, after restructuring.

C. The Problems in the Domestic Market

The mergers of the Chinese airlines beg the following questions: what is the future for small and mid-sized airlines? How can such airlines survive in the face of huge Titans?

¹⁴² Yanhua Li, "How Can Small and Mid-Sized Airlines Survive in the Regroups?" (2002) 22 China Civil Aviation. 28. [translated by author].

"Business costs" is the cost one company spends on certain project in order to get profit back.

"Operation costs" is the cost one company spends on all the items to support the existing and normal operation. For example, the salary paid to its employee.

¹⁴³ An "economy of scale" is an economic theory stating that a plant's marginal cost of production decreases as the plant's operation increases. The more of a good you produce, the less it costs for each additional unit. For example, a plant that produces 1,000 cars would be more efficient than a plant that produces five cars.

Do some of the small airlines with high efficiency and strong competitive power have the potential to be champions?

The answer to these questions may be addressed from three perspectives. First, a healthy market environment is the function of any airline's growth. The opening and reform of the Chinese socialist market economy, which have greatly contributed to the development of many Chinese industries, can also undoubtedly support the air transportation industry. Furthermore, after becoming a member of the WTO, many of China's industries are undergoing liberalization, thus creating a more open market environment for China's airlines.

Secondly, small and mid-sized airlines may have a better chance of survival in the modern environment of drastic competition. Small firms are more agile than large conglomerates. They have lower management costs and risk control costs¹⁴⁴, and, because of their small scale, their ability to react is much better than that of their larger counterparts. It offers convenience in terms of the processing of system innovations, the ability to catch or exploit opportunities, and the potential to use civil aviation resources more efficiently.

Thirdly, whether the government can provide a favorable legal guarantee is the key. The "*Law of The Peoples' Republic of China On Advancing of Small and Mid-Sized Enterprises*,"¹⁴⁵ which was promulgated in June 2002, does exist; however, the need for a

¹⁴⁴ A "risk control costs" is the cost one company spends on the safety and security projects to avoid any possible risk.

¹⁴⁵ "*Law of The Peoples' Republic of China On Advancing of Small and Mid-Sized Enterprises*" was adopted at the 28th Session of the Standing Committee of the 9th National People's Congress, promulgated by Order No. 69 of the President of the People's Republic of China on June 29, 2002, and effective as of January 1, 2003. Chapter I General Provisions Article 1: "This law is formulated with a view to improving the business environment of small and mid-sized enterprises, advancing the healthy development of them, increasing the job opportunity both in cities and countries, promoting the important function of small and mid-sized enterprises in national economy and social development." (This was translated by author from

detailed statute to regulate small and mid-sized airlines remains so that these airlines can find their niches in the fiercely competitive market.

1.3.3 Privatization and Foreign Investment in Chinese Civil Aviation Industry

A. The Need for Privatization

Large investments and comprehensive cooperation provide enough capital to satisfy the financial demand of airlines (e.g., airlines need capital to finance new requirements, training new crews, and promote management.). Privatization and foreign investment are necessary to generate sufficient capital to meet the demands of airline operations.¹⁴⁶

In addition, “privatization could enhance efficiency, reduce government costs, generate new government revenues, as well as improve the airlines’ service.”¹⁴⁷

B. The Legal Environment

Article 18 of *the Constitution of the People’s Republic of China* stipulates, “the People’s Republic of China permits foreign enterprises, other foreign economic organizations and individual foreigners to invest in China and to enter various forms of

Chinese to English.)

¹⁴⁶ See Hong Hu, *supra* note 27, at 78. He mentioned that CAAC Vice Chairman, P.N. He, holds that “an airline has to open itself to foreign investors to a certain extent in order to meet its own requirements of development.” See also P.N. He, “The Prospect of Cooperation between Chinese and Foreign Airlines” (1995) XX: 6 Air & Sp. L. 318.

¹⁴⁷ C. Cheng, “Recent Developments in the Aviation Industry of the People’s Republic of China” (1995) 20 Air & Sp. L. 69.

economic cooperation with Chinese enterprises.”¹⁴⁸ There are numerous laws concerning foreign investment¹⁴⁹ to implement this provision. In addition, some administrative documents do focus on Civil Aviation.

*The Regulation of Foreign Investment in Civil Aviation Industry*¹⁵⁰ was efficient on 1 August 2002 as Decree No.110 of the General Administration of Civil Aviation, the Ministry of Foreign Trade and Economic Cooperation, the State Development Planning Commission of the People's Republic of China. This new administrative document supersedes a related 1994 CAAC Notice,¹⁵¹ and creates a dramatic increase in the potential for private sector participation in the ownership, development, and financing of China's airports and airlines.

The new regulation allows for a larger percentage of foreign shareholders who can introduce advanced management and mature business models to Chinese partners, while simultaneously sharing in the rapid development of one of the world's largest and fastest growing aviation markets. As explained below, the new regulation encourages Chinese civil aviation enterprises and airports to better utilize both domestic and international resources and to import more funds and management expertise. The regulation increases

¹⁴⁸ Article 18 of the *Constitution of People's Republic of China* promulgated for implementation by the Proclamation of the National People's Congress on 4 December 1982.

¹⁴⁹ These laws include the *Law of the People's Republic of China on Chinese Foreign Equity Joint Ventures*, *Regulations for the Implementation of the Law of the People's Republic of China on Chinese Foreign Equity Joint Ventures*, *Law of the People's Republic of China on Foreign Capital Enterprises*, *Law of the People's Republic of China on Chinese Foreign Contractual Joint Ventures*, and *Provisions of the State Council of the People's Republic of China for the Encouragement of Foreign Investment*.

¹⁵⁰ *The Regulation of Foreign Investment in Civil Aviation Industry* (CCAR -201), passed on 10 December 2001 as Decree No. 110 of the General Administration of Civil Aviation, the Ministry of Foreign Trade and Economic Cooperation, the State Development Planning Commission of the People's Republic of China, efficient on 1 August 2002. online: <<http://www.caac.gov.cn/zfgg/wstz.html>> (last visited on December 16, 2004) [hereinafter the new regulation]

¹⁵¹ In 1994, the Chinese government began to formally open its civil aviation to foreign investors through *The Notice on Policies Concerning Foreign Investment in Civil Aviation*. This document was jointly issued by the CAAC and the Ministry of Foreign Trade and Economic Co-operation. It primarily involves foreign investment in two sectors, airports and airlines.

the strength of the Chinese civil aviation enterprises and airports, improves their economic benefit, promotes their constant growth, and realizes the new development of civil aviation.

Compared to the former policy concerning foreign investments, this new regulation primarily addresses the following issues:

First, the new regulation stipulates that investments can be made in two types of civil airport projects: (1) airside projects, such as runways, taxiways, and apron airfield aid lighting systems; and (2) terminal projects, such as terminal construction. A Chinese party must hold "relative majority shares"¹⁵² in the joint venture.¹⁵³ Moreover, the fees for the aeronautical services and facilities of a foreign-invested airport will be set by the central government, but the airports' non-aeronautical fees can be set by the airport at its discretion, so long as those fees are confirmed by the local pricing bureau.¹⁵⁴ Of course, a foreign investor who invests in civil airports receives priority in investment opportunities in other aviation-related projects.¹⁵⁵

Second, the regulation addresses the domestic airlines. The cap on foreign investment by any one investor (including its affiliates) is set at 25% in an airline engaged in public transportation, and the cap on total foreign investment is set at 49%.¹⁵⁶ This

¹⁵²"Relative majority shares" means that the shareholding percentage of the Chinese party has to be greater than any of its foreign partner(s).

¹⁵³ See the new regulation, article 3. (1).

¹⁵⁴ See *ibid.*, article 8.

¹⁵⁵ See *ibid.*, article 5.

¹⁵⁶ See *ibid.*, article 6.

For example, in 2002, the foreign investment of the Shanghai Airline is 14.65%, its governmental ownership is 56.24%. See "The stock report of Shanghai Airline" online:

<http://www.sse.com.cn/cs/zhs/scfw/gg/ssgs/2002-09-16/600591_20020916_1.pdf> (last visited on January 7, 2005)

In 2003, the foreign investment of the Southern China Airline is 26.8%, its governmental ownership is 50.3%. See "SouthernChina2003" online:<http://www.sse.com.cn/cs/zhs/scfw/gg/ssgs/2003-07-07/600029_20030707_1.pdf> (last visited on January 7, 2005)

In 2004, the governmental ownership of the Eastern China Airline is 61.64%. See "Eastern China's Annual

figure has been increased from the 35% limit outlined under the 1994 CAAC Notice.¹⁵⁷ Furthermore, Chinese investors must hold majority shares in airlines engaged in governmental, industrial, and sightseeing services, while foreign investors may hold majority shares in airlines providing agricultural, forestry, and fishing services.¹⁵⁸ Finally, any foreign investor investing as a cooperative joint venture partner in airlines engaged in public transportation, be it for governmental or sightseeing services, must be a Chinese legal entity.¹⁵⁹

Third, for investments in aviation-related projects, the current 49% limitation on foreign ownership of aviation oil supply and aircraft maintenance services remains, while no such limitation exists on cargo storage, ground services, food catering, and parking lots.¹⁶⁰

Finally, for all the three categories of investment, foreign investment in aviation projects can take the form of Sino-foreign joint ventures, stock purchases, or other approved investment methods.¹⁶¹ However, no joint ventures should exceed 30 years in duration.¹⁶² Foreign investment and/or management in air traffic control systems are/is not permitted.¹⁶³ It is also important to note that the regulations do not require the Chairmen of the Boards of Directors or the managers of the companies or airlines supported by foreign investment to be Chinese.¹⁶⁴

Report" online: <<http://finance.sina.com.cn/stock/company/sh/600115/10.shtml>> (last visited on January 7, 2005)

¹⁵⁷ See *supra* note 142, article 7.

¹⁵⁸ See *ibid.* article 6.

¹⁵⁹ See *ibid.*, article 4. (3).

¹⁶⁰ See *ibid.*, article 6.

¹⁶¹ See *ibid.*, article 4. (3).

¹⁶² See *ibid.*, article 7.

¹⁶³ See *ibid.*, article 3.

¹⁶⁴ See *general* the new regulation, *ibid.*

C. The Problems of the Current Approaches of Privatization and Foreign Investment

According to the new regulation, the restructuring of the Chinese civil aviation system has aimed at giving foreign operators and investors wider access to China's fast-growing aviation market.¹⁶⁵ Such regulations "expand the channel for using foreign capital, stepping up the solicitation of direct foreign investment and cooperation with moderate rein given to the restriction on the direct foreign investment in China's civil airports and airlines."¹⁶⁶ It is a vast undertaking with a highly complicated implementation process. There are some problems in the current situation of foreign investment in China's aviation.

First, the current structure of foreign investment in China is unreasonable. For example, foreign investment is currently concentrated in some short-term projects, such as food manufacturing and hotel services. There is little foreign investment in the long-term ventures that necessitate large amounts of capital, such as airport construction.¹⁶⁷

Second, the CAAC's control on Chinese airlines' business, in some level, is another obstacle to attracting foreign investment. For example, the airlines cannot get full freedom and independence without the relaxing of the CAAC's absolute control. If the airlines cannot make their management decisions freely (e.g., currently the Chinese airlines cannot decide ticket price by themselves, but under the control with the CAAC),

¹⁶⁵ See *ibid.*, article 1.

¹⁶⁶ By People's Daily Online, "Foreign Investment to Chinese Airports and Airlines Possible" online: People's Daily Online <http://english.people.com.cn/200206/05/eng20020605_97211.shtml> (Last visited on November 28, 2004)

¹⁶⁷ See Zhenzhong Wei, "China Civil Aviation Regroups, Filled with Happiness and Worry" 22 (2002) China Civil Aviation 18.

the potential foreign investments could not go to China without worry.¹⁶⁸

Third, during the process of importing funds, China did not place enough emphasis on importing advanced management techniques and management personnel. In fact, there has been some question as to whether foreign airlines, especially American ones, will swallow the Chinese airlines.¹⁶⁹ It is expected that more globally advanced management ideas, methods, and personnel will be imported, and that Chinese civil aviation will welcome new development.

Being in the initial throes of conversion from being government-run to being privately owned, the Chinese airline industry is at a key turning point. The nature of the Chinese political system makes it unclear as to whether full privatization will occur; however, it is expected that the aviation industry will come of age over the next decade, becoming more efficient and effective. The Chinese government should encourage this evolution.

2. Alliances: A Strategic Means to Avoid Restrictions

The spawning of many innovations in the airline industry, such as hub-and-spoke networks and frequent flier programs, has created a harsher competitive climate. Meanwhile, privatization, liberalization, and globalization have also increased competition. To survive this competition, the carriers have been forced to undergo major restructuring and to seek international strategic alliances.

¹⁶⁸ See Jing Xiao, "Airfare Reform Analysis after the Hearing" 32 (2003) China Civil Aviation 18.

¹⁶⁹ Paul Nisbet, "Global business, Ask the Experts" *TIMES* (May 2001), online: <<http://www.time.com/time/global/may/ask.html>> (Last visited on November 28, 2004)

2.1 Background and Current Approach of Airline Alliances

There is no uniform legal definition of the term ‘alliance’ in the context of aviation. In general, an alliance is a commercial agreement in which reciprocal rights are negotiated between two or more airlines from the same or different States; however, the purpose of the agreement can vary from one arrangement to the next.¹⁷⁰ An alliance links the route networks of two or more airlines, thereby allowing an airline to expand its network overseas without adding new services.

In brief, an ‘alliance’ is the airlines’ response to the global economic competitive environment. In the deregulated economic environment, the aviation market is no longer a limited geographic region in the throes of global competitive practices. Meanwhile, the staggering growth of international civil aviation will accelerate globalization. As a result, airlines worldwide have begun cooperating in order to compete. Their current strategy is expansion in order to achieve economies of scale, global marketing, and a presence in a new market.¹⁷¹ The industry is highly concentrated, as only a few global mega-carriers cover most of today’s world market.¹⁷²

Since the *Wings* alliance evolved out of a partnership between *KLM* and *Northwest* in 1993, an increasing number of airlines have followed the example, namely *Star* alliance,¹⁷³ *OneWorld* alliance,¹⁷⁴ and *SkyTeam*.¹⁷⁵ Statistics indicate that in 2004, *Star*

¹⁷⁰ Isabelle Lelieur, *Law and Policy of the Substantial Ownership and Effective Control of Airlines*, (Burlington: Ashgate, 2003) at 25.

¹⁷¹ *Ibid.* at 18

¹⁷² P. S. Dempsey, “Airlines in Turbulence: Strategies for Survival” (1995) 15 Transp. L. J. 97; R. Doganis, “Relaxing Airline Ownership and Investment Rules” (1996) 21 Air & Space L. 267.

¹⁷³ The *Star Alliance* was founded by Lufthansa and United Airlines in April 1993, and includes Air Canada, Air New Zealand, All Nippon Airways, Asiana Airlines, Austrian Airlines Group, Bmi-British Midland, LOT-Polish Airlines, Mexicana, Scandinavian Airlines System (SAS), Spanair, Singapore Airlines, Tai Airways International, and VARIG of Brazil. South African Airways and TAP-Air Portugal will become full

alliance dominated 19.5% of the world passenger traffic, *OneWorld* alliance took 12%, and *SkyTeam* took 18%.¹⁷⁶ The common points of cooperation among the airlines of these alliances are joint sales and marketing, shared airport facilities, technical cooperation, common purchasing, lot exchanges, code-sharing agreements, combined CRS displays, schedule cooperation, and pricing integration.¹⁷⁷ A comparison of the numbers of the Alliances in 1996 and 1998 reveals a 32% growth over this two-year period.¹⁷⁸

At the beginning of this new millennium, airline alliances are progressing further towards concentration. Most established airlines have become a partner of one of the major global alliances. Moreover, the main global strategic alliances have shown remarkable development in recent years.

“A major long-term objective of Star Alliance is to share the same terminal building for the convenience of passengers and as a cost-saving measure to the carriers. The first Star Alliance terminal is under construction at Miami International Airport; capable of handling 3 million passengers annually when it opens in 2005.”¹⁷⁹ In addition,

members in 2005.

¹⁷⁴ *OneWorld* was founded in August 1994 by American Airlines and British Airways. It includes Aer Lingus, Cathay Pacific Airways, Finnair, Iberia, LanChile, Qantas Airways, and other code-sharing partners. It focuses on international frequent business travelers and corporate accounts, and generates growth by providing an increased level of services and unique alliance fares worldwide.

¹⁷⁵ *SkyTeam* was founded in August 1995 by Air France and Delta Airlines. It includes KLM Royal Dutch Airlines, Air France, Aeromexico, Alitalia, China Southern Airlines, Continental Airlines, Czech Airlines, Korean Air, Northwest Airlines, and Royal Air Maroc.

¹⁷⁶ By 1 October 2004, the *Star* Alliance of 17 carriers, represents 19.5% percent of world passenger traffic and a round 25 percent in passenger revenue. The *OneWorld* Alliance of 8 carriers represents a round 12 percent of world passenger traffic and 14.5 percent in passenger revenue. The *SkyTeam* Alliance of 9 carriers represents around 18 percent of world passenger traffic and 18.5 percent in passenger revenue. Interview of Mr. A.D. Groenewege (14 November 2004).

¹⁷⁷ John M. Balfour, “Transatlantic and Global Alliances under EC Competition Law” (Paper presented to the PAO Seminar, 10 June 1999. See also Angela Cheng-Jui Lu, *International Airline Alliances* (New York: Kluwer Law International, 2003).

¹⁷⁸ Sue Wood, “Hold Your Horses,” (June 1998) 43 *Airline Business*, and the statistics available in *Airline Business*, June 1996.

¹⁷⁹ Adrianus D. Groenewege, *Compendium of International Civil Aviation*, 3rd ed. (Montreal, Quebec: International Aviation Development Corporation, 2003), which is constantly updated for the Fourth Edition to be published in the future [unpublished]

“another important recent development is the introduction of the StarNet system whereby any alliance member will be able to retrieve a passenger’s entire record, regardless of which airline made the original booking.”¹⁸⁰ With these new developments, the passenger will truly experience the conveniences of the alliance’s service.

Meanwhile, some new concepts have been introduced into this field. In 2004, *Star Alliance* introduced the concept of regional membership, of which Finland’s Blue1, an SAS subsidiary, became the first member, followed by Adria Airways and Croatia Airlines on 15 December 2004. *SkyTeam* also introduced the concept of associate membership and Kenya Airways became the first member in the associate category in 2004. “The cost for regional membership is considerably less than for a full member, but a regional airline does not have full voting rights. In establishing the regional membership, a basic objective was to keep costs and complexities as low as possible. For instance, regional members have to be integrated with the frequent flyer programs of their sponsoring carrier.”¹⁸¹

Both recent history and new developments display the powerful potential of the alliances; therefore, an analysis of the alliances’ positive and negative factors is important and practically significant. The alliances’ success can be attributed to the broad scope of their code-sharing networks and the high degree of integration that their airlines have achieved. Through a code-sharing agreement with the alliance partners, the airline can sell tickets under its own name for travel that occurs within both partners’ networks. In this way, alliances can drastically reduce their sale limitations.¹⁸²

¹⁸⁰ *Ibid.*

¹⁸¹ *Ibid.*

¹⁸² See Chapter III. 2.6., below, for more information on code-sharing.

2.2 The Motivation Behind the Creation of Airline Alliances

“Four factors appear to be motivating the creation of airline alliances: (1) the desire to achieve greater economies of scale, scope, and density; (2) the desire to reduce costs by consolidating redundant operations; (3) the need to improve revenue by reducing the level of competition wherever possible as markets are liberalized; and (4) the desire to skirt around the nationality rules which prohibit multinational ownership and cabotage.”¹⁸³

On a macroscopical level, the need for global air travel in an increasingly globalized economy has prompted the advent of airline alliances. However, on a microscopic level, airlines themselves have, for the most part, entered into alliances with foreign partners in order to fill their international and domestic flights with passengers entering their home market from destinations that the airlines themselves do not serve. This lack of service to and from particular destinations is due either to the unprofitability of the routes in question, to bilateral constraints, or to restrictions on cabotage. Consequently, alliance-building serves as a further method of increasing market access and optimizing profits.¹⁸⁴

The bilateral framework is one of the factors that forced airlines to create alliances, as the restrictions imposed by bilateral agreements on certain traffic rights results in notable distortions. Not only do national rules limit foreign ownership of airlines, even the scope of private ownership differs among countries. “In practical terms, airline alliances and partnerships have become a way for airlines to bypass bilateral conventions that prevent them from flying to certain countries or from owning foreign airlines.”¹⁸⁵

¹⁸³ Dempsey, “The Evolution of Bilateral Air Transport Agreement” (2004) [unpublished]

See also R. Doganis, *supra* note 96, at 71.

¹⁸⁴ Milan A. Racic, *supra* note 6, at 84.

¹⁸⁵ Adrianus D. Groenewege, *supra* note 179.

In some ways, the term “alliance” connotes weakness. Historians know that military alliances are often the result of a momentary balance of power and might quickly disappear if this balance is significantly altered. Airline alliances are no exceptions to this rule; however, in the current situation, airlines cannot choose a steadier method, such as cooperation. The alliance is one viable option. Because the framework of international aviation indicates the exchange of commercial traffic rights between States on a bilateral basis, only an airline from contracting parties can avail itself of these rights.

In addition, although their impact is largely insignificant,¹⁸⁶ economies of scale¹⁸⁷ exist, to a certain extent, in the airline industry, as a force that supports creation of airline alliances. Economies of scale also allow airlines to increase the variety or scope of the services they offer, including increased city-pair services, more attractive frequent flyer programs, more efficient use of computer reservation systems, discriminatory pricing, and increased utilization of hub-and-spoke systems.¹⁸⁸ Therefore, regardless of their level of significance for airlines, economies of scale are necessary to extend the airlines’ scope of business.

In summary, airline alliances will continue to be subjects of discussion for civil aviation liberalization and air service agreements alike, as airline alliances are a market response to today’s government air law and policy.

¹⁸⁶ The O.E.C.D. found that while some evidence of the existence of economies of scale does exist in air transport, it does not appear very significant at the overall firm level, See O.E.C.D., *Deregulation and Airline Competition* (Paris: O.E.C.D., 1988) at 22.

¹⁸⁷ *Supra* note 134.

¹⁸⁸ *Supra* note 6, at 36.

2.3 The Benefits and Risks of Airline Alliances

Alliances are controversial, in terms of their varying benefits and risks to participating air carriers, as well as to passengers, communities, travel agencies, and employees.

2.3.1 The Benefits of Airline Alliances

There are two main bodies that stand to gain from the airline alliances: consumers and airlines. From the customers' perspective, alliance member carriers can offer their customers a more beneficial product than non-allied carriers. On the one hand, they offer the consumer purportedly seamless travel services. (e.g., "new non-stop service was inaugurated by Northwest/KLM between Minneapolis-Amsterdam and by Delta/Swissair between Cincinnati-Zurich"¹⁸⁹). Thereby passengers could enjoy the one-stop travel purchase, check-in, and boarding service; simplified baggage transfers; shorter layover times; and connective schedule coordination. In this way, passengers realize "global passenger service support" and "seamless" service. On the other hand, through joint frequent flyer programs between the alliance' members, the consumers found it much easier to earn air mile points. Therefore, the consumers could enjoy better service and save money at the same time.

From the airlines' perspective, alliances provide airlines with increased access to international hub airports and growth markets. Some have joint distribution and fully use

¹⁸⁹ P. S. Dempsey, "Carving the World into Fiefdoms: The Anticompetitive Future of International Aviation", (2002) 27 Ann. of Air and Space Law. 247

information and technology in order to ensure a harmonious product. In this way, industry heavyweights and powerful allies on other continents win the opportunity to establish themselves to a greater extent than they otherwise could. "At the same time alliances serve as a vehicle by which to strengthen their own hubs and sometimes even to turn these into true strongholds ("fortress hubs") in which henceforth it would be extremely difficult for a competitor to gain a foothold."¹⁹⁰ As members of alliances, smaller airlines get the opportunity to gain a foothold in distant markets. By having their logos appear on the check-in counters of partner airlines, alliances increase the worldwide visibility of smaller airlines. Therefore, for both the big and small airlines, "by increasing an airline's network scope and geographic reach", the alliances "produce marketing benefits which generate more passengers, freight and revenue."¹⁹¹

In addition, members of an alliance might reduce expenses and share risk through the alliance's joint sales functions, advertising and sales promotions, insurance premiums and airport handling, and yield management and training programs.

Alliances have come to replace the air transport market that was once rife with battles between several airlines; in today's market, the competition is between alliances and non-alliances. In other words, the airline that does not join an alliance is forced to survive on the margins of the market. For instance, code-sharing softens the edges of head-to-head competition, thus rendering it a potential cure for the underlying problem of unprofitability that plagues much of the industry.

Summarily, airlines enjoy the following principal benefits from an alliance:

" (1) An ability to provide more capacity and enter new markets without having to

¹⁹⁰ Sebastian Steinke, "Airline Alliance Becoming Increasingly Important" online: Flug Revue Online < <http://www.flug-revue.rotor.com/FRheft/FRH0105/FR0105a.htm> > (Last visited on November 29, 2004)

¹⁹¹ Dempsey, *supra* note 189, at 253.

make large capital expenditures for aircraft purchases or airport infrastructure;

(2) An ability to generate thousands of new “on-line” city-pair combinations;

(3) An ability to extend the reach and scope of their frequent flyer programs to enhance consumer loyalty;

(4) An ability to generate between three and four new passengers per flight;

(5) An ability to generate net benefits of at least ten per cent (and often twenty per cent) of relevant revenue from the alliance;

(6) Revenue enhancement of approximately two per cent above market yield;

(7) An ability to capture market share from non-aligned competitors;

(8) An ability to fix prices with competitors in dominant markets;

(9) An ability to reduce competitive capacity in key markets to improve yields;

(10) A reduction in the costs of equipment and services from third party vendors as a result of greater bargaining power of pooled purchases;

(11) A reduction in airport handling, airport operations, selling and ticket costs as a result of economies of scale and the sharing of support services;

(12) A reduction in travel agent commission costs achievable as a result of carrier market power; and

(13) An ability to pool costs and revenue to share risks and rewards.”¹⁹²

Lastly, close collaboration between alliance members might affect other industries, such as aircraft manufacturing. Standardization and joint procurement could mean cost savings for the airlines. For example, joint aircraft purchases by alliance members would give them more market power, thus enabling them to force down prices.

¹⁹² *Ibid.* at 254-255. n. 20.

2.3.2 The Risks of Airline Alliances

“The most serious problems with alliances are their anticompetitive dimensions.”¹⁹³ As a “predatory weapon”, code-sharing “can result in market allocation, capacity limitations, higher fares, or foreclosure of rivals from markets, all to the injury of consumers.”¹⁹⁴ The success of global airline alliances hinges upon whether they are granted antitrust immunity by the U.S., or competition immunity by the E.U. As a matter of public policy, the U.S. government has been willing to offer antitrust immunity to the air carriers of various countries for transatlantic alliances as a quid-pro-quo for “Open Skies” bilateral air service agreements. A CAAC official believed that the U.S. Department of Transportation considers the conclusion of the liberal Open Skies Agreement as a pre-condition to the granting of antitrust immunity and the approval of any international airline alliance.¹⁹⁵ The U.S.’s “Open Skies” policy is designed to open the skies outside of the America; through the exertion of American domestic law, including the antitrust law, and its foreign jurisdiction, the U.S. led the development of the global air transport industry.¹⁹⁶

Furthermore, under code-sharing the consumers do not realize that they are actually purchasing more than one airlines’ product.¹⁹⁷ In the computer reservation systems, the combination of the several purchases creates CRS clutter, thereby “shoving competitive

¹⁹³ Dempsey, *supra* note 189, at 255.

¹⁹⁴ *Ibid.* at 255-256. n.24.

¹⁹⁵ Chunyu Ding, “Global Airlines Alliance” 27 (2003) 3 China Civil Aviation, 42. The author works in the International Cooperation Bureau of the CAAC. He put an example to support this opinion: the U.S. attached rigorous conditions in the case regarding One-World Alliance’s British Airways and American Airlines’s preparing for antitrust-immunity in 2001. The U.S. DOT did so mainly because the U.S. and the U.K. have not concluded an “Open Skies” agreement and a failure to do so might hamper the development of the alliance.

¹⁹⁶ Interview of the person who works in the Chinese Delegation of ICAO, (March 2004).

¹⁹⁷ Dempsey, *supra* note 189, at 255.

alternatives off the first page of the CRS screen, where eighty-five per cent of all flights are sold.”¹⁹⁸ “Moreover, some code-sharing connections are less than consumer-friendly. Some transfer passengers onto airlines or aircraft on which they would prefer not to fly. For example, a code share can put a passenger on an aging Soviet or small unpressurized turboprop aircraft sans lavatory.”¹⁹⁹

Of course, a global alliance with numerous members (such as *Star*) might find it increasingly difficult to keep each of its members happy. Keeping every member’s business choices balanced requires a very complex decision-making process. However, in defining a common alliance strategy, in achieving consensus on the new member who wants to join the alliance, and in building the brand of a common product to the customer, global alliances face a weightier task than do individual airlines.

2.4 Chinese Airlines Enter Into the World Alliances

2.4.1 The Main Reasons Why Chinese Airlines Should Join Global Alliances

First, entering into global alliances will contribute to the survival and growth of Chinese airlines in the international aviation market. Because of globalization, the destinations to which passengers and cargo are traveling are becoming increasingly diversified. Not one of the world’s major airlines can supply ubiquitous service. The bilateral air transport agreement system is an important reason why no airline can reach all of the travel sites on the earth. Therefore, airline alliances have come to be an effective

¹⁹⁸ *Ibid.*

¹⁹⁹ *Ibid.*

way for most airlines, including Chinese airlines, to seek survival and development.

Secondly, it will benefit China to expand its presence in the international market. In 2002, the number of passenger on international routes of Chinese air transportation accounted for 9.28% of the whole number of passenger on both Chinese domestic and international routes.²⁰⁰ The points of origin of most international passengers are outside of China; yet the Chinese airlines do not have significant presences abroad to capture the overseas market. If Chinese airlines joined global alliances, it would bring them increased opportunities to introduce their services to foreign passengers. This would help Chinese airlines establish a pressure in international markets.

Thirdly, through cooperation with other airlines in the alliances, Chinese airlines will be forced to improve their management strategies and service products. Consequently, the Chinese airlines will be making a positive investment for their future.

2.4.2 Current Approaches

A. Air China and United Airlines Establish a Market Alliance

In August 2003, Air China and United Airlines signed a code-sharing agreement to form a marketing alliance that would expand services in both China and the U.S. Analysts saw it as “a first step for Air China to join the world’s biggest airline network, Star Alliance, anchored by United and Lufthansa AG.”²⁰¹

Air China’s extensive network covers all of the major business and travel hubs in

²⁰⁰ *Supra* note 126.

²⁰¹ See CNN, “China, U.S., sign air expansion deal” online: CNN.COM
<<http://edition.cnn.com/2004/TRAVEL/08/23/bt.china.souther.rent/>> (Last visited on November 29,2004)

China. Under the agreement, United extended its service beyond Beijing and Shanghai to five other cities via code-sharing flights operated by Air China's planes carrying United's codes.²⁰² Air China also expanded its network to 14 U.S. cities with code-sharing flights. Additionally, under the codes from both airlines, the two airlines offered a total of 26 non-stop code-sharing flights per week between China and the U.S.²⁰³

Although Air China entered into a code-sharing relationship with United, it concluded that it was not the time to join *Star Alliance*. Air China's business was adversely impacted by the SARS outbreak in April and May 2003. However, joining an alliance is a key component of Chinese airlines' globalization strategy.²⁰⁴

B. China Southern to Join Airline Alliance

China Southern Airlines Ltd., the country's largest carrier, is expecting to become the first Chinese airline to join a global alliance. On 28 August 2004, it signed a memorandum of understanding to enter *SkyTeam*. The agreement is a preliminary step in the process for China Southern to officially join the alliance. Once it fulfills *SkyTeam*'s quality standards, China Southern will beat domestic rivals to the punch by becoming a part of the *SkyTeam* alliance, thereby expanding its worldwide network.

²⁰² The five cities are Guangzhou, Shenyang, Xi'an, Fuzhou, and Shenzhen.

²⁰³ See *supra* note 177.

²⁰⁴ A CAAC official suggested that "joining certain international aviation alliances would be good moves for the three new groups currently forming out of the previous 10 national airlines to grab more international market share. The official, who only gave his surname as Wu, told Business Weekly that CAAC supports domestic airlines joining big aviation alliances without any preconditions. Wu said membership in international alliances, which are operated by the most experienced international air carriers, would help Chinese airlines to be connected to worldwide aviation networks. Making use of the mass air links from alliances, domestic airlines could extend their access to nearly the whole world, and they would see a sharp increase in passengers, Wu said." People's Daily, "China Weighs Membership in Air Clubs" online: <http://english.people.com.cn/200105/24/eng20010524_70916.html> (last visited on December 12 2004)

China Southern Airlines is the largest airline in China in terms of fleet size, number of routes, and annual passenger and cargo volume.²⁰⁵ It is currently consolidated with the former China Northern Airlines and Xinjiang Airlines. After the consolidation, “it will have a fleet of 215 aircraft, over 660 routes and serves about 30 million passengers annually, accounting for one third of the market share in the Chinese civil aviation.”²⁰⁶ Joining *SkyTeam* requires further reforms and an opening to the international community, both of which are effective ways to strengthen their international co-operation and sharpen their competitive edge in the global aviation market.

As a member of *SkyTeam*, China Southern will be able to optimize its management and service levels, expand its international market, and diversify its investment and sales channels. China Southern Airlines’ passengers will benefit from ability of its passengers to take advantage of the frequent flyer program on all flights operated by *SkyTeam*, have access any city that any *SkyTeam* flight can reach, enjoy greater fare options, and have only one check-in process for multi-leg flights.

For *SkyTeam*, it also could offer its passengers more forward-looking benefits: greater access, more choices, and greater convenience regarding the country and region. Moreover, after joining *SkyTeam*, the new Guangzhou Baiyun International Airport, which began operation in early August 2004, will be the first hub airport in China for *SkyTeam*. It will further expand *SkyTeam*’s strong hub network in Asia.

China Southern has already forged a close relationship with *SkyTeam* members. For

²⁰⁵ With a fleet of 140 aircraft, China Southern serves 21 million passengers annually and operates 334 routes that serve 94 destinations, including Los Angeles, Sydney, Singapore, Amsterdam, Paris, Seoul, and Tokyo. Through one of the world’s most extensive hub networks, *SkyTeam* offers its 218 million passengers a year a worldwide system of more than 8,300 daily flights covering all major destinations. “New partnership: Skyteam Signs Agreement with China Southern Airlines” online: BOARDING.NO <<http://www.boarding.no/art.asp?id=13020>> (Last visited on November 29,2004)

²⁰⁶ *Ibid.*

example, the first ever code-sharing pact in Chinese aviation history was signed in 1997 between China Southern and Delta Air Lines. Similarly, in January 2004, China Southern joined hands with Air France to launch Guangzhou-Paris service under a code-sharing agreement, after which it initiated a code-sharing agreement with Korean Air in August. In addition, another *SkyTeam* member, KLM Royal Dutch Airlines, also has a strong relationship with China Southern in terms of both passenger and cargo services.²⁰⁷

This agreement of China Southern's entering into *SkyTeam* marks a significant move by China Southern in China's civil aviation industry, as China Southern will be the first Chinese airline to join an international airline alliance. This step may encourage other Chinese airlines to seek membership in global aviation alliances in order to optimize and strengthen themselves and their place in the world aviation market.

2.4.3 China Stands on the Edge of Global Alliances

After the 9/11 tragedy, when the global air transportation industry fell into a recession, the Chinese air transportation industry enjoyed a potential development, because the whole Chinese economy enjoyed a growth rate of 7% per year.²⁰⁸ Each

²⁰⁷ See People's Daily Online, "Southern Airline to join global alliance" online: People's Daily Online <http://english.people.com.cn/200408/30/eng20040830_155250.html> (last visited November 29, 2004) "As a code-sharing partner of China Southern, KLM Royal Dutch Airlines announced in Beijing [in June 2004] that it will conduct double daily services from both Beijing and Shanghai to Amsterdam. The positive economic climate in China will further stimulate business travel as well as leisure travel to and from Beijing and Shanghai, said Boet Kreiken, senior vice-president of KLM. He said that as a result of the expansion of aero-rights, KLM will operate twice as many flights from Shanghai and Beijing to Amsterdam as it did in the summer of 2003. Furthermore, the introduction of the new Boeing 777-200ER will make it possible to deploy larger aircraft and will improve in-flight services on designated flights to and from Beijing and Shanghai, Kreiken said. By increasing flights from three to seven each week, KLM becomes one of the top three European airlines in China. Chinese passengers can transfer to more than 100 other European cities via Amsterdam." People's Daily Online, "China Southern eyes Sino-European Air Transport Market" online: <http://english.people.com.cn/200406/17/eng20040617_146657.html> (last visited on December 12 2004)

²⁰⁸ In October 2003, China official said "China would maintain an annual economic growth rate of 7 percent

alliance aims to get Chinese airlines into them so that they can enjoy the benefits of the growing Chinese market.²⁰⁹ That Chinese airlines will join global alliances is inevitable. Although no Chinese airline has, to date, officially joined any alliance, as noted above, they are on the very brink of doing so.²¹⁰

The Chinese government provides oversight over whether airlines are allowed to join alliances. Airline alliances are business agreements between airlines; however, in China, although a socialist market economy system has been established, national ownership is still the main form of airline industry.²¹¹

Through policies and regulations, the CAAC oversees the airlines' process of joining global alliances. At present, the law and legal regulations governing Chinese air transportation market include "Civil Aviation Law," "Anti-malfeasance Competition Law," "Price Law," and "Regulation on prohibiting malfeasance competition conducts on the civil aviation market"²¹². Actually, besides such regulations, CAAC officials rely on

or higher over the next two decades." People's Daily Online, "China's economy grows 8.5 percent in first 8 months" online: <http://english.people.com.cn/200310/17/eng20031017_126253.shtml> (last visited on December 12 2004)

²⁰⁹ "So what is the real size of the Chinese market? At the end of 2002, the date of the most recent official estimate, China had a population of 1.28 billion, of which two-fifths (502 million) lived in urban areas and the rest in rural ones, and which was growing at 0.65% a year. The average disposable income per person was 4,520 yuan (\$545), nowhere near the \$5,000 level at which economists say discretionary spending takes off, and little more than 2% of America's \$25,000-plus. Measured by GDP per person, which breached \$1,000 in 2003, China is only half-way to becoming a middle-income country as measured by the World Bank, ranking below places such as Namibia, Guatemala and Morocco."

"A billion three, but not for me" *The Economist* (20 Mar 2004) 5.

²¹⁰ It is expected that China Southern Airlines will formally become a full member of *SkyTeam* sometime in 2005-2006. See *supra* note 177.

²¹¹ See Chapter II. 1.3.3., above, for more information on the limitation of foreign investment on Chinese airlines.

²¹² This is translated from Chinese by author.

"Civil Aviation Law of the People's Republic of China" was adopted at the 16th Meeting of the Standing Committee of the Eighth National People's Congress on October 30, 1995, promulgated by Order No. 56 of the President of the People's Republic of China on October 30, 1995 and effective as of March 1, 1996.

"Anti-malfeasance Competition Law of the People's Republic of China" was adopted at the 3rd Meeting of the Standing Committee of the Eighth National People's Congress on September 2, 2003, promulgated by Order No. 10 of the President of the People's Republic of China on September 2, 2003, and effective as of December 1, 1993.

"Pricing Law of the People's Republic of China" was adopted at the 29th Meeting of the Standing

numerous policies and non-public documents, which is far from the requirement of “administration according to law” that arose from China’s entrance into the WTO. The legal system in China does not as yet comprehensively address all commercial and competition issues.

To enter into the international market, China should perfect its legal system with respect to civil aviation, particularly antitrust law. During the process of improving competitive power or after joining an alliance, airlines may engage in some monopolizing or unfair competitive actions. For example, according to the code-sharing agreement, the partners in any alliance may restrict each other’s traffic ability and may also agree to raise ticket prices. The absence of an antitrust law in China causes the CAAC’s oversight of competition in the air transportation market to lack legal foundation.

Furthermore, in order to join any global airline alliance, the Chinese airlines must bring benefits to their partners. In any alliance, win-win stratagem is the main principle through which alliances are established. The current scale of any Chinese airline is very small in the international aviation market. Whether in the domestic or international market, the managerial sophistication of any Chinese airline is weak and the scale economy is undeveloped. The restructuring of Chinese airlines into large conglomerates, which is now ongoing, will contribute to expand China’s route network in the international market. By consolidation, large Chinese airlines will enjoy advantages in negotiations with their foreign alliance partners.

In conclusion, in today’s Open Skies environment, alliances enjoy broad commercial

Committee of the Eighth National People’s Congress on December 29, 1997, promulgated by Order No. 92 of the President of the People’s Republic of China on December 29, 1997, and effective as of October 1, 1998.

“Regulation on prohibiting malfeasance competition conducts on the civil aviation market” was adopted by CAAC on February 7, 1996, and effective as of February 7, 1996.

opportunities in the world's most important markets. Chinese airlines' development will be in line with the development of global airline alliances. It is believed that China Southern Airlines will officially join *SkyTeam* in one or two years, thus rendering it the first Chinese airline to join an alliance.²¹³

²¹³ See *supra* note 208.

Chapter III: Comparison of the Civil Aviation Relations between China, the U.S., and Germany

1. The Evolution of Bilateral Air Transport Agreements

This chapter provides a detailed analysis of China's bilateral aviation relations with the U.S. and Germany. U.S. is the driving force behind liberalization and Germany followed, whereas China, enough seeing international air transport's positive role in furthering economic growth, is still in a stage of protecting its airlines against too much foreign competition and thus takes a careful approach towards full liberalization.

In order to achieve a better understanding of China's liberalization process in international air transportation, it will also be useful to examine the history of the international air transport agreements between China, on the one hand, and U.S. and Germany, on the other.²¹⁴

After the WWII, the People's Republic of China and the U.S. signed their first bilateral air transport agreement²¹⁵ in September 1980, in which each party designated

²¹⁴ There is a more than forty years history of the bilateral air transport agreements between the U.S. and Germany, including the *Air Transport Agreement of 7 July 1955* (See *Air Transport Agreement between the United States and the Federal Republic of Germany and Related Exchange of Diplomatic Notes*, 7 July 1955, entered into force 16 April 1956, 275 U.N.T.S. 3, 7 U.S.T. 527, T.I.A.S. No. 3536, German Law Gazette II, 1956, at 403 [hereinafter *1955 U.S.-Germany Agreement*]); the *Protocol of 1 November 1978* (See *Protocol Between the United States of America and the Federal Republic of Germany Amending the 1955 Agreement*, 1 November 1978, 1203 U.N.T.S. 280, 30 U.S.T. 7323, T.I.A.S. No. 9561 [hereinafter *1978 U.S.-Germany Protocol*]); the *Interim Arrangement of 6 November 1992* (See *Interim Agreement between the US and Germany Concerning Air Services*, 6 November 1992, reproduced in J. Fox, *The Regulation of International Commercial Aviation* (New York: Oceana, 1994) [herein after *1992 US-Germany Interim Agreement*]); the 1993 Germany-US Transitional Aviation Agreement (See Memorandum of Consultations of 24 September 1993 between the *US and Germany on Transitional Arrangements for Air Transport Service* [unpublished] [hereinafter *1993 US-Germany Memorandum*]); the *Transitional Agreement of 24 May 1994* (See *Agreement between the Government of the United States of America and the Government of the Federal Republic of Germany on Transitional Arrangements for Air Transport Services*, 24 May 1994 [unpublished] [hereinafter *1994 US-Germany Transitional Agreement*]); and finally, the *Open Skies Agreement of 23 May 1996* (See *Protocol between the United States of America and the Federal Republic of Germany to Amend the Air Transport Agreement of 7 July 1955 as Amended*, with related Route Schedule, 23 May 1996 [hereinafter *1996 US-Germany Open Skies Agreement*]). Hong Kong and Macao are two special administration districts in China. They have right to sign bilateral air transport agreements with the other countries separately.

²¹⁵ *Agreement Between the Government of the United States of American and the Government of The People's Republic of China Relating to Civil Air Transport*, September 17, 1980, U.S.-P.R.C., T.I.A.S. No.10, 326, at 4 [hereinafter *1980 China-U.S. Agreement*].

two major airlines that would provide international air transport services; the bilateral also contained capacity, frequency, designated airports and other standard clauses. As a result, the first Chinese Boeing 747 touched down at San Francisco International Airport on January 7, 1981.²¹⁶ This incident marked the resumption of air services between the People's Republic of China and the United States since the establishment of the Peoples Republic of China in 1949,²¹⁷ thus allowing China to enter the modern global civil aviation era.

Since 1980, the China-U.S. bilateral agreement has been amended four times—in 1992, 1995, 1999 and 2004—resulting in an increased number of flights, airlines, and routes, and expansion of capacity.²¹⁸ The July 2004 agreement between the U.S. Department of Transportation and the Civil Aviation Administration of China will approximately quadruple the number of commercial passenger and cargo flights between the two countries over 6 years.²¹⁹ This agreement is a big step forward in the Chinese air transport liberalization process. Compared with other major Asian countries, China takes a cautious and conservative approach in bilateral air transport negotiations.²²⁰ Nevertheless, the agreement between China and the U.S. is well on its way toward full

²¹⁶ See Wallace Turner, "Scheduled Air Service from China to U.S. Resumes", N.Y. Times, (8 January 1981) A 16. See also Gabriel S. Meyer, *supra* note 5.

²¹⁷ *Ibid.*

²¹⁸ *Agreement Between the Government of the United States of America and the Government of The People's Republic of China Amending the Agreement of September 17, 1980*, February 10, 1992, U.S.-P.R.C., T.I.A.S. No. 12, 448, at 6-7 [hereinafter 1992 China-U.S. Agreement].

Agreement Between the Government of the United States and the Peoples Republic of China Relating to Civil Air Transport, as amended, April 8, 1999, U.S.-P.R.C., Hein's No. KAV 5630 [hereinafter 1999 China-U.S. Agreement].

Protocol to the Agreement Between the Government of the United States of America and the Government of the People's Republic of China Relating to Civil Air Transport, amending the Agreement of September 17, 1980, June 2004, [unpublished] [hereinafter 2004 China-U.S. Agreement].

²¹⁹ See "China, U.S. sign air expansion deal" (July 25 2004) CNN.com, online: <<http://www.cnn.com/2004/TRAVEL/07/25/bt.china.us.air.pact/>> (last visited on December 2, 2004)

²²⁰ Singapore is the typical reference, who is the first Asia country targeted to come on board for open skies by the U.S.. They signed an "Open Skies" agreement in April 1997.

liberalization. Similar air transport relations between China and the European countries are not as developed as are those between China and the United States.

Germany has had a long-term air transport relationship with China; it can therefore be taken as a model for the other European countries. The first Civil Air Transport Agreement between the Government of the Federal Republic of Germany and the Government of the People's Republic of China was signed on 31 October 1975,²²¹ at a time when China's air transportation industry was still relatively isolated.²²² This agreement was amended in 1995.²²³ However, the cooperation between China and Germany in the air transport field, especially the liberalization progress taking place, has changed the air transportation dramatically. An updated bilateral agreement between China and Germany is called to be more appropriate for the current liberalization process.

2. Analysis of Bilateral Agreements Between China, and the U.S., and Germany

A comparative study of the China-Germany and China-U.S. bilateral air transport agreements will help clarify China's current development and liberalization policy, which can be used as model for air transport agreements between China and other foreign countries.

²²¹ It has entered into force on 24 May 1978.

²²² The innovation of the whole Chinese industry began from Mr. Deng Xiaoping's "Open and Reformation" Policy in 1978.

²²³ *Protocol Amending the Civil Air Transport Agreement between the Government of the Federal Republic of Germany and the Government of the People's Republic of China*, signed at Beijing on 11 December 1995.

2.1 The Negotiating Position

The negotiating power of each of China, the U.S., and Germany varies according to the substantially different levels of development of their respective aviation systems.²²⁴

The aviation industries in both the U.S. and Germany exhibit a significantly higher level of development than that in China in terms of technology, service and management.²²⁵

²²⁴ See World Airline News, "China Says Slow, U.S. Pushes for Go" (Oct. 20, 2000) (Lexis). (last visited on November 29, 2004) The CAAC's Wang Ronghua stated in October 2000, "[W]e should not lose sight of the fact that the aviation systems of the U.S. and China are at different levels, and it will take time for China to catch up. It is in all our best interests that the progress be taken gradually." See also Geoffrey Thomas, "China's Long Haul", *Air Transport World*, (Oct. 1, 2000) 49-50. As the CAAC's Director General for the Department of International Affairs and Cooperation noted, "You must remember that there are individual airlines in the U.S. that have a larger fleet than the whole of China."

²²⁵ For example, in 1995, the U.S. DOT announced that it would follow the following approach in international aviation negotiations:

" . Extend invitations to enter into open aviation agreements to a group of countries that share our vision of liberalization and offer important flow traffic potential for our carriers even though they may have limited Third and Fourth Freedom traffic potential. This would assist the development of global systems and increase the momentum for further worldwide liberalization. . . .

. Renew efforts to achieve liberal agreements with trading partners with which our aviation relationships lag behind those of our general trade advancements, as we have done successfully with Canada. . . .

Seek changes in U.S. airline foreign investment law, if necessary, to enable us to obtain our trading partners' agreement to liberal arrangements to the extent it is consistent with U.S. economic and security interests. . . .

Given the diverse positions of our trading partners and their varying degrees of willingness to liberalize aviation relations, we must also have a strategy for dealing with countries that are not prepared or willing to join us in moving quickly to an unrestricted air service regime. Our approach is a practical one: It proposes to advance the liberalization of air service regimes as far as our partners are willing to go, and to withhold benefits from those countries that are not willing to move forward. Specifically, we will pursue the following strategy:

1. We will offer liberal agreements to a country or group of countries if it can be justified economically or strategically. We will view economic value more broadly than we have in the past, in terms of both direct and indirect access and in terms of potential future development. Moreover, there may be strategic value in adopting liberal agreements with smaller countries where doing so puts competitive pressure on neighboring countries to follow suit.

2. We recognize that some countries believe that they can resist the trend of economic forces and continue to control access to their markets tightly. We believe that they cannot, and that attempts to do so will ultimately fail. Nevertheless, we will work with these countries to develop alternatives that address their immediate

The U.S. has long been a leader in the international aviation industry. German airlines, such as Lufthansa, are also major European airlines.

A comparison of the aviation industries in the U.S. and Germany reveals that the Chinese aviation industry is still in a primary developmental stage. Until the Chinese

concerns where this will advance our international aviation policy objectives. We will examine alternative approaches that may include departing from established methods of negotiation (perhaps negotiations with two or more trading partners); trying to develop service opportunities for the foreign airline to make service to the U.S. more economically advantageous for it; and continuing our efforts to help those governments and their constituencies appreciate the benefits that unrestricted air services can bring to their economies and industries.

While we work with such countries, we can consider, in the interim, transitional or sectoral agreements.

Transitional agreements- Under this approach, we would agree to a specified phased removal of restrictions and liberalization of the air service market. This approach contemplates that both sides would agree, from the beginning, to a completely liberalized air service regime that would come into effect at the end of a certain period of time.

Sectoral agreements- Traditionally, aviation agreements have covered all elements of air transportation between two countries. However, as a first step, we can consider agreements that eliminate restrictions only on services in specific aviation sectors, such as air cargo or charter services.

3. For countries that are not willing to advance liberalization of the market, we will maintain maximum leverage to achieve our procompetitive objectives. We can limit their airlines' access to the U.S. market and restrict commercial relations with U.S. airlines. When airlines request authority to serve restricted bilateral markets that is not provided for under an international agreement, we will consider their requests on a case-by-case basis in light of all our policy objectives, including, inter alia:

- . Whether approval will increase the variety of pricing and service options available to consumers;

- . Whether approval will improve the access of cities, shippers and travelers to the international air transportation system;

- . The effect of granting code-sharing authority on the Civil Reserve Air Fleet program;

- . The effect of the proposed transaction on the U.S. airline industry and its employees. In this regard, we will ascribe greater value to code-sharing arrangements where U.S. airlines provide the long-haul operations. We will also recognize the greater economic value of such arrangements where the services connect one hub to another; and

- . Whether the transaction will advance our goals of eliminating operating and market restrictions and achieving liberalization.

If aviation partners fail to observe existing U.S. bilateral rights, or discriminate against U.S. airlines, we will act vigorously, through all appropriate means, to defend our rights and protect our airlines." 60 Fed. Reg. 21841 (May 3, 1995). at 21844-45. See also Dempsey, *supra* note 183.

aviation industry is fully restructured, it will not be strong enough to benefit from international competition. For this reason, the Chinese government holds a generally conservative attitude towards bilateral air transport relations with developed countries.

Despite China's reluctance to enter into "Open Skies" agreements, every country expects the ability to fly through or add routes to China. China is a large, albeit underdeveloped, market; therefore, the first airline to take advantage of this market will have the opportunity to reap the greatest benefit. Chinese airlines transported 90.64 million passengers in the first three quarters of 2004, a 50 percent increase from the same period in 2003.²²⁶ A CAAC official predicted that passenger transport in 2004 as a whole would exceed 100 million.²²⁷ IATA forecasts that China's total number of airline passengers will reach 291.5 million by 2010;²²⁸ and Boeing predicts that China's civil aviation market will grow to become second only to the United States by 2020.²²⁹ The *2004 China-U.S. Agreement* and the potential it represents will provide U.S. airlines with the valuable opportunity to launch crucial additional non-stop China service.

The negotiation of bilateral agreements involves a balancing of both partners' negotiating objectives and interests. "Liberalization only occurred where it was in the interest of the airlines."²³⁰ In this way, airline interests dominate the bilateral relationship. The negotiation between the U.S. and Germany is one example. The powerful airlines of

²²⁶ If thinking about the SARS's effect on the Chinese air transportation in 2003, we could compare with the number of passenger on Chinese market in 2002, it is 77.56 million passengers in the whole year of 2002. Obviously there is a great increase in 2004. See *supra* note 126.

²²⁷ "Chinese Airlines Transport 90 Million Passengers In Three Quarters", *Aviation Daily*, (12 November 2004).

²²⁸ Filbert Fisher, "1998 Amendment to the U.S.-Japan Civil Air Transport Agreement: The Battle May be Won, but the War for Open Skies is Far from Over" (2000) 9 Minn. J. Global Trade 327, 329.

²²⁹ "Boeing Predicts China Civil-Aviation Market Will be World's Second Largest", *ChinaOnline*, (Sept. 24, 2001) (Lexis). (Last visited on November 30, 2004)

²³⁰ Arnt R. Goppert, *The Liberalization of International Air Transport Services: Developments in the US-German Bilateral Relations and their Implications on Future Regulatory Approaches Towards Aviation*. (LL.M. Thesis, McGill University, 1998)[unpublished] at 83.

the U.S. and Germany were the most influential in the talks, actively lobbying to get their positions represented in the agreements. The strong link between Lufthansa's interests and its negotiating position is due to the fact that, until 1994, Lufthansa was majority-owned by the German government. Other interest groups, such as consumers, airports, or the tourism industry were neither as influential nor as organized; often their interests were not adequately represented in the outcome of the negotiations. Similarly, the U.S. DOT insisted on including code-sharing issues in the negotiation. The U.S. successfully exploited it in the U.S.-Germany negotiations of 1992-1996, using them to increase the pressure the U.S. was placing on the German government and on Lufthansa.²³¹

Such balancing could also be found in the negotiations between China and the U.S./Germany. China is interested in developing and strengthening its domestic and international air services. Through cooperation with foreign countries and their airlines, the Chinese aviation industry will be able to absorb the advanced technology and management of the foreign countries. The cooperation is also consistent with the aviation industry's natural character—it is a global industry. Just as China stands to benefit from cooperating with countries with more developed airline industries, Western countries such as the U.S. and Germany seek increased access to China's enormous passenger base, especially considering that China's continued economic increase will enlarge this potential customer group. When foreign airlines fight to be the first one to build cooperative relations with China, in order to achieve a mutually beneficial situation, China is struggling to protect its weaker carriers and to help them survive and expand in competition with foreign airlines. This is one of the reasons for the slow progress of the negotiations.

²³¹ See *ibid.*, at 93.

2.2 Traffic Rights

In bilateral air transport relations, parties have always exchanged traffic rights on a strictly reciprocal *quid pro quo* basis. The granting of a new traffic right to a country means a new opportunity for that country to offer additional services. Therefore, traffic rights are treated for routes or other items in bilateral negotiations. The following table offers a picture of the situation regarding the traffic rights between China, the U.S., and Germany before the emergence of Open Skies agreements.

Table1: GRANT OF RIGHTS (before Open Skies)²³²

		P. R. China -US	P. R. China - Germany	US-Germany
Traffic Rights	Overflight	Yes	Yes	Yes
	3rd/4th	Yes	Yes	Yes
	5th	Yes	Yes	Yes
	6th	----	----	----
	7th	----	----	----
	Cabotage	----	----	----
	Non-Scheduled Traffic Rights	Yes	----	Yes
	All-Cargo Traffic Rights	Yes	----	----
	Cooperative Arrangements	----	----	----
	Leasing	Yes	----	----

As the first Open Skies Agreement between US and a large European country, the *1996 U.S.-Germany Open Skies Agreement* granted more freedoms than before, most notably including a new provision granting full Seventh-Freedom rights to scheduled all-cargo services.

In general, without the granting of the Seventh-Freedom, combined services limit the carrier's operational flexibility in that one point in the route flown by the carrier must

²³² See ICAO, Database of the World's Air Services Agreements, 2004 Edition, Doc 9511. In all the tables in this chapter, "before Open Skies" means the statistic here only include the summary of provisions in the *1980 China-U.S. Agreement* (including amendment in 1982), the *1975 China-Germany Agreement* (including amendment in 1995, 1979), the *1955 U.S.-Germany Agreement* (including amendment in 1978, 1968).

be in the country of designation of the carrier. In the case of a change of gauge,²³³ the transportation must be a “continuation of the transportation from or into the country designating the carrier”.²³⁴

Introducing Seventh Freedom into the cargo sector allows the carriers of both contracting countries to offer service without any operational linkage on the performed route within the country of designation. The granting of these kinds of rights shows the commitment of both parties to dramatically liberalize their aviation relations.²³⁵

The *1975 China-Germany Agreement* grants “the airlines designated by each Contracting Party the right to make stops at the point on the specified route in the territory of the other Contracting Party for the purpose of putting down or taking on international traffic in passengers, baggage, cargo, and mail coming from or destined for the territory of the first Contracting Party as well as that coming from or destined for the intermediate points between the territories of the two Contracting Parties.”²³⁶ The 1995 Protocol clearly re-announced to allow the same 5th Freedom Service to Germany again;²³⁷ however, such provisions does not grant Germany the full 5th Freedom Right beyond China. In the air transport relationship between China and Germany, the granting of rights stopped there.

The *1980 China-U.S. Agreement* also included the first five freedoms,²³⁸ but until the new *2004 China-U.S. Agreement*, no significant progress in the traffic rights was made. Nevertheless, China gradually has been moving to change this. On May 22, 2003,

²³³ Starburst change of gauge means that the type and number of aircraft operating one service can be changed at any point en route.

²³⁴ See *1996 US-Germany Open Skies Agreement*, *supra* note 214, part I, s.3.

²³⁵ See Arnt R. Goppert, *supra* note 230, at 83.

²³⁶ The *1975 China-Germany Agreement*, article 1. (2).

²³⁷ See the *1995 China-Germany Agreement*, article 1. (2).

²³⁸ See *supra* note 214, Article 2.

China and Singapore entered into a bilateral agreement granting Fifth Freedom traffic rights to each other. China designated two cities to be open to foreign airlines: Xiamen and Nanjing. At the end of June 2003, the CAAC permitted Hainan as a test province in order to attempt the granting of the Third, Fourth and Fifth Freedoms. This trend led China to exchange more traffic rights and designate more airports in their bilateral agreements.

2.3 Route Exchange

The exchange of routes grants each Contracting Party's airlines the right to fly to designated airports within the borders of the other Contracting Party. The following table demonstrates the development of route exchange between China, the U.S., and Germany over the past three decades.

Table 2: ROUTE EXCHANGE (before Open Skies)²³⁹

Conditions/Restrictions Applicable to Routes:

A-Allowance for additional traffic points;

C-Allowance for the omission of points with or without permission;

D-Time restrictions on the exercise of the rights granted;

E-Restrictions on airline designations;

²³⁹ See ICAO, *supra* note 232.

- F-Restrictions on the number of points served on route;
- G-Limitations on capacity, frequency, or scheduling on particular routes;
- H-Reference to stopover;
- I-Scheduled all-cargo routes only;
- J-Non-scheduled routes only;
- K-Separate agreement or exchange of diplomatic notes concerning the route exchange;
- M-Other significant operational or traffic conditions and/or restrictions.

UNITED STATES - CHINA

ROUTE EXCHANGE				
Points in Party A	Intermediate Points	Points in Party B	Beyond Points	General Conditions
A NEW YORK, NY SAN FRANCISCO LOS ANGELES, CA HONOLULU, HI	TOKYO or JAPAN	SHANGHAI BEIJING(PKING) FA		ECG
A CHICAGO, IL SAN FRANCISCO LOS ANGELES, CA SEATTLE, WA or HONOLULU, HI A UNITED STATES B BEIJING(PKING) SHANGHAI	TOKYO or JAPAN intermediate points TOKYO or JAPAN	SHANGHAI GUANGZHOU(CTON) BEIJING(PKING) FA CHINA HONOLULU, HI LOS ANGELES, CA SAN FRANCISCO NEW YORK, NY ANCHORAGE, AK HONOLULU, HI or SEATTLE, WA LOS ANGELES, CA SAN FRANCISCO CHICAGO, IL ANCHORAGE, AK UNITED STATES	 beyond points M M beyond points	H IJA EC H IJA
B BEIJING(PKING) GUANGZHOU(CTON) SHANGHAI B CHINA	TOKYO or JAPAN intermediate points			

CHINA - GERMANY

ROUTE EXCHANGE

Points in Party A	Intermediate Points	Points in Party B	Beyond Points	General Conditions
A BEIJING(PEKING) CHINA	TEHERAN FA BUCHAREST intermediate points	FRANKFURT or FA COLOGNE	EASTERN EUROPE	FA CK
B FRANKFURT GERMANY	TEHERAN FA KARACHI INDIA intermediate points	BEIJING(PEKING) or F SHANGHAI FA	TOKYO	CK

UNITED STATES - GERMANY

ROUTE EXCHANGE

Points in Party A	Intermediate Points	Points in Party B	Beyond Points	General Conditions
A UNITED STATES A UNITED STATES B GERMANY	intermediate points intermediate points intermediate points	C GERMANY ANCHORAGE, AK ATLANTA, GA BOSTON, MA CHICAGO, IL LOS ANGELES, CA MIAMI, FL NEW YORK, NY PHILADELPHIA, PA SAN JUAN, PR UNITED STATES	beyond points beyond points M JAPAN D beyond points FAD	C C J M C
B GERMANY	intermediate points	C UNITED STATES	beyond points	C J

In the 1996 U.S.-Germany Open Skies Agreement, each country's carrier has the right to fly from any point in one country to any point in the other country without directional or geographical limitations, thus allowing them to serve any combination of behind, intermediate and beyond points.²⁴⁰ The airlines have acquired maximum flexibility in performance of their services, giving them the right to operate flights in

²⁴⁰ See Route Schedule of 23 May 1996 (scheduled services) part I, ss. 1 & 2 & part II, s. 1 (charter services). *Supra* note 218.

either or both directions, to combine flight numbers, omit stops at any point, and transfer en route traffic from one aircraft to another.²⁴¹

Designating more air routes in the China-U.S. or China-Germany bilateral agreements could increase the amount of traffic between China and these two nations; however, the routes exchanged in the China-U.S. and China-Germany bilateral agreements are not as extensive as those in the U.S.-Germany agreement. All of the agreements lift restrictions on routing, thus allowing the airlines of both countries a certain degree of operational flexibility to and beyond each other's countries. The 1975 China-Germany Agreement stipulates that the route shall be confirmed through an exchange of diplomatic notes between the two Contracting Parties.²⁴² Under the Agreement in question, the Aeronautical Authorities of both Contracting Parties shall agree two points in each country, to be served by two countries' carriers. And both Contracting Parties shall designate two more intermediate points for German carriers and five for Chinese carriers.²⁴³ However, the agreement is not absolute. Similarly, the

²⁴¹ See *ibid.*, part I, s. 2(1)-(5).

²⁴² See *supra* note 218, Article 1 (1): "Each Contracting Party grants to the other Contracting Party the right to operate scheduled air services (hereinafter referred to as "the agreed services") on the route to be agreed upon and confirmed by an exchange of diplomatic notes between the two Contracting Parties (the route and the diplomatic notes shall hereinafter be respectively referred to as "the specified route" and "the Exchange of Notes on Route Schedule")."

²⁴³ The implementation of Article 1, Paragraph 1 of the 1975 *China-Germany Agreement*, article 1.2. "1. The route of the agreed services operated by the designated airline of the Government of the Federal Republic of Germany shall be as follows in both directions: Frankfurt and another point in the territory of the Federal Republic of Germany to be agreed upon between the Aeronautical Authorities of both Contracting Parties—Athens—Tehran—Karachi—two more intermediate points to be agreed upon between the Aeronautical Authorities of both Contracting Parties—Peking or Shanghai—Tokyo. The exercise of the right to carry international traffic in passengers, baggage, cargo and mail between the point in the territory of the People's Republic of China and the point beyond on the specified route shall be subject to future consultations between the two contracting Parties."

2. The route of the agreed services operated by the designated airline of the Government of the People's Republic of China shall be as follows in both directions: Peking and another point in the territory of the People's Republic of China to be agreed upon between the Aeronautical Authorities of both Contracting Parties—five intermediate points to be agreed upon between the Aeronautical Authorities of both Contracting Parties—Frankfurt or Cologne Bonn—two points on the American Continent to be agreed upon between the Aeronautical Authorities of both Contracting Parties. The exercise of the right to carry

agreements between U.S. and China and their amendments imposed sharp limitations upon gateway cities.²⁴⁴ Under the 1999 China-U.S. Agreement, U.S. carriers were restricted to flying to five Chinese cities, while Chinese airlines could fly to 12 U.S. cities.²⁴⁵

The new 2004 *China-U.S. Agreement* clearly represents a movement toward enhanced liberalization, permitting an increasing number of international routes for both countries. China will open its cities step by step, first by opening particular aviation areas, then by expanding to an increasing number of points. The new 2004 Agreement created China Zone 3, a specific aviation area²⁴⁶ allowing access to inner cities from the North to the South of China, as opposed to limiting its service to only a few East coast cities, such as Beijing and Shanghai. Although each U.S. airline may only choose 5 points in China Zone 3, the creation of the Zone constitutes significant progress toward more “Open Skies”.

China’s move to open its cities to foreign airlines is aligned with China’s policy of

international traffic in passengers, baggage, cargo and mail between the point in the territory of the Federal Republic of Germany and the points beyond on the specified route shall be subject to future consultations between the two Contracting Parties.”

²⁴⁴ Under the 1980 *China-U.S. Agreement*, international flights operating between the United States and China were restricted to the following airports in the United States: New York City (John F. Kennedy International Airport), Los Angeles (Los Angeles International Airport), San Francisco (San Francisco International Airport), Honolulu (Honolulu International Airport), and Anchorage (Anchorage International Airport). *Super note* 214. In China, flights were restricted to the following airports: Beijing (Capital Airport) and Shanghai (Hongqiao Airport). *Ibid.* In addition, the agreement specified fourteen alternate airports in the United States and the three alternate airports in China to be used in the event of a diversion from the assigned airport. *Ibid.*

²⁴⁵ The 1999 Amendments designate Guangzhou, Shanghai, and Beijing as the Chinese cities that U.S. passenger flights may serve. The U.S. government may select two additional Chinese gateway cities that U.S. passenger carriers may serve. The 1999 amendments also permit Chinese passenger flights to serve additional U.S. gateway cities including Chicago, Fairbanks, Seattle, Atlanta, and Portland. The Chinese government may also select two additional U.S. gateway cities to be used for Chinese airline passenger operations. Cargo carriers from both countries may fly to any airport in either country open for scheduled operations.

²⁴⁶ See 2004 *China-U.S. Agreement* Article 3, China Zone 3 consists of the points in the following areas: Chongqing, Gansu, Guangxi, Guizhou, Hainan Island, Heilongjiang, Inner Mongolia, Jilin, Liaoning, Ningxia, Qianhai, Shannxi, Sichuan, Tibet, Xinjiang, and Yunnan.

Western Development.²⁴⁷ The Chinese government hopes to attract significant investment, technology, and human resources in order to encourage the economic development of its western cities. Linking such cities to the international market by opening air routes to them undoubtedly will be an effective way of contributing to the development of the travel and trade resources in Western China. Moreover, although the western cities are just beginning to develop, this vast interior area of the country illustrates the true potential of the Chinese market. In the near future, more of China's western cities will become points in China's international route system. In terms of development, the western market will come to be the key element of China's strength, and of its partner relations with the foreign countries.

²⁴⁷ The "Western Development" is a comprehensive policy focus on the western part in China. "At the turn of the new century, while continuing to promote the opening up of the coastal regions, the Chinese government has begun to implement the strategy for the wide-ranging development of the western China. Western China includes Shaanxi, Gansu, Qinghai, Sichuan, Yunnan and Guizhou provinces, the Ningxia Hui, Xinjiang Uygur and Tibet autonomous regions, and Chongqing Municipality. Western China has an area of 5.4 million sq km, making up 56 percent of the country's total land territory; and a population of 285 million, accounting for 23 percent. Western China is rich in mineral resources, and has advantages in energy (including hydraulic power), tourism and land resources." See "Opening Western China Wider to the Outside World" [April 13 2001] online:

< <http://english.chinataiwan.org/web/webportal/W2044050/A2047227.html> > (Last visited on November 30, 2004)

2.4 Capacity

Unrestricted capacity growth is regarded as an essential means for carriers to expand market share.²⁴⁸ Open Skies agreements allow free-determined capacity. In modern “Open Skies” agreements, “Air carriers can freely decide types of aircraft to be used, frequency of services, and in some cases, number of seats based on statistics for existing traffic and on reasonable estimates for future traffic.”²⁴⁹ This method protects the free competition and the most efficient use of resources.

The following table reviews the development in the capacity clause between China, the U.S., and Germany before the Open Skies agreements.

Table 3: CAPACITY CLAUSE (before Open Skies)²⁵⁰

Significant Elements:

A-Statement of general principles governing capacity;

B-A Formula or division of capacity on routes between two contracting parties;

C-A statement of principles governing capacity on routes to or from third countries;

E-Principles expressly excluding unilateral capacity controls;

²⁴⁸ “Unrestricted capacity” is “The right to fly any number of seats on any number of frequencies would be determined by the carrier, based solely on market condition.” Rosenfield, “United States Government—Industry Partnership,” 478 (1982) 16 Int’l Lawyer 473, 478.

In 1995, the ICAO issued a guideline for determining capacity. It states that contracting parties expect market forces to result in a level of offered capacity that will ensure the carriers a reasonable economic return and avoid the “dumping” of capacity. See ICAO, *Regulation of Capacity in International Air Transport Services, Policy and Guidance Material on the Regulation of International Air Transport*, ICAO Doc. 9587 (1995) at 20-21.

²⁴⁹ Hong Hu, *supra* note 27, at 33.

²⁵⁰ See ICAO, *supra* note 232.

F-Inter airline arrangements affecting capacity;

G-A requirement for filling and approval by authorities of capacity, frequencies, timetables and/or schedules;

H-Non scheduled capacity arrangements;

I-Scheduled all cargo capacity arrangements;

J-Change of gauge

		P. R. China -US	R. R. China - Germany	US-Germany
Type of Capacity Clause	Bermuda I	----	----	----
	Free-Determination	----	----	Yes
	Pre-Determination	Yes	Yes	----
	Other	----	----	----
Significant Elements		A B C G H I J	A C F G	A E J

China insisted upon the inclusion of a Pre-Determined Capacity²⁵¹ clause in its agreements with the U.S. and Germany. For example, in the 1975 China-Germany

²⁵¹ "As the term suggests, a system providing for predetermination of capacity requires prior governmental approval of capacity before air services on specified routes may commence. The scope of this prior governmental approval requirement varies from bilateral to bilateral." Dempsey, *supra* note 18, at 63. See also P. Haanappel, *supra* note 33, at 35.

Diamond commented the pre-determination of capacity as, "The freedom of the air the United States has long advocated under the Bermuda principles is a special kind of freedom; the freedom of the stronger (in terms of traffic generating capability and bargaining power) to freely compete with the weaker. This Darwinian notion of freedom has understandably not set well with that large body of politic of countries which together compromise the category of "the weaker." Like weaker species in nature, these countries have fought back with whatever weapons they happened to have at hand. This arsenal of weapons (i.e., restrictions) has been more than a match for the single big weapon in the U.S. arsenal—traffic generating capacity. The reasons noted for this ... stem from the fact that, to paraphrase John Donne, no nation is an island unto itself in international air transportation." Diamond, "The Bermuda Agreement Revisited; A Look at the Past, Present and Future of Bilateral Air Transport Agreements," 41 *J. Air L&Com.* 419, 459, 462 (1975). See also Dempsey, *supra* note 18, at 63.

Agreement, "Matters relating to the operation of the specified routes such as frequency, type of aircraft, timetable, sales representation and ground handling shall be agreed upon through discussion between the designated airlines of both Contracting Parties. Frequencies, types of aircraft as well as timetables as agreed shall be subject to the approval of their respective Aeronautical Authorities."²⁵² Contrary to the Free-Determination of the U.S.-Germany Agreement, Pre-Determination means that the CAAC has absolute control over capacity before its introduction into the market. China also exercises its regulatory oversight in a highly conservative way.

Nevertheless, over the past two decades, the gradual changes to the pre-determination capacity clause of such agreements reflected an effort to satisfy the increasing necessity for the greater flight frequency, and evolution of aircraft technology. For example, since 1980, China-U.S. agreements have dramatically increased the frequency with which each nation's airlines could fly.²⁵³ It granted each country the right to designate two airlines to provide international service between China and the U.S. At that time, the Chinese state-run airline operated all civilian passenger flights in China.²⁵⁴ The 1995 *China-U.S. Agreement* had restricted the number of scheduled weekly flights from each country to 27, thereby placing significant limits on the number of routes and points that can be served. Only three airlines from each nation could serve the other's

²⁵² 1975 *China-Germany Agreement*, Article 7.

²⁵³ According to the discussion after the 1980 Agreement, within two years, implementation of additional service to be operated by a second airline from each nation. See 1980 *U.S.-China Agreement*, *supra* note 214, at 28. The 1992 amendments called for an incremental rise in the number of flights operated by each nation, from eighteen in 1992 to twenty-seven in 1996. See 1992 Amendments, *supra* note 214, at 11. The 1999 agreement allowed each nation to authorize four carriers to fly between them beginning in 2001. See 1999 Agreement, *supra* note 214. Hong Kong, which became a part of China in 1997, continued to be covered under a separately negotiated and less restrictive aviation treaty, which was further liberalized in 1999. See 1995 agreement between Hong Kong and U.S. in Sept. 1995.

²⁵⁴ See Craig S. Smith, "China to Merge Domestic Carriers in Reorganization" *N.Y. Times* (July 22, 2000) at C2. In the late 1980s, CAAC was split into six regional carriers. Later, the Chinese government allowed provincial governments to create their own airlines.

market; the U.S. carriers were Federal Express (for cargo), and Northwest and United Airlines (as combination carriers).²⁵⁵

Since 1999, the liberalization of the U.S.-China aviation trade occurred in relatively larger increments. The 1999 amendments permitted the two country's airlines to operate an additional 27 weekly roundtrips, thus raising the total to 54 as opposed to the 2 originally permitted by the 1980 Agreement.²⁵⁶ The 2004 Agreement represents the U.S.-China aviation market's biggest step toward liberalization. In a gradual process beginning in August 2004, the Agreement allows each of the U.S. and China to add 14 new passenger flights a week. By the end of six years, each nation can offer a total of 249 flights a week in six years, compared with the current total of 54.²⁵⁷

Compared with the development of the China-U.S. agreements in the last two decades, the China-Germany agreement has remained static. The development of China-Germany relations is calling for an updated agreement. For example, the China-Germany 1995 Protocol announced that the number of airlines permitted to serve in the China-Germany Agreement would be restricted to two, without mention of flight frequency.²⁵⁸ Such provisions are not suit for the current China-Germany air transport market.

²⁵⁵ In April 1999, China and the U.S. were allowed to designate one additional airline, for a total of four, to serve the market. This number was reannounced in the new *2004 China-U.S. Agreement*.

²⁵⁶ See 1999 Amendments, *supra* note 214, at 5 (allowing fifty-four frequencies). U.S.-China 1980 Agreement, *supra* note 214, at 15 (allowing two frequencies). 1992 Amendments, *supra* note 214, at 11 (allowing twenty-seven frequencies).

²⁵⁷ The *China-U.S. 2004 agreement* will allow an additional 195 weekly flights for each side—111 by all-cargo carriers and 84 by passenger airlines—resulting in a total of 249 weekly flights at the end of a six-year phase-in period.

²⁵⁸ It was raised from one to two. See 1995 Protocol Article 1 (2).

2.5 Pricing

Market forces determine prices in Open Skies agreements. There are two types of liberalized pricing clauses: “country of origin” and “double disapproval.”²⁵⁹ The former allows governments to control a certain degree of price fixing in their own territories; the latter is the most liberal method of determining prices. The following table provides a basic overview of the development of bilateral relations between China, the U.S., and

²⁵⁹ “Bilateral pricing provisions fall into five general categories:

1. Most bilateral air transport agreements concluded by the United States after 1978 include mutual disapproval pricing provisions. Nations with which the U.S. has signed such bilaterals include Belgium, TIAS No. 9903; Costa Rica TIAS No.--; El Salvador, TIAS No. 9613; Jordan, TIAS No. 9868; South Korea, TIAS No. 9427; Malaysia TIAS No.--; Singapore, TIAS No. 9001; Taiwan, TIAS No.--; and Thailand, TIAS No. 9704. Article 12 of U.S. –Belgium bilateral concluded in 1980 is fairly typical of these.
2. Three of the post-1977 bilaterals include zone arrangements which establish different pricing zones and mutual approval or disapproval. These include bilaterals with Barbados, TIAS No. 10370; the Peoples Republic of China, TIAS No. 10326; and the Philippines, TIAS No. 10443.
3. Country-of-Origin pricing provisions have been included in U.S. bilaterals with Australia, TIAS No. 1574 & 1980 MOU; Fiji, TIAS No. 9917; the Federal Republic of Germany, TIAS No. 9591 & 3536; the Netherlands, TIAS No. 4782&8998; New Zealand, TIAS No. 9956; Poland, TIAS No.--; and Syria, TIAS No. 9176. Rather typical are Articles 6 and 11 added by 1978 protocol to the 1955 bilateral between the U.S. and the Federal Republic of Germany.
4. Most pricing provisions are of the *Bermuda I* variety. These include bilaterals the United States has concluded with Canada, TIAS No. 5972; Chile, TIAS No. 1905; Colombia, TIAS No. 5338; Cuba, TIAS No. 2892 (suspended); Czechoslovakia, TIAS No. 6644; Denmark, TIAS No. 3104; Egypt, TIAS No. 5706; France, TIAS No. 1679; Hungary, TIAS No. 7577; India, TIAS No. 3504; Indonesia, TIAS No. 6441; Iran, TIAS No. 8149 (suspended); Italy, TIAS No. 6957; Ivory Coast, TIAS No. 9766; Japan, TIAS No. 2854; Liberia, TIAS No. 8997; Mexico TIAS No. 4675 and 7167; Morocco, TIAS No. 6877; Nigeria, TIAS No. 8999; Norway, TIAS No. 3015; Pakistan, TIAS No. 1586; Panama, TIAS No. 6270; Paraguay, TIAS No. 8966; Romania, TIAS No. 7901; Senegal, TIAS No. ; South Africa, TIAS No. 1639 (suspended); Spain, TIAS No. 7735; Sweden, TIAS No. 3013; Switzerland, TIAS No. 1929; the U.S.S.R. , TIAS No. 6135; Uruguay, TIAS No. 5692; Venezuela, TIAS No. 2831; Yugoslavia, TIAS No. 9364; and Zaire, TIAS No. 6935. Typical is that embraced in Article 10 of the U.S. –Italy bilateral, concluded in 1970.
5. Finally, the U.S.-U.K. has a unique pricing provision in *Bermuda II*, TIAS No. 8641, concluded in 1977.”

“The new bilaterals typically provide for either country-of-origin pricing (under which a fare may be unilaterally disapproved only by the state from which the flight originates), or mutual disapproval pricing (under which new fares may be freely inaugurated unless both states disapprove them), the latter being the most liberal of the two.

Under a country-of-origin pricing provision, a nation’s right to take unilateral action suspending fares proposed by a carrier is limited to those situations where the first point in its itinerary is located within its territory.

Mutual disapproval pricing provisions differ in that neither nation may disapprove tariffs for traffic originating in its territory unless the other concurs in the disapproval. If the two nations cannot agree, the air carrier’s proposed rates go into effect.”

Dempsey, *supra* note 18, at 35, 59.

Germany.

Table 4: TARIFF CLAUSE (before Open Skies)²⁶⁰

	P. R. China -US	R. R. China - Germany	US- Germany
Scope of Applicability	Yes	Yes	----
Dual Approval	Yes	Yes	----
Tariff Approval	Dual	----	----
	Disapproval	----	----
	Country of	----	Yes
	Origin	----	Yes
	Free Pricing	----	----
Zone Pricing	Yes	Yes	Yes

In the 1996 *U.S.-Germany Open Skies Agreement*, the rates for international transportation had to be “based upon commercial considerations in the marketplace.”²⁶¹

Intervention by the Contracting Parties was limited to:

1. The prevention of unreasonably discriminatory prices or practices.
2. The protection of consumers from prices that are unreasonably high or restrictive due to the abuse of a dominant position.
3. The protection of airlines from prices that are artificially low because of direct

²⁶⁰ See ICAO, *supra* note 232.

²⁶¹ See *U.S.-Germany 1996 Open Skies Agreement*, *supra* note 214, art. 1, s. 10.

or indirect governmental subsidy or support, prohibiting only discriminatory and predatory prices or practices.²⁶²

The *1980 China-U.S. Agreement* put into place detailed procedural requirements on pricing;²⁶³ however, the *2004 China-U.S. Agreement* made several major changes to the pricing provisions.

The first major change is, “prices may be established for scheduled air services at reasonable levels by each airline based upon commercial considerations in the marketplace.”²⁶⁴ This indicates the Chinese government’s awareness of the impact of the market on pricing. The Chinese air transport industry is moving toward greater emphasis on market economy theory instead of administrative direction.

This idea will be realized in two steps.²⁶⁵ The first step is from August 1, 2004 through March 24, 2008. “Prices may be established for scheduled air services at reasonable levels by each airline based upon commercial considerations in the marketplace. A Party shall have the right to approve or disapprove prices for one-way or round-trip carriage on the specified routes which commence in its own territory. Neither Party shall take unilateral action to prevent the inauguration of proposed prices or the continuation of effective prices for one-way or round-trip carriage on the specified routes commencing outside its territory.”²⁶⁶

The second step is effective on March 25, 2008. “Each Party shall allow prices for scheduled air services to be established by each airline based upon commercial considerations in the marketplace. Intervention by the Parties shall be limited to: (a)

²⁶² *Ibid.*

²⁶³ See *China-U.S. 1980 Agreement*, *supra* note 214, Article 13.

²⁶⁴ See *China-U.S. 2004 Agreement*, *supra* note 214, Article 8.

²⁶⁵ See *ibid.*, In article 8, the regulation on price was divided into two steps, the first one is from August 1, 2004 through March 24, 2008; the second one is effective March 25, 2008.

²⁶⁶ *Ibid.* Article 8, 2. (1).

prevention of unreasonably discriminatory prices or practices; (b) protection of consumers from prices that are unreasonably high or restrictive due to the abuse of a dominant position; and (c) protection of airlines from prices that are artificially low due to direct or indirect governmental subsidy or support.”²⁶⁷

Second, the new Agreement tried to balance the benefits of both parties and build fair and reasonable pricing provisions. Regulations that will go into effect on 15 March 2008 seek to prevent “unreasonably discriminatory prices or practices.”²⁶⁸ The current phase also forbids a Party from taking unilateral action to decide prices on specified routes commencing outside of its territory.²⁶⁹ While this provision is in effect for both countries, the discrepancy between the stages of development of the two means that it will, in practice, mainly apply to the U.S. This will provide the Chinese aviation industry, which is relatively less developed, with a certain measure of protection.

Third, price benefits for consumers and airlines were also considered,²⁷⁰ thus demonstrating that the Chinese government is not only paying attention to the development of its aviation industry or its economic prosperity, but also to the social ingredients that play an important role in the industry’s long-term development.

The 1975 *China-Germany Agreement* stated, “ ‘tariff’ means the prices to be paid for the carriage of passengers, baggage, and cargo and the conditions under which those prices apply, including prices and conditions for agency and other auxiliary services, but

²⁶⁷ *Ibid.* Article 8, 2 B (1).

²⁶⁸ See *ibid.*, article 8, 2 B.

²⁶⁹ See *ibid.*, article 8, 2A(1).

²⁷⁰ See *ibid.*, article 8, 2 B (1) (b) (c). “(1) Each Party shall allow prices for scheduled air services to be established by each airline based upon commercial considerations in the marketplace. Intervention by the Parties shall be limited to:(b) protection of consumers from prices that are unreasonably high or restrictive due to the abuse of a dominant position; and (c) protection of airlines from prices that are artificially low due to direct or indirect governmental subsidy or support.”

excluding remuneration or conditions for the carriage of mail.”²⁷¹ Compared with the *China-U.S. Agreement*, this China-Germany Agreement did not clarify the standards, which would govern pricing. For instance, it stated, “Such tariffs shall be established at reasonable levels, due regard being paid to all relevant factors, including cost of operation, reasonable profit, and the tariffs of other airlines.”²⁷² Obviously, in practice, a more detailed explanation is required. For example, “all relevant factors” needs a precise explanation. Similarly, it pointed out that “.... tariffs shall be established at reasonable levels,”²⁷³ but it did not give an exact definition of what is “reasonable”. Meanwhile, it did not explain the progress governments would use to define pricing.

Interestingly, the 1975 *China-Germany Agreement* contains a dispute settlement provision on pricing.²⁷⁴ When one party is dissatisfied, both parties “shall endeavour to determine the tariff by mutual agreement.” However, if both parties cannot agree on a tariff, the difference of opinion shall be settled in accordance with the dispute settlement provision in the Agreement.²⁷⁵ This provision that seeks to facilitate the resolution of disputes on pricing can be regarded as some explanation on how to define the pricing. On the contrary, the 2004 *China-U.S. Agreement* merely states, “if the Parties reach agreement with respect to a price for which a notice of dissatisfaction has been given, each Party shall use its best efforts to put that agreement into effect.” It did not say what

²⁷¹ See 1975 *China-Germany Agreement*, article 8.

²⁷² See *ibid.*, article 8, 2.

²⁷³ *Ibid.*

²⁷⁴ *Ibid.*, Article 8, 5. “If the Aeronautical Authorities of both Contracting Parties cannot agree on any tariff submitted to them under paragraph 3 of this Article, or on the determination of any tariff under paragraph 4 of this Article, the difference of opinion shall be settled in accordance with the provisions of Article 13 of the present Agreement.”

²⁷⁵ See *ibid.*, Article 13. “If any dispute arises between the Contracting Parties relating to the interpretation or implementation of the present Agreement, the Contracting Parties shall in the first place instruct their respective Aeronautical Authorities to settle it by negotiation. If the said Authorities fail to reach an agreement, each Contracting Party may request consultation with the other Contracting Party. Such consultation shall begin within a period of sixty days from the date of the request.”

happens if the Parties do not reach agreement. Whether such a vague statement is adequate for maintaining amicable relations between China and the U.S. remains to be seen.

2.6 Code-Sharing

There is no universal definition of Code-Sharing. IATA initially followed its Passenger Services Conference Resolution 766, paragraph 1: “Code sharing exists when: (a) one carrier operates a flight on behalf of another, using that carrier’s airline designator in the flight number; (b) two or more carriers jointly operate a flight under one or more airline designators.”²⁷⁶ The U.S. Department of Transport explained that code-sharing is “a common airline industry practice where, by mutual agreement between co-operating carriers, at least one of the airline designator codes used on the flight is different from that of the airline operating the flight.”²⁷⁷

Beginning with the 1992 Agreement, Chinese and U.S. airlines began to enter into code-sharing arrangements with one another,²⁷⁸ under which two airlines could link their reservation network system and provide seamless passenger services. Thus, one airline could operate a flight using its aircraft and crew while selling tickets for the second airline. Passengers need only check in once and receive boarding passes for all legs of the

²⁷⁶ IATA, Res. PSC1(10)766, effective 1 April 1989.

²⁷⁷ Senarath Devapriya Liyanage, *International Airline Code-Sharing*, (LL.M. Thesis, McGill University, 1996) [unpublished] at 7. Also see H. Shenton, “Code Sharing—Is Airlines Gain Consumers Loss?” [October 1994] *Avmark Aviation Economist* 13.

²⁷⁸ See the 1992 *China-U.S. Agreement* and the 1999 *China-U.S. Agreement*. The 1999 Agreement permitted the addition of eight additional weekly roundtrip round trip frequencies by each nation’s airlines, effective April 1, 1999. It raised the total number of allotted frequencies to thirty-five for each side. The amendments granted an additional nine frequencies to each side on April 1, 2000, and a final ten additional frequencies on April 1, 2001, thereby allowing each nation to operate a total of fifty-four weekly round trip U.S.-China frequencies.

trip at the outset of their travel. Code-sharing arrangements boost aviation traffic and enable passengers to enjoy uninterrupted journeys through a single-source ticket purchasing as well as enjoying the benefits of mutual frequent flyers programs.²⁷⁹

After the expanded code-sharing opportunities in 1995 Agreement,²⁸⁰ the new 2004 Agreement offers the U.S. the opportunity to designate additional carriers²⁸¹ to provide new non-stop service to China, and increases the carriers' code-sharing rights with China.²⁸² The new Agreement eliminates restrictions on destinations and permits unlimited code-sharing between Chinese and U.S. airlines on any China-U.S. route.²⁸³

The *1975 China-Germany Agreement* and its 1995 Protocol did not mention about the code-sharing provision. Partly, that is because they signed in such an early date. Code-sharing "allows market penetration without full capital expenditures."²⁸⁴ The lack of code-sharing provision will impede the development of the travel industry between China and Germany, even the whole Europe, develop.

²⁷⁹ It allows them to earn mileage credit on either airline in the partnership.

²⁸⁰ It authorized Northwest Airlines to inaugurate tri-weekly passenger/cargo combination service between Detroit and Beijing. It also permitted China Southern Airlines to operate the first-ever non-stop service between Guangzhou and the United States. See "Agreement Reached With China Permitting Expanded Air Services" PR Newswire, Financial News, (Dec. 23, 1995).

²⁸¹ See *2004 China-U.S. Agreement*, article 1 (1)-(e). There are five situations in each of which the U.S. may designate one additional airline to operate the agreed services on different routes.

²⁸² *2004 China-U.S. Agreement*, article 5,1 "(1) In operating or holding out the authorized services, a designated airline of one Party shall have the right to enter into cooperative marketing arrangements, including wet-leasing, blocked-space and code-sharing arrangements with a designated or non-designated airline or airlines of either Party, and an airline or airlines of a third country, subject to the following: (a) A Chinese airline or airlines may code share with any U.S. airline or airlines without limitation. Subject to the mutual agreement of the participating Chinese and U.S. airlines, such code share arrangements may also involve airlines of third countries. U.S. and Chinese airlines may hold out code-shar services pursuant to this subparagraph on routes that include points in the territories of the Parties and also may include any behind, intermediate and beyond points in third countries;...."

²⁸³ U.S. Department of Transport, "U.S., China Commit to Far-Reaching Aviation Agreement" online: <<http://japan.usembassy.gov/e/p/tp-20040621-12.html>> (last visited on December 2, 2004)

²⁸⁴ C.A. Shifrin, "Singapore First Asian Nation to Accept Open Skies Pact" [3 February 1997] *Av. Wk&Sp. Tech.* 26.

2.7 Cargo Hubs

The 2004 *China-U.S. Agreement*'s amended Article 11 *bis*, titled "Cargo Hub", deserves particular attention. A cargo hub is defined as a point in the territory of the other Party:

1. that a designated airline serves with at least 72 all-cargo aircraft movements per week, with aircraft movement defined as a landing or take-off at that hub point; and
2. where such designated airline employs personnel at that hub point to facilitate the movement of cargo; and
3. where such designated airline utilizes airport facilities at that hub point for the movement of cargo; and
4. where such designated airline utilizes a bonded facility under the supervision of customs authorities for the movement of transit traffic at that hub point.²⁸⁵

At an all-cargo hub, the airline enjoys extensive rights, such as the right to determine the frequency and capacity of the international air services and the type of aircraft in operation. Airlines also have the freedom to enter into cooperative marketing arrangements with airlines of either Party or of a third country.²⁸⁶ Such special provisions on an all-cargo hub were not included in the Agreements signed by China with any other Western country. Although the all-cargo hub provision in the bilateral has many

²⁸⁵ *China-U.S. 2004 Agreement*, Article 9.

²⁸⁶ See *ibid.*, Article 9 (2) (a)-(e).

limitations,²⁸⁷ this provision shows that the Chinese government has realized the importance and different characters of the air cargo services, warranting the separation of air cargo services from other provisions.²⁸⁸

2.8 Looking Ahead

The official U.S. opinion on the 1999 bilateral agreement with China is that the Agreement is “a fundamental obstacle to achieving what is truly possible in one of the world’s most important bilateral trade relationships.”²⁸⁹ According to DOT Under-Secretary Jeffrey Shane, “A 54-flight limit actually discourages traffic growth in a market we should be working to expand. The agreement, if not expanded, will actually act as a serious impediment to future growth in China-U.S. trade.”²⁹⁰ Annual trade between the two countries increased from \$4.8 billion in 1970 to \$170 billion in 2003.²⁹¹ For this reason, the U.S. attempted to use the 2004 Agreement to further penetrate the Chinese market.

Although China urged its airlines to enhance their competitiveness in order to take advantage of the expanded air services agreement with the U.S., China is still wary of further liberalization in its skies, fearing that U.S. passenger carriers will get most of the

²⁸⁷ For example, between its cargo hub point and a non-hub point in the territory of the other Party, the airline coterminates flights shall not be counted against the limitations on the number of frequencies applicable to the non-hub point before January 1, 2007. See *ibid.*, Article 9 (2) (f)

²⁸⁸ This topic will be addressed more in next Chapter.

²⁸⁹ U.S. Dept. of Transportation Under Secretary for Policy Jeffrey Shane says that. See Willaim Dennis, “U.S., China To Improve Out-Of-Date Bilateral Agreement”, *Aviation Daily*, (April 7, 2004).

²⁹⁰ *Ibid.*

²⁹¹ See *supra* note 227.

benefits of the new agreement.²⁹² One of the reasons for this is, since 11 September 2001, Chinese citizens and students have found it extremely difficult to obtain visas to enter the U.S.; therefore, the number of Chinese passengers in the China-U.S. route is limited.

The growth in investment and trade between China and the U.S. will encourage further liberalization. Their interrelated economies will ensure continued negotiations. The *2004 China-U.S. Agreement* allows the two sides to reopen talks in 2006 on whether to further liberalize air travel.

China also plans to conclude more Open Skies agreements with Europe, on the lines of the existing China-Germany Agreements. The need for this is felt as the existing China-Germany Agreement cannot satisfy the current market requirements. Supporting the air transport industry in such a rapidly-growing market renders necessary the liberalization of such agreements. With this in mind, the CAAC sent a delegation to Germany to close the first of what it hoped would be several Open Skies agreements with European countries in October 2004. Meanwhile, China begins bilateral aviation talks with Germany in 2004, which might significantly increase the number of passenger flights by each side.²⁹³ However, as each European market currently negotiate individually with China, it will take some time to build liberalized air transport relations between China and Europe.

Looking ahead, however, the development of a unified Europe indicates that each of the European countries will eventually be represented by the EU Commission in air

²⁹² Willaim Dennis, "Some Chinese Airlines Wary Of New Bilateral With U.S." *Aviation Daily* (July 27, 2004).

²⁹³ "China and Germany in talks to increase bilateral flights", online:

<<http://biz.thestar.com.my/news/story.asp?file=/2004/9/14/business/8887914&sec=business> > (14 September 2004) (Last visited on December 2, 2004).

transport negotiations.²⁹⁴ As one party, the E.U. will be more equipped to compete leverage its strength in the negotiations. Thus, while China currently has the ability to negotiate specific agreements with each European nation, it will soon have the E.U. as a whole to contend with as its negotiating partner.

²⁹⁴ The EU has already warned member states not to negotiate individually. See Chapter II, 1.2.2. above, for more information on EU Court of Justice decision in 2002.

Chapter IV: The Development of Distinct Open Skies Agreements for Cargo and Passengers in China.

This chapter maintains that negotiations will be more effective when passenger rights and cargo rights are discussed as separate categories. The particular characteristics of air cargo give it the opportunity to advance further in the liberalization process than air passengers, a fact that has already been proven by the practices of the Open Skies All-Cargo template, which will be discussed below. It is more viable for China to begin its liberalization process with air cargo, as its reduced complexity could promote the further liberalization of China's aviation industry as a whole.

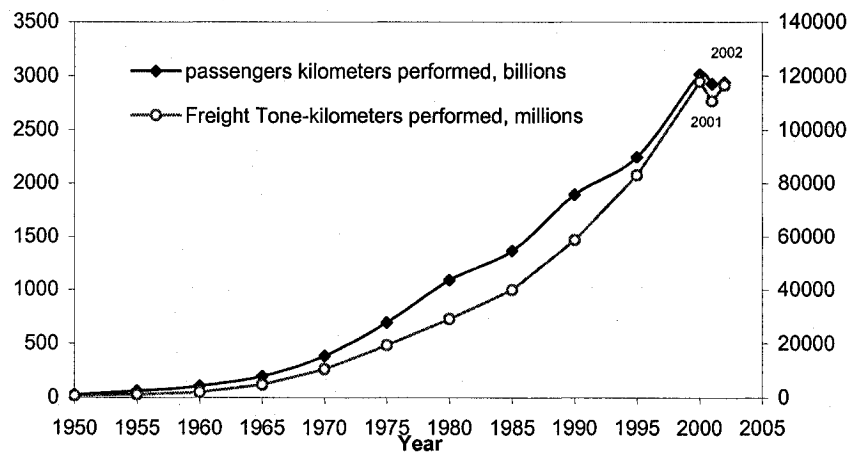
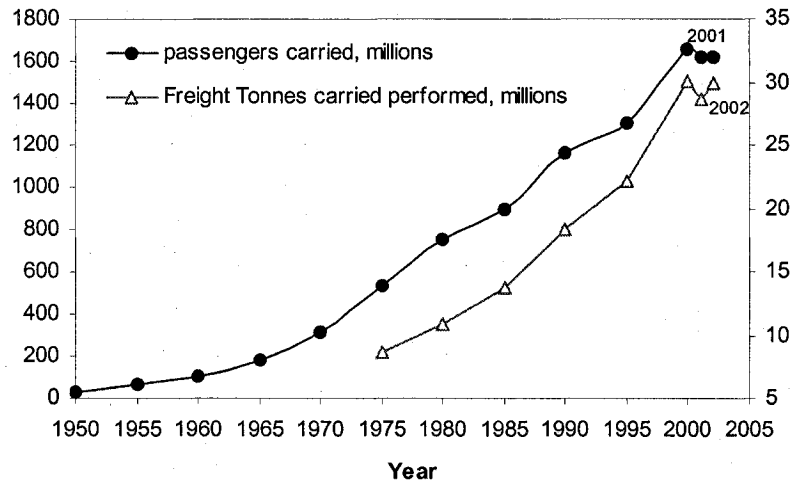
1. The Development of Air Cargo

"The increase in total air traffic (domestic and international) is mirrored in the overall growth performance of its two main components: passenger traffic and freight traffic."²⁹⁵ Air cargo²⁹⁶ has experienced huge development in the past five decades. The following table provides an overview of the total global international and domestic airfreight traffic for the period 1950 through 2002, thus illustrating its rapid and influential development.

²⁹⁵ Wolfgang Michalske, Michel Andrieu & Barrie Stevens, *supra* note 9, at 8.

²⁹⁶ There is no legal definition of air cargo. The IATA Conditions of Carriage (which are not legally binding) state that "cargo, which is equivalent to the word goods, means anything carried or to be carried in an aircraft except mail, or baggage carried under a passenger ticket and baggage check, but includes baggage moving under an air waybill or shipment record". See Jean Louis Magdelénat, *Air cargo : regulation and claims*, (Toronto : Butterworths, 1983), at 5.

Chart 1&2: Overview of world total international and domestic air freight traffic of scheduled services of airlines of ICAO Contracting States for the period 1950 through 2002. For the years 1950 through 1970, the traffic statistics for the former U.S.S.R. are not included. Source: ICAO²⁹⁷



²⁹⁷ See Adrianus D. Groenewege, *supra* note 179, Appendix 4.

The impressive growth of air freight demonstrates that the traditional role of air freight as being exclusively the speedy shipment of emergency supplies, goods of high value, and perishables has expanded to become the economical shipment of a tremendous range of goods in large volumes to almost any destination worldwide.²⁹⁸ Coincident with the growth of international trade, cargo has come to represent a higher proportion of the total transportation. Compared with the carriage of goods by sea or on the road, air cargo enjoys a stronger potential. For example, although air cargo's cost to the consumer is higher than that of the carriage of goods by sea, its total cost is significantly lower. Air cargo reduces "packing, warehousing, handling, insurance costs, [and] reductions in interest on capital." It also allows for "lower inventories [and higher] speed and flexibility, resulting in a more efficient distribution."²⁹⁹

Lufthansa summarized the advantages of air cargo and commented on it as:

"[f]ull utilization of all the advantages offered by air cargo transportation necessitates an exact and objective analysis which examines and plainly distinguishes all cost factors and profitable efficiency criteria, produced by the specific features of aircraft or means of surface transportation respectively.

The following efficiency factors must be taken into account: speed, security, frequency, network composition, capacity, reliability and costs of alternative means of transportation."³⁰⁰

Meanwhile, "[b]y using air freight, manufacturers and wholesalers will be able to

²⁹⁸ See Adrianus D. Groenewege & Roderick Heitmeyer, *Air Freight- Key to Greater Profit*, (United Kingdom: Aerad Printers and Publishers, 1964) at 13.

²⁹⁹ *Ibid.*

³⁰⁰ Deutsche Lufthansa AG, *An Introduction to Air Cargo*, (Germany: Lufthansa Sales Offices; 1976, 3ed.) at 45.

tune their operations more closely to supplies of materials and production and, more importantly, to changes in consumer demand.”³⁰¹ “A satisfied customer is probably the most important single element in any marketing activity.”³⁰² The special characteristics of air cargo provide customers some quick, convenient and economical traffic service, which is an important part of current customers’ requirements.³⁰³ More companies will choose air cargo over other means of transportation. Air cargo’s growth trend will continue in the future; therefore, placing special attention on air cargo in bilateral negotiations will prove extremely valuable.

2. The Special Characteristics of Air Cargo: Why Air Cargo Should Be Distinct in Bilateral Agreements

“Air cargo, and in particular all cargo operations, should be considered for accelerated liberalization and regulatory reform in view of its distinct features, the nature of the air cargo industry and the potential trade and economic development benefits possible from such reform.”³⁰⁴

Although the ICAO did not specify that air cargo should be separated into another agreement system, it has come to pay special attention to the liberalization of the air cargo industry. For example, the ICAO provided a model clause on air cargo services,³⁰⁵ enumerating the following three means by which States should consider the possibility of liberalizing all cargo services:

³⁰¹ *Supra* note 298, at 131.

³⁰² *Ibid.*

³⁰³ See Chapter IV. 2. below, for more information on the special characteristics of air cargo.

³⁰⁴ ICAO, *supra* note 21, at 32.

³⁰⁵ See *Ibid.*, at 32-33.

1. Unilateral liberalization of market access for all cargo services without bilateral reciprocity or negotiation.
2. Liberalization of all cargo services through bilateral agreements and negotiations to ensure reciprocity.
3. Use a multilateral/plurilateral approach for the liberalization of all cargo services.³⁰⁶

In fact, air cargo services have been gradually separated from air passenger services, the result of which has placed air cargo in its own distinct negotiation block.

2.1 The Special Characteristics of Air Cargo

Air cargo is generally unilateral, or “one way” traffic. Most of the time, the flux in one direction is several times that of the other, (i.e. from the manufacturing center to distribution centers, or from the production center to consumer centers). In addition, the flow of cargo may be parochial, as it will be affected by the lopsided import and export trade between different countries and regions. Therefore, pure freight carriers may choose triangle freight or hub freight and may vary routes and prices. “Open Skies” policies, including special flight routes for pure cargo carriers, as well as the Seventh Freedom rights, are necessary for the development of the air cargo industry.

Cargo is generally less sensitive than passengers are to the length of time between the points of departure and arrival, flight routes, and the location and frequency of stops

³⁰⁶ *Ibid.*, at 32

along the way. Most cargo can wait, be forwarded through different routes, and make many stops. Therefore, the Fifth and Seventh Freedoms are crucial to the cargo carriers' ability to respond rapidly to market requirements and to operate the hub-spoke network that could not be sustained by the flight of a single cargo carrier.

In practice, "it must be remembered that passengers can and do complain—freight consignments can not."³⁰⁷ Air passengers pay more attention to the service quality of airlines, while the rapid and smooth movement from the point of acceptance to the final destination is the main concern of airfreight shipments. Thus, satisfied airfreight customers are likely to become regular users of this most modern and rapid method of transport.

Air cargo is often linked with many other kinds of transportation so that it can take advantage of the most convenient airports. Furthermore, cargo must be shipped from its packing place to its point of delivery. For the cargo providers, having effective ground services and diverse means of transportation is crucial to offering non-stop service to consumers.

Moreover, a particular kind of air cargo emphasizes the necessity to separate it from passengers—"the carriage of dangerous goods by air."³⁰⁸ Although a very minimal quantity of a select few dangerous goods are permitted on passenger aircraft, dangerous goods must generally be carried on all-cargo aircraft. For example, "the IATA Dangerous Goods Regulations prescribe special packing requirements, handling methods, storage and labeling, and specify the maximum net quantity permitted per package for both passenger and all-cargo aircraft. Any article or substance acceptable for air transport must

³⁰⁷ Adrianus D. Groenewege & Roderick Heitmeyer, *supra* note 298, at 135.

³⁰⁸ See Adrianus D. Groenewege, "Dangerous Goods: An Historical Overview" (November/December 1996) *Cargo Services*, IATA INSIGHT.

show the proper shipping name on the outside of the package and must be accompanied by any necessary instructions to ensure safe handling during transport. Most importantly, all shipments must be packed, marked and labeled in accordance with the specific safety provisions of the IATA Dangerous Goods Regulations.”³⁰⁹

The current bilateral system is therefore the air cargo network’s main impediment to efficient service and economical circulation. The separation of cargo and passengers in air transport negotiation will solve this problem.

2.2 The Motivation of Distinct Air Cargo Provisions in Bilateral Agreements

There are numerous reasons why air cargo should be separated from air passenger in the liberalization process. An increasing number of countries have noticed that effective air cargo services contribute to the flow of materials, which further boosts economic growth and the development of trade, thus having a more comprehensive and beneficial impact on the national economy. A nation with air transport capabilities that are sufficient for driving its national economy is far superior to one that holds its ground on traditional rules in aviation policy.

For example, Singapore highlighted the benefits of the liberalization of air cargo services by proposing a phased multilateral or plurilateral approach with three elements:

1. Designated carriers would exercise the Third through the Seventh Freedoms of the Air for all cargo services operated on a scheduled or non-scheduled basis;
2. Non-discriminatory treatment of carriers with respect to access to ground facilities, clearance and other services with cooperative arrangements such as code-

³⁰⁹ *Ibid.*

sharing; and

3. A definitive timeline for the phased and progressive multilateral liberalization of airfreight, taking into account the varying conditions and levels of development of the various economies.³¹⁰

Singapore's understanding of "the varying conditions and levels of development of the various economies" in the third element implied that the liberalization process would have an impact on other aspects of the country's economies. Singapore also advanced that "this multilateral air freight liberalization could be achieved independently of the liberalization of passenger services."³¹¹

From the most basic point of view, more types of aircraft available to the airlines create more options for the profitable development of air cargo. As available capacities expand, there will be greater emphasis on more attractive rates. Such rates could be closely connected to the marketing conditions under the international trade environment.³¹² More liberal capacity and traffic clauses in the bilateral agreements could advance the development of air cargo in international trade.

The development of high-tech production is rendering lightweight and high-value materials (such as computer components and software, communication devices, microelectronics, and audiovisual products), a larger proportion of revenue for the air transport industry.³¹³ When cargo shipments came to be composed of lightweight and high-value materials, the face of air cargo changed. Air cargo is no longer a by-product to fill up the untapped belly capacity on the plane; rather, it now merits its own flights.

³¹⁰ ICAO, *supra* note 29, at 30.

³¹¹ *Ibid.*

³¹² See *supra* note 298, at 130-131.

³¹³ Traditionally, the types of cargo include: articles of high value; merchandise which is needed urgently; and extremely perishable goods. See Jean Louis Magdelénat, *supra* note 296, at 6-9.

In the environment of economic globalization and multinational development, it is difficult to pinpoint the owner of any given product. When a country removes its barriers to importation, the concept of “homeland” operations in the air transportation industry will change. Moreover, as has been seen in recent times, when a regional or an international crisis halts passenger travel, air cargo becomes instrumental in maintaining aviation revenues. For example, the travel advisory issued by the WHO in response to the 2003 SARS outbreak in Asia discouraged passengers from traveling to Asian countries. Passenger revenues were all but nonexistent; nevertheless, cargo revenues saved Cathay Pacific, among other Asian carriers.³¹⁴

From the above analyses, air cargo’s independence in bilateral agreements could create beneficial conditions through which its special characteristics can allow for much more efficient development in the liberalization process than air passengers.

2.3 Case Study of Open Skies All-Cargo Template

The Indian government adopted an Open Skies policy in order to develop its air cargo industry and boost exports. During the 1980s, the Indian economy suffered from a chronic shortage of international air cargo capacity. The country’s air cargo reform began in 1986, when the Indian government allowed air taxi operators to provide on-demand services, primarily to boost tourism on major routes. In the early 1990s, the Indian government announced an industry-wide “economic disengagement” policy, aimed at moving from a planned closed economy towards a much less regulated market system.³¹⁵

³¹⁴ See Lim, *supra* note 21, at 8.

³¹⁵ ICAO Secretariat, “India’s Open Skies Policy on Air Cargo”, online:

In 1990, India began to practice its air cargo policy, which was fully adopted in 1992.³¹⁶ According to this policy, any airline, including domestic and foreign ones, could operate scheduled and non-scheduled air cargo services to or from any airport in India at which customs and immigration facilities were available, so long as said services met specified operational and safety requirements. The Indian government also abolished its former mandatory airfreight rates for major export goods.³¹⁷ “These new policies were consolidated into a package together with further liberalization on domestic air taxi operations and relaxation of the rules on international tourist charters, and were implemented on a unilateral basis without requiring comparable rights for Indian carriers from bilateral partners in return.”³¹⁸

The Indian government’s opening of its air cargo policy had several effects. The adoption of an Open Skies policy prompted significant growth in international air cargo traffic in India. Indian government statistics showed that the increase was from about 300,000 tonnes in 1991 to over 420,000 tonnes in 1998.³¹⁹ The increase in traffic was mainly due to a huge growth spurt in scheduled services operated by foreign airlines under the permission of the Open Skies policy. “For example, Lufthansa, Air France, and

<http://www.icao.int/icao/en/atb/ecp/CaseStudies/India_En.pdf> (Last visited on November 30, 2004)

³¹⁶ In 1990, the Government of India decides to deregulate her command economy structure by bringing in far reaching reforms. The liberalization of the aviation sector included: “(1) The Air Corporation Act, 1953 repealed paving the way for the opening up of the domestic sector and the disinvestments of the two public sector airlines. (2) New privately owned airlines start functioning.” “India declares unilateral policy of ‘open sky’ for international air cargo: [1] Any foreign operator permitted to carry cargo to and from India, without restriction on the number of flights and types of aircraft, to any airport in India with customs and immigration facilities, even without the existence of bilateral agreements. [2] No requirement to comply with national ownership of aircraft/company norms. [3] ICAO gives due credit to India in Working Paper 10 of the 5th. World Wide Air Transport Conference beginning in Montreal on Monday, the 24th of March.” See Sana Kaul, “India, Liberalized Airlines, Ownership and Control” present to the Council of the ICAO, March, 2003, Montreal. Online:

<<file:///C:/WINDOWS/Temporary%20Internet%20Files/Content.IE5/OAEZTW27/kaul%5B1%5D.ppt#256,1,INDIA>> (last visited on December 14, 2004)

³¹⁷ Weimin Liu, “Traffic Rights Opening, a Necessity of the History”, (2003) 33 China Civil Aviation. 30. [translated by author].

³¹⁸ ICAO Secretariat, *supra* note 315.

³¹⁹ *Ibid.*

KLM doubled their capacities to India, while most foreign airlines adopted a strategy of selective entry in peak periods without long term commitments.”³²⁰ The Open Skies policy stimulated the Indian air cargo boom; in return, the development of air cargo could drive the liberalization of its whole air transport industry.³²¹

India is not the only country that has adopted an open air cargo policy. On October 18, 2003, Thailand and the United States signed an agreement providing Open Skies for cargo only.³²² Full Seventh Freedom cargo rights were included, evidencing significantly further liberalization than the former U.S.-Thai cargo air transport agreement, as it gives U.S. and Thai cargo air carriers the right to make decisions on routes, capacity, and pricing without government interference.

In addition, both the Organization for Economic Co-operation and Development (OECD) and the United States itself deem the drafting of Open Skies all-cargo bilateral or multilateral agreements important.³²³ The same thinking about all-cargo flights is likely taking place in numerous countries worldwide.

³²⁰ *Ibid.*

³²¹ Carriage on foreign airlines' non-scheduled services also doubled for the first three years of the 1990s in India, but sharply declined to less than the 1991 level by 1998 because of a marked shift to scheduled services and sea cargo. Although infrastructure bottlenecks including a shortage of warehousing facilities have gradually hampered potential cargo business opportunities, the boom in air cargo was propelled by the progress of the country's economic liberalization. *Ibid.*

³²² Embassy of the U.S. in Manila, "Benefits of an open skies aviation agreement U.S. and Thailand", (11/15/2003). Online: < <http://www.asianresearch.org/articles/1687.html> > (last visited on December 2, 2004)

³²³ Between 1999 and 2002, the IECD undertook extensive work on the subject of "Regulatory Reform in International Air Cargo Transportation." The results of these efforts appeared in 2002, when the OECD widely circulated a finalized draft open skies all-cargo multilateral agreement as well as a substantively comparable template for amending bilateral agreements. See *Liberalization of Air Cargo Transport*, OECD Doc. DSTI/DOT (2002), 1/REVI (May 2, 2002) online: <<http://www.oecd.org>>. (Last visited on November 30, 2004)

Porpot Changyawa & Preeyanat Phanayanggoor, "Open-Skies Air Cargo Deal With United States" (October 19, 2003) Bangkok Post (Lexis).

3. Contrasting Air Cargo Issues with Air Passenger Issues in China

3.1 China Further Opens Its Traffic Rights, Paving the Way for the Liberalization of Air Cargo and Air Passenger

China's economy has been growing steadily for the past two decades.³²⁴ China emerged strongly with the highest growth rate in per capita in terms of Gross National Product (GNP). Economic development boosted China's export-oriented policy, thus increasing the volume of export trade, which created an increased demand for commercial travel and cargo transportation.

In the aviation field, China is facing ever-increasing external pressure from Western countries, most notably the U.S. and Europe, to deregulate. The aviation markets in North America and Europe have matured, becoming saturated and increasingly competitive. U.S. airlines have too few profitable domestic routes to provide for future growth. Therefore, China is, in the U.S. and European countries' eyes, an attractive and ideal market that offers increased opportunities for growth and profit.³²⁵

In addition, the needs of Chinese air cargo are expanding, despite its limited capabilities. China should gradually open its aviation market and adopt a competitive approach in order to meet its needs and stimulate its air transport industry. Introducing competition will enable China to develop its aviation industry, thereby contributing to its

³²⁴ Since 1978 Deng Xiaoping's policy brought the national economy to experience a high growing.

³²⁵ The U.S. once placed an emphasis on reaching open skies accords in the closed aviation market of the Asia-Pacific region. U.S. officials said "open skies initiatives are humming along around the world, and they expect the rest of Europe and key parts of Asia to eventually fall neatly, if not quickly, into place." See "U.S. Airlines' Prospects Are Grim on Expanding Access to Asian Skies" *Wall Street Journal* (25 September 1996).

national economy. At the 5th ICAO Worldwide Air Transport Conference, China clearly expressed its intention to advance the civil aviation liberalization process.³²⁶ China then decided to make Hainan an experimental unit in its 2003 opening of traffic rights.³²⁷ More foreign airlines were permitted to enter the Hainan international air transport market, which has become a testing ground on which Chinese domestic airlines face fierce international competition.

Although many provinces are appropriate for the implementation of the Third, Fourth, and Fifth Freedoms, Hainan was chosen for very specific reasons. First, with its tourism industry, Hainan is the district with the most particular economy in China. It is an island-style-economy, as the majority of its market and raw materials are outside its limits. Hainan's economy therefore depends upon a perfect transportation network. However, before 2003, international air transport in Hainan was sluggish, having only one international route to Seoul in addition to some regional routes to Hong Kong and Macao. This minimal scale of air transport severely restricted Hainan's economy.³²⁸

Secondly, Hainan's air transport market is independent from the mainland; it is the main destination in the ASEAN Free Trade Area. Because of its particular economy, Hainan enjoys benefits from special policies; therefore, opening traffic rights in Hainan would not drastically affect its interior regions. In fact, it could contribute to the ability of domestic airlines to compete with foreign carriers. After the opening of the Third, Fourth, and Fifth Freedoms, Hainan gave foreign airlines the freedom to fly into and out of Hainan, as well as other related aviation operation privileges, thus allowing the creation

³²⁶ See generally the discussion of Chinese delegation in the 5th ICAO Worldwide Air Transport Conference's report. *Supra* note 29.

³²⁷ See Xinpeng Tan, "The experimental unit of Hainan traffic rights bring shake, The Civil Aviation Reform does not play short spear?" People.Com (August 07, 2003), online: <www.people.com.cn/GB/jingji/1038/2005067.html> (Last visited on November 30, 2004)

³²⁸ See *supra* note 167.

of new international routes and the expansion of the route networks of domestic airlines.

Thirdly, Hainan was chosen as a test case, which if successful, would then be replicated for the whole country. The Chinese government believes that development should follow a specific plan.³²⁹ The pilot location will allow the industry to earn enough capital and experience to open other areas, and to promote development in the Western part of China. If successful, this experiment in economics and in practice may encourage the CAAC to go further toward the full Open Skies.

In choosing to open traffic freedoms, China is embracing the liberalization and is expanding traffic rights for the benefit of the Chinese economy. On this basis, the separation of air passenger and air cargo negotiations is possible.

3.2 Air Passengers' Development Towards Liberalization is Limited by Many Elements in China

The number of air passengers in China has grown considerably in recent years, making the country one of the largest potential markets in the world. The rapidly developing national economy, booming tourism, large population, and increasing per capita income have accelerated the growth of the aviation market. An increasing number of people in China have extra money available for overseas travel. In 2002, Munich, the capital of Bavaria and Germany's third largest city, received a total of 1,418 million foreign tourists, of which up to 30 thousand were from the Chinese mainland.³³⁰ In

³²⁹ In the DengXiaoping Theory, it emphasizes that some body should go to be rich first, and then the others could go to rich together.

³³⁰ "Air China Launches Beijing –Munich airline" (August 12, 2004) *SinoCast China Business Daily News*

addition, as a highly desirable travel destination, China is attracting enormous numbers of tourists, over 80% of whom arrive by air.

Following the trend toward liberalization, China has relaxed foreign air access to some of its biggest cities, especially the tourist destinations. To attract more foreign airlines to Hainan, the CAAC allowed carriers to fly into Haikou and Sanya, its two main cities, and then connect to other Chinese destinations, including Beijing, Shanghai, and Guangzhou.³³¹

Despite China's present trend of growth, certain aspects of the air passenger market in China limit its development towards liberalization. Most of the open areas in China are big seaport cities or tourist destinations, such as Beijing, Shanghai, and Hainan. Such areas are the near-exclusive destinations of international air passengers; however, there are some limitations on the development of air passenger transportation in such areas. First, seaport cities and tourist destinations comprise only a small portion of the total Chinese territory. The development of these few areas cannot decide the development of China as a whole.

Second, as is true everywhere, China's season for high volumes of passenger travel is limited and concentrated. After the peak season, the number of international air passengers to China drops dramatically.

Third, the quantity of international air passengers to China has been affected by regional and international crises several times in recent years, such as the Asian Financial Crisis (1997) and SARS (2003). It is therefore reasonable to believe that the number of international air passengers to China will again plummet should another such crisis arise.

(Lexis) (last visited on November 26, 2004)

³³¹ P.T. Bangsberg, "China opens air access via island" (March 2, 2004) *Journal of Commerce online* (Lexis). (Last visited on November 30, 2004)

In summary, the aforesaid elements have caused instability in air passenger transportation for China's international routes, especially for the routes from foreign countries to China.

3.3 Chinese Air Cargo Transport Could Progress Further Toward Liberalization

China has become the air cargo market every carrier wants to serve. "Official figures show China moved 2.2 million tons of cargo and mail last year, up 8.4 percent over 2002. International consignments totaled 514,000 tons, an increase of 21 percent. China accounted for 4.6 percent of the global air-cargo market in 2003. The forecast volume will rise to 4.7 million tons by 2010."³³² As the largest air freight market for the US, Chinese airfreight has grown at an average of 15% a year in the past decade, with exports up by 17% to the US and 23% to Europe.³³³ Boeing predicts that airfreight from China to the U.S. will grow an average of 9.6% a year over the next 20 years, compared to 9.3% in Europe. China would come to be the world's ultimate low-cost producer, the workshop to the world.³³⁴

China is a leading producer in many industries, such as cars, mobile telephones, electrical appliances, and even toys. Shanghai is the destination of most global operators. In the near future, more cities in China, such as Kunming, Xiamen, and Hainan. will assume Shanghai's role.

³³² P.T. Bangsberg, "China woos foreign air cargo" (June 9, 2004) *Journal of Commerce online* (Lexis). (Last visited on November 30, 2004)

³³³ Peter Conway, "Open for business" (July 1, 2004) *Airline Business* (Lexis). (last visited on November 26, 2004)

³³⁴ *Ibid.*

However, there remain several problems for cargo carriers to China, such as the sharp imbalance of its routes,³³⁵ the lack of aircraft and flights,³³⁶ undeveloped surface infrastructure, and other inefficiencies.³³⁷ The solution to such problems requires support from the Chinese government in terms of both policy and finance. If the Chinese government should decide to accelerate development of air cargo transport by means of liberalization, it would reap immediate rewards. In fact, many foreign carriers are waiting in line for this exact event to occur. Once China permits a true Open Skies cargo agreement, foreign countries will immediately extend their cargo services to China. For example, the DOT has proposed allowing Polar Air Cargo to fly airfreight to China as well as expanding the rights of FedEx, UPS, and Northwest Airlines under a new liberal bilateral agreement between the United States and China.³³⁸ Such cooperation could develop further after the independent liberalization of air cargo.

However, because the Chinese air passenger and air cargo situations differ so significantly, air cargo cannot adequately develop towards liberalization together with the air passenger sector. If air cargo was forced to be on the same negotiation platform as air passenger carriers, more time will be wasted in bilateral negotiations. The best one can expect of the continued combination of air cargo and air passenger negotiations is the significantly decelerated development of bilateral air transport relations; the worst one can expect is its perpetual blockage.

³³⁵ Of the 675,000 tonnes of air cargo between China and the USA in 2003, roughly 500,000 tonnes was Chinese exports, so the ratio is more than 5 to 1. China-Europe exports at 250,000 tonnes and imports at 175,000 tonnes in 2003, a ratio of 1.4 to 1, but with imports to China growing 9.1% a year in coming years, while exports grow 9.5%. *ibid.*

³³⁶ China only has 21 freighter aircraft, and just three more are expected to be added in 2004. See P.T. Bangsberg, *supra* note 332.

³³⁷ In China, most air freight is still centered around a few east coast cities, such as Shanghai, Fuzhou, Wuhan, Beijing, Guangzhou, Nanjing, Shenzhen, Xiamen. The western areas of China account for just 15%-17% of the nation's air freight tonnage. See Peter Conway, *supra* note 333.

³³⁸ Andrew Beadle, "Polar to Enter China, DOT Boosts Existing Carriers" (September 3, 2004) *Traffic World* (Lexis). (last visited on November 22, 2004)

In practice, China has been relaxing its rules in order to allow overseas and domestic cargo airlines set up joint operations. Their policy is to encourage airlines to run joint- or solely-funded ventures as they expand within the air cargo market.³³⁹ The CAAC has received an application from the Express Unit of the Memphis-based FedEx Corp. for a solely-funded cargo base in Guangzhou. Shenzhen Airlines has also applied to establish a joint venture cargo airline with Lufthansa Cargo.³⁴⁰ In 2003, FedEx signed an agreement with the Guangzhou Airport Authority to explore the possibility of a future hub at Baiyun International Airport, and UPS Asia Pacific President Ken Torok said that the agreement "will have impact not only between the U.S. and China, but throughout the world. It will accelerate the flow of goods into and out of China, providing substantial benefits to workers, businesses, and consumers of this fast-growing region."³⁴¹ The new 2004 Agreement lets U.S. cargo carriers establish hubs in China.³⁴²

In practice, air cargo has surpassed air passenger carriage in the liberalization process. If the CAAC would use air cargo as a test of opening more rights in bilateral agreements with the other countries, the success of the Full Cargo Open Skies experience could help the development of the air passenger side of the aviation industry.

³³⁹ P.T. Banbgsberg, "China woos foreign air cargo" (June 9, 2004) Journal of Commerce online (Lexis). (Last visited on November 30, 2004)

³⁴⁰ *Ibid.*

³⁴¹ *Ibid.*

³⁴² William Dennis, "Some Chinese Airlines Wary of New Bilateral With U.S." *Aviation Daily* (July 27, 2004).

CONCLUSION

Air transport plays a central role in economic globalization, contributing significantly to regional development. With the continuing growth of tourism and higher-value-added production in various industries, air transport will take an even more important place in the future. Moreover, as economic activities become increasingly integrated throughout the world, the potential of China's aviation industry, which will impact the Asia-Pacific Region and the whole world, is becoming evident. This appraisal would be incomplete without some mention of the future of the air transport industry in China.

Towards an Increasingly Globalized World

Over the past 100 years, the development of the aviation industry has coincided with the evolution of human civilization and the progress of science and technology. Not only has aviation greatly changed our lives it has also developed into a huge international industry that heavily impacts the global economy.

Changes in political and economic conditions, privatization, deregulation, liberalization, and globalization have forced the air transport industry into a new era of increased competition. In order to survive in this competitive environment, airlines attempt to provide consumers with better service by increasing the size of their markets and strengthening their market power in the global air transport industry.³⁴³

The existing linkage between the aviation industry, the airlines, and the government

³⁴³ Angela Cheng-Jui Lu, *supra* note 177, at 2.

clearly anchors air transport policy within the economic and political sphere. The relationship between a government and airlines has been replaced by the relationship between different governments. The general framework established by the Chicago Convention created an environment within which States could negotiate the exchange of traffic rights with each other. With its resulting emphasis on governmental identification with airlines, the bilateral negotiations served the industry well until the late 1970s when changes started to occur in the industry. As a result of aviation technology,³⁴⁴ management technology,³⁴⁵ and information technology,³⁴⁶ air transportation ceased to be an independent activity, becoming rather an integral part of, and channel for the entire spectrum of, international trading activities. With its increasing importance in the global economy, air transport should be regulated with a view to maximizing its overall potential. This reality requires a rethinking and readjustment of national ownership and control provisions, bilaterally negotiated traffic rights exchanges, restrictions on cabotage, and other elements in the aviation liberalization process.

The Development of Chinese Civil Aviation

China's large land mass and vast population distribution make transport connections a vital part of the country's economic and social development. Accordingly, China's civil aviation industry has seen increasing investment and rapid development over the last 20 years. The Chinese government considers civil aviation to be a key sector

³⁴⁴ From the 1950s to the early 1970s – the introduction of jet engines for civilian transport and the development of larger and more efficient planes culminated in the 747.

³⁴⁵ From the 1970s to the 1990s – frequent flyer schemes, yield management systems, organizational restructuring, quality and customer service improvements.

³⁴⁶ From the 1970s to the 1990s – computerized reservation systems.

in China's continuing economic development. Both China's accession to the World Trade Organization (WTO) and the Opening-Up the West Policy (to develop the poorer Western Region of China) are devoting increased spending to the civil aviation infrastructure.

In 2003, China's civil aviation sector reported, handled 87.59 million passengers and 2.19 million tons of cargo, on both domestic and international routes, up 1.9 percent and 8.4 percent, respectively, from 2002. 79.8 percent of the flights were scheduled, 3.1 percent higher than that of the previous year, and 61.4 percent of passengers traveled at public expense.³⁴⁷ Analysts predict that the air transportation industry will enjoy a more favorable environment in 2004. System reform in civil aviation will promote the productive forces of the sector. Stricter safety control and greater emphasis on better service will enhance the development of the sector. A new, more flexible pricing policy governing domestic airfare will boost demand. After reform and restructuring are conducted and the management regime is improved, air transportation companies will upgrade their operations and potential to compete. The Chinese civil aviation industry will grow in the future.

According to China's Industrial Development Report 2004, China's total passenger transport volume is expected to surge by 20 percent to reach 103.8 million people in 2004. The cargo transport volume by air will reach 2.5 million tons this year, exhibiting an annual increase of 18 percent.³⁴⁸ The report forecasts that China's civil aviation industry would enter a period of rapid growth in 2004, as the General Administration of Civil Aviation of China plans to adopt a series of measures to boost the development of the aviation sector and its related industries. These measures include loosening market

³⁴⁷ See CAAC, *supra* note 126.

³⁴⁸ *Supra* note 140.

accession conditions for cargo transportation airline companies and feeder airways, allowing inflow of private funds into the civil aviation transportation, and reducing and exempting taxes on feeder airways among others.³⁴⁹

The Challenges and Opportunities of Building China into an Aviation Power

China is an enormous market and has tremendous potential to develop air transportation for its vast area, large population, and abundant resources. The future of China's air transportation industry is expected to be a bright one.

The rapid development in economic activity should cause China's aviation market to flourish. The rapid growth of the State's economy that was evident at the outset of the 21st Century will be maintained. In the next 20 years, the GDP will increase by about 7%. With the past as an indication, the Chinese aviation industry could grow at a rate of up to 14% per annum. The air passenger service entered its period of growth in 1984, while growth did not begin until 1990 for air cargo. Between 1991 and 2001, domestic air passenger traffic increased at an average rate of 15.9% per year, while the average increase in domestic air cargo traffic per annum was 17.3%.³⁵⁰ According to the history of the development of international aviation, this growth period in the aviation industry could be maintained for another 30 or 40 years. The peculiar economic conditions of China provide a strong likelihood that the Chinese aviation industry would grow in the next 20 years.³⁵¹

³⁴⁹ *Ibid.*

³⁵⁰ See Kun Li, "Challenge and Opportunities for Building China into an Aviation Power" (November 2003) 35 *China Civil Aviation* 34.

³⁵¹ *Ibid.*

The success of the airlines of the future will depend upon their efficiency, financial strength, and access to global markets.³⁵² The changing Chinese investment system is a financial guarantee of the expansion of the scale of civil aviation enterprises. Following the promulgation of the “Chinese Civil Aviation System Reform Proposal” and the “Regulation of Foreign Investment on the Chinese Civil Aviation Industry” in 2002, the restrictions on foreign investment in civil aviation were eased, which allowed channels of foreign capital to enter the Chinese aviation industry.³⁵³ The market will play a larger role in the allocation of civil aviation resources. China plans to open its aviation market to the outside world and to seek out more partnership opportunities with foreign counterparts.³⁵⁴

The Memorandum of Understanding of the China/US Aviation Cooperation Program (ACP) was signed by the CAAC and the U.S. Trade and Development Agency (USTDA) on 5 April 2004. Under the new plan, the USTDA will improve the coordination of the U.S. private sector’s assistance to ACP projects, including financial support, technological assistance, and personnel training.³⁵⁵ In 2004, the procedures for the examination and approval of domestic airline management will be streamlined so that a fair and liberal administration system can be established that is in line with market demand. Meanwhile, market access will be broadened and investors will be allowed to enter the sector by establishing new enterprises or by using their shares in existing companies. Both international and domestic capital will be encouraged to invest in China’s civil aviation industry.

³⁵² See A. Bock, “How to Restore the Airline Industry to Its Full Upright Position: An Analysis of the National Commission to Ensure a Strong, Competitive Airline Industry Report” (1994) 59 JALC 663.

³⁵³ See Chapter II. 1.3.3. B., above, for more information on the legal environment of foreign investment in china.

³⁵⁴ Weimin Liu, “Opening, a Basic Policy for China to Develop Air Transportation” (2004) 40 China Civil Aviation 19.

³⁵⁵ Desheng Cao, “Aviation sector to open wider” *China Daily*, (6 April, 2004).

The role of the central government is to offer a political guarantee for the development of aviation industry. The Chinese government considers the transportation industry to be an important foundation for economic development. The development of both the coastal area and the west, for example, will be improved and balanced by governmental policy. Similarly, civil aviation reform, which is a social system project, cannot be successful without cooperation between the local government, diplomats, customs, frontier defense, quarantine, and cordial relations between mainland China and Taiwan, Hong Kong, and Macao. The rapid transformation of the government's functions creates a favorable external environment for civil aviation reform.

Booming overseas travel enables the internationalization of Chinese aviation. China had approximately 20 million visitors in 2003 (a growth of 22% since 2002).³⁵⁶ According to the World Tourism Organization, China could well rank 1st on tourist destinations in the world and a major source of outbound tourism, with an estimated 100 million outbound travelers by 2020.³⁵⁷

In 2002, the number of overseas travelers into and out of China exceeded 97 million, representing a 12% increase from the previous year. Meanwhile, the number of overseas business travelers was more than 16 million, evidencing a rise of approximately 40%.³⁵⁸ The size of this market provides ample demand and opportunity for the international development of Chinese airlines. Furthermore, there will be an increased demand for direct flights between China and the rest of the world, particularly in light of the 2008 Olympic Games scheduled to take place in Beijing.

Entering the WTO will also prove beneficial to the development of civil aviation by

³⁵⁶ *Supra* note 350.

³⁵⁷ *Ibid.*

³⁵⁸ *Ibid.*

enabling China to benefit from the opening of non-aviation markets by other member states of the WTO. It will further expand the industry which WTO regulated, and will broaden the exchange on politics, economy, science, technology, and culture. with other countries. The reduction of tariffs and restrictive trade measures will contribute greatly to the expansion of China's importing and exporting of goods and services and will promote the growth of the national economy. In particular, commercial intercourse will be enhanced and the flow of passengers and cargo increased, creating favorable market conditions for the development of China's civil aviation industry.³⁵⁹

All of these factors place increasing demands on air transportation. According to China's Five Year Civil Aviation Development Plan, in place from 2001 to 2005, the industry aims at raising the total traffic turnover up to 20.5 billion ton-kilometers until 2005 with an annual growth rate of 10%, passenger transportation up to 100 million with an annual growth rate of 8%, and cargo and mail transportation up to 2.8 million tons with an annual growth rate of 13%. The operation of general aviation is predicted to experience an annual growth rate of 5%. Between 2006 and 2010, the annual rate of growth of air transportation is expected to remain at around 8%. Until 2010, the total traffic turnover will reach 30 billion ton-kilometers, 140 million passengers, and 4.7 million tons of cargo & mail.³⁶⁰ Air transportation will take a bigger share of the State's comprehensive transportation system, and general aviation will be operated in more areas.

Of course, China has a long way to go to develop and perfect its market regulations and policies, and its airlines are not yet strong enough in terms of competitiveness,

³⁵⁹ Paul Freeman & Raymond Lam, "Current Chinese Aviation Policy in the Light of Economic Globalization" (February 2002) 27 Air & Space Law I.

³⁶⁰ "Aerpace (Civil) Industries in China", UK Trade & Investment, Online: <<http://www.trade.uktradeinvest.gov.uk/aerospace/china/profile/overview.shtml>> (last visited on December 2, 2004)

adaptation to market changes, and creativity. There are also discrepancies between the infrastructure capability and the demand for air services, such as in the areas of airport and air traffic management. Insufficiencies also exist in China's aviation enterprises system, human resources, route distribution, operating ability, and manage/service levels, all of which restrict China's exploitation of the commercial opportunities potentially available under an "Open Skies" regime.

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