
THE NEW U.S.—JAPAN BILATERAL AVIATION AGREEMENT: AIRLINE COMPETITION THROUGH THE POLITICAL PROCESS

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ABSTRACT

International aviation is still dominated by the remnants of a 1950s regulatory regime. A mosaic of bilateral treaties continues to control supply, price, and market share as well as other aspects of aviation. The U.S.-Japan airline market was previously defined by the U.S.-Japan Bilateral Agreement of 1952, as amended. This paper offers a glimpse in how the aviation industry participates in the political process to advance its own interests. The result of years of debate and political maneuvering resulted in a new bilateral agreement between the U.S. and Japan with all sides gaining some improvement over the prior 1952 agreement.

INTRODUCTION

In the midst of rapid change in the airline industry, recent negotiations between Japan and the U.S. on a new bilateral aviation agreement remind us of some basic principles of corporate political behavior in a regulatory world. The most prominent lessons from these negotiations include the following.

1. Each regulatory issue affects different firms differently. As a result, each firm participates in the political process to advance its own corporate interests. Such behavior is legitimate, but it means that corporate political behavior is seldom guided by broad values, such as the sanctity of competition or free markets, and that notions of a singular “industry position” seldom apply.
2. Firms must connect their interests to broad public interests or well established policies. The result is a rash of common references to the benefits of competition, lower prices, economic development, etc.

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3. Regulatory politics involve firms with similar interests who coalesce to contend with opposing coalitions. Each actor competes for the economic value that regulatory outcomes create, such as structuring U.S.–Japan air commerce to fit its circumstances.

Background: Bilateral Agreements

International aviation is undergoing such rapid structural change that observers have difficulty keeping pace. Japan has recently deregulated its domestic market and entire regional markets have been deregulated by the European Union and South America's Mercosur countries. New carriers are popping up everywhere. At the same time, open-skies agreements between countries are becoming commonplace and trans-border alliances between carriers, which were almost unknown a few years ago, have divided much of the world's traffic among just a handful of large airline groupings. Now U.S. carriers have taken the next step with same-country alliances among the world's six largest air carriers.

Yet, as this vibrant change unfolds and aviation rushes into a brave new world, international aviation is still dominated by the remnants of a 1950's regulatory regime. In international aviation, a mosaic of bilateral treaties continues to control supply, price, market share, etc.

Before the recent agreement, the U.S.–Japan airline market was defined by the U.S.–Japan Bilateral Agreement of 1952, as amended. The 1952 Agreement entrenched Northwest, Pan Am and Japan Air Lines (JAL) as incumbents for so-called Third- and Fourth-Freedom Rights.¹ Third and Fourth Freedoms essentially authorize a carrier to operate round trip flights between the carrier's home country and another country. Fifth-Freedoms (beyond rights) authorize a carrier to operate a flight between the two countries, then continue the flight to another destination.

United Airlines replaced Pan Am as an incumbent when United bought Pan Am's Pacific routes. FedEx became an incumbent cargo operator in the same way. Other carriers secured limited rights over the years. These carriers are identified synonymously as nonincumbents or MOU carriers, as their rights were not rooted in the original agreement, but were granted under subsequent Memoranda of Understanding (MOU). MOU carriers included American; Continental, its subsidiary, Continental Micronesia; Delta; UPS; All Nippon Airways (ANA); and Japan Air Systems (JAS).

Given the political environment after World War II and the existence of only one Japanese carrier at the time, U.S. carriers got the better of the 1952 agreement. Even today, U.S. carriers control a third of all slots at congested Tokyo Narita and account for just over half of all international operations there. The remaining international service at Narita is divided among carriers from Japan and all other countries. Similarly, U.S. carriers received more Fifth Freedom rights than did Japanese carriers under the 1952 Agreement. U.S. carriers operated to eight destinations beyond Japan. Japanese carriers operated

just one beyond flight twice a week—JAL to Brazil through Los Angeles.

New beyond rights or the extension of expiring beyond rights for United and Northwest were a central issue in the negotiations. This was especially true of Northwest, as Japan had denied separate requests for beyond service from Seattle through Osaka and onto Kuala Lumpur and Jakarta. Northwest and the U.S. Department of Transportation (DOT) argued that these rights were guaranteed under the 1952 bilateral, as Northwest was an incumbent. However, Japan argued that these particular beyond points were not incumbent and therefore constituted new authority. Beyond rights also proved critical to FedEx.

Early Terms of The Debate

The initial debate placed Japan's preference for equalization against the U.S. preference for open skies.² The U.S. term of "open skies" might imply straightforward competition—let the best airline win. In fact, the term has always meant less than that, though it indeed means major liberalization. The U.S. uses the term to mean unlimited Third and Fourth Freedoms and, often, the expansion of Fifth Freedoms. However, moving freely within someone else's domestic market is decidedly not part of open skies for the U.S., despite the connotation of wide open competition. Japan generously noted this point in the negotiations, as a brief item in the *Aviation Daily* illustrated in June 1996:

Rejecting open skies, Japan says U.S. policy would open the international market without any safeguards while keeping [the] U.S. domestic market for U.S. airlines exclusively.... This policy... is pregnant with the risk of further concentration in the international market by mega-carriers.³

The sheer size of the U.S. airline industry is often lost on Americans. For example, measured by flights operated, the U.S. is home to the world's eight largest airlines, including FedEx. Measured by jets operated, the U.S. is home to the world's seven top carriers; British Airways nudges into eighth place, just three jets ahead of Southwest (265 jets versus 262 as of May 1998). The domestic market alone in the U.S. still accounts for a third of world airline demand. Simply put, U.S. allusions to the virtues of competition stuck in the throats of Japan's aviation officials when they were excluded from a third of the world market.

However, opening up the internal U.S. market just was not part of the conversation for DOT or for U.S. carriers, whether the carriers operate internationally or only domestically. The same, of course, is true in other regions of the world that have substantial domestic markets, including Japan and the now single European Union. Nevertheless, this irritant was real, given the size of the U.S. market.

The Genuine Appeal of Open Skies. Despite its qualified meaning, open skies has real intellectual appeal. It is a major liberalization of international aviation. DOT has persistently pursued open skies as its core policy in aviation since

the Bush Administration signed the first open skies agreement with the Netherlands. The Clinton Administration has also successfully pursued open skies in all its aviation negotiations. While inheriting open skies with the Netherlands and a trans-border agreement with Canada, the Clinton Administration has since driven new open-skies agreements in Central America, the Caribbean, Western Europe, Asia, and most of South America.

DOT's interest in open skies is related to, but goes beyond, the normative value of markets versus command-and-control regulation. Deregulation and liberalization have become the primary direction of economic policy around the world in most industries, including major domestic and regional aviation markets. Whatever its historical justifications, extensive economic regulation of international airline service no longer has a meaningful point in DOT's view. Open skies now is a goal in its own right.

Japan's View. In contrast to DOT's reference to principles of competition and ending an outdated regulatory regime, Japan strongly resisted what it characterized as "U.S.-style open skies." By qualifying the term with "U.S.-style," Japan noted its exclusion from the huge airline market in the U.S. interior. Japan saw open skies" as offering nothing meaningful in exchange for more access to Japan and unlimited beyond rights into other parts of Asia.

Instead, Japan spoke of equalization. Japan bristled at having just one beyond-flight through the U.S. and sought to equalize beyond rights and its market share between the two countries. Real issues of national pride were involved—Japan wanted to move beyond what it saw as an aviation treaty that reflected Japan's status as a conquered nation in 1952. Equalization meant equal status as a sovereign nation.

However, equalization also involved a few issues other than national pride. First, Japan was coping with the volatility of domestic deregulation. For 50 years, Japan had just three air carriers: JAL; ANA; and JAS. Deregulation in Japan's domestic market could add six or more new carriers within a year. As the U.S. learned after 1978 and as Europe is learning today, a newly deregulated industry can be volatile and is not without losers.

Japan had little interest in adding to the volatility of deregulation by introducing open competition with U.S. carriers on international routes. Simply put, U.S. carriers beat Japanese carriers badly on cost and productivity. On average, unit costs for Japanese carriers exceed those of U.S. carriers by two-thirds or more. JAS is especially hard pressed to reduce its costs, which have long been more than double world averages. Such enormous cost differentials made competition with U.S. carriers a tough issue for Japan.

Japan also had advantages to protect in beyond rights. If Japan were to secure a major increase in beyond-U.S. rights, Japan would have to reciprocate. However, Japanese carriers, especially JAL, were far better established elsewhere in Asia than were U.S. carriers. Japan's airlines carried substantial traffic from other Asian cities to Tokyo or Osaka, then to the U.S. on other

flights. Under the bilateral, such traffic originated in Japan, since these were not through flights. Therefore, Japan already enjoyed extensive de facto beyond rights. Japan had little to gain by conceding more beyond rights to U.S. carriers.

Finally, Japan argued that the U.S. simply ignored self-evident physical constraints at Tokyo's congested Narita, where no new slots would be available for anyone until a new runway was built. Consequently, Japan held that open skies simply was impossible. In addition, airlines from all over the world had applied for new or expanded access to Narita. Japan argued that U.S. carriers, who already controlled over half the international slots at Narita, could not expect special treatment in order to jump the queue.

DOT countered the runway argument with three points. First, Japan had talked about a new runway at Narita for several years. The time had come to get on with it. Second, DOT noted that many disputes involved rights to and beyond Osaka, not Narita. Therefore, the issue was about more than Narita, with or without a new runway at Narita. Third, DOT said much of the congestion at Narita was self-imposed by the absence of high-speed taxiways that are commonplace at other single-runway airports, such as London Gatwick, San Diego, etc., where aircraft exit quickly after touchdown. Japan's conservative ATC requirement on aircraft spacing restricts capacity even further. As a result, Narita's single runway handles a maximum of about 25 operations an hour; a comparable runway in the U.S. or Britain would handle twice that.

Japan's Counter Offer. Instead of open skies, Japan sought "dynamic liberalization," or "controlled expansion," in which Third- and Fourth-Freedoms would increase, but would remain regulated. The question for U.S. carriers and DOT was how many new flights Japan would accept. DOT implied that an increase of 150 to 200 weekly flights could be—could be—acceptable. Japan did not commit itself publicly to a number, but dismissed DOT's numbers as preposterous. Speculation commonly identified 90 new slots as the absolute maximum, or an increase of 36 percent.

Japan began outlining to negotiators in the summer of 1996 just what controlled expansion and equalization would mean. Japan allowed that it would accept an unlimited number of U.S.–Japan points for two carriers from each country (presumably Northwest, United, JAL and ANA), with an orderly expansion of beyond-rights for U.S. incumbents, plus some new beyond authority for non-incumbent U.S. carriers. In addition, nonincumbents would be offered a substantial increase in frequencies and two new nonincumbents could be designated. In exchange, Japan would expect ANA to be designated an incumbent, and beyond rights and unlimited points would have to be equalized for Japan's two incumbents.

Though DOT continued to claim that open skies remained its goal, the debate shifted to whether controlled expansion would offer enough new slots to keep U.S. carriers happy, or whether it was only a negotiating ploy by Japan to delay open skies indefinitely. U.S. negotiators and many U.S. carriers added that, if

Narita really precluded new slots, controlled expansion would not be worth the trouble. Based largely on this reasoning, Northwest and its allies continued to insist on open skies, lest the U.S. trade away real growth in exchange for a phony deal.

Yet, expansion, controlled or not, could advance the interests of many U.S. carriers. Clearly, Japan was not interested in open skies. As a practical matter, DOT's challenge was to move Japan as close as possible to open skies while still accepting some regulatory limits. Though the question of how many remained for U.S. carriers and DOT, Japan's offer of expansion split the U.S. industry's insistence on open skies.

Positions Taken by U.S. Carriers And Others

Incumbent U.S. Carriers. From the start, U.S. carriers had different interests in the negotiations. United and Northwest, as incumbents, had dominated the U.S.-Japan market and were well established in Japan, with hangars, gates, sales operations, and regional maintenance facilities. As of summer 1997, United operated 87 round trips per week to and from Japan, while Northwest operated 154. Nonincumbent U.S. carriers shared 30 weekly round trips, for a U.S. total of 271 round trip slots per week. Japanese carriers had a total of 134, or just 31 percent of the total.⁴

At a minimum, United and Northwest sought to protect their positions and their capital investments. United and Northwest first sought nothing short of open skies. Northwest was especially vocal in its demand for open skies. On its face, Northwest's 154 weekly flights versus United's 87 would indicate Northwest had more at stake than United. In fact, this understated the relative importance of Japan to Northwest.

First, Northwest was ready to expand its presence in the region and sought beyond authority into East Asia through Japan. Beyond-authority would enable Northwest to build on its base in Japan before other U.S. carriers could do so. Consequently, beyond-authority was important to Northwest, who, like DOT, contended that Japan's rejection of Northwest's requests violated authority included in the existing bilateral from 1952.

A related and more general concern for Northwest was its perceived need to protect its base of 154 flights and its dominant position in the Japan-U.S. market. This base was more important to Northwest than it was to United, important though it was to United. By any measure, United was at least a third larger than Northwest. United also had a few more options via its wider range of alliances with foreign carriers. United's Star Alliance included Air Canada, Lufthansa, SAS, Thai Airways, and Varig. At the same time, ANA had entered agreements with several Star Alliance partners, and was talking to United about a possible agreement (which it later completed). Meanwhile, JAL and American were talking about expanding a limited frequent flyer agreement into a broader alliance, including codesharing, common services, etc.

In contrast, if Japan could convince United that the increase in total slots under controlled expansion would be adequate not only to protect its base but to build on it, United likely would be happy to accept something short of open skies, as would the three nonincumbent U.S. carriers. However, Northwest could not easily afford to be so flexible. Depending on the details, controlled expansion might not provide enough net growth to assure Northwest that it could expand to or through Japan, or that it could protect its position against United, or against alliances like JAL–American or ANA–United, or against the sum of new frequencies operated directly by JAL, ANA, the existing U.S. MOU carriers and any newly designated MOU carriers. Consequently, Northwest continued pressing for open skies.

United, in fact, was satisfied that expansion and a deal with ANA would suit it well enough. United suddenly softened its position and thereafter portrayed Japan's offer as something that was valuable and within reach. United added that the proposed increase would offer satisfactory growth for all. Meanwhile, Northwest continued to play hardball.

Nonincumbent U.S. Carriers. Nonincumbent U.S. carriers (American, Continental and Delta) recognized that controlled expansion would enable them in practice to expand as much as open skies would, given the relatively weak base from which each would need to build. Consequently, those carriers lobbied hard for DOT to accept what they characterized as meaningful change in the right direction. In short, forget open skies and take a useful deal.

TWA put everyone on notice that it would apply for U.S.–Japan authority when negotiations were completed, whether they led to open skies or expansion. TWA still preferred open skies as a matter of principle, but access was access. U.S. Airways and Hawaiian Airlines later added their names to the list of carriers who likely would apply for new authority.

However, other carriers also had interests consistent with those of Northwest. Alaska Airlines, for example, had entered several codesharing and frequent flyer agreements with Northwest. Though Alaska was unlikely to seek authority to operate to Japan, it supported its new ally, Northwest.

America West also supported open skies. Though the carrier no longer operated to Japan, it had done so in the past and might want to do so again. However, expansion likely would mean benefits for incumbents and MOU carriers. Even with one or two new U.S. MOU carriers, America West was unlikely to be one of those new designees. Therefore, controlled expansion might permanently exclude America West from the U.S.–Japan market. America West sought open skies to keep its options open.

More significantly, FedEx had a strong interest in the issue of beyond rights. FedEx had been involved in bitter negotiations with Japan since at least 1993 over Fifth-Freedom services through Japan. FedEx's plans called for the use of 747s on the trunk lines to North America, with a fleet of smaller aircraft, such as 737s, to provide collector and distribution operations throughout East Asia.

FedEx and DOT both argued publicly that FedEx was entitled to these approvals under the 1952 bilateral. Japan, however, saw it differently and said flatly that this de facto cargo hub was outside the incumbent Fifth-Freedoms under the 1952 bilateral.

FedEx could get approval only for new Third- and Fourth-Freedom flights or straightforward Fifth-Freedom rights, neither of which fit the carrier's plans. In fact, FedEx had not used many of its allotted Third- and Fourth-Freedom slots under the bilateral agreement, because they did not advance FedEx's long-term strategic objectives. These unused slots later would become the source of a bilateral compromise.

Yet, FedEx was not especially concerned about open skies, though open skies would yield what FedEx sought. Instead, FedEx's primary concern centered on its Fifth-Freedom requests, with or without open skies.

The air carrier lineup eventually put incumbent United on the same side of the issue as American, as well as Continental and Delta. Hawaiian, U.S. Airways and TWA also came down on that side of the issue, as controlled expansion likely would accommodate any realistic plans they might have. On the other side, Northwest held firm in its demand for open skies and more beyond rights, with support from Alaska and America West, and an angry FedEx in the corner.

Domestic Politics in The U.S.: Non-airline Stakeholders

Open skies advocates enjoyed the early advantage of being on the side of a well-established government policy that was consistent with basic American assumptions about the virtues of markets. The appeal of the open skies label was reflected in early and vocal support from Capital Hill, especially from the Senate. Up to 20 Senators went on record, either in letters to the White House or in public statements, to urge the Administration to hold firm on open skies. Many of those Senators took the extra step of warning the Administration several times against settling for anything short of that objective.

Those Senators included Chairmen of seven committees, the Minority Leader, and several members of the Appropriations Committee, plus Jesse Helms, Chairman of the Senate Foreign Relations Committee. This was no small base from which to build support for open skies. Senator Helms, in fact, went to the wire, with strong statements and threatening last-minute hearings on the issue.

Besides benefitting from the connotations of open skies, Northwest successfully linked its position to larger trade issues, arguing that open skies with Japan was a test case demonstrating U.S. resolve in all trade issues with Japan. Northwest got vocal support on this tact from Chrysler, General Motors and the Automobile Manufacturers Association. Northwest lobbied Congress hard with this argument and undertook an aggressive advertising campaign in the *Washington Post*, with full-page ads that were complete with Japan bashing, bureaucrat bashing, and references to Asia's financial crisis. The ads regularly included a half-page comic strip that portrayed President Clinton

aboard a JAL jet being duped by his own staff into giving away the U.S. market. Northwest's ads used large, bold print to emphasize selected points. The ads and their cartoons told readers the following.

Anything less than open skies is a surrender to Japan's bureaucracy.

For decades, Japan has protected its industries from foreign competition in Japan while orchestrating their expansion into the U.S. Other Asian countries followed the Japan Inc. model. It hurt us, but it worked for them, **until now!** (Original in bold.)

The Asian economic crisis is a direct result of these protectionist policies. The remedy is the U.S. model—open markets and free competition. ...Unfortunately, Japan's bureaucrats still haven't gotten the message.... Japan is still insisting on an aviation deal that follows the old 'Japan Inc.' model. It will allow them to control ticket prices, keeping them high, and restrict U.S. landing slots to Tokyo, protecting their inefficient airlines, all the while doubling Japan's access to the lucrative U.S. market.... That's why U.S. negotiators must insist on our policy of deregulation in international aviation.

On the other side, advocates for controlled expansion included more than a few cities and airport authorities who, for their own reasons, agreed that expansion was valuable and within reach. Those airport authorities included Chicago O'Hare (United and American hubs), Dallas/Fort Worth (an American hub), Honolulu (to ensure continued arrival of Japanese tourists on U.S. or Japanese carriers), Los Angeles (a likely destination for new JAL and ANA flights), San Francisco (United's Pacific hub) and others. Congressional support for expansion included three Senate chairmen, most of the Illinois delegation from both parties, the Governors of California, Hawaii and Illinois, and the cities of Chicago, Los Angeles, New York, and San Francisco. In addition, organizations known as the Midwest Coalition and Access U.S.–Japan (each of whom represented a group of airlines, including American and Delta, airport authorities, and state and local governments) added their weight and ran their own advertising campaign.

The U.S. side essentially moved to two coalitions of carriers and related interests. Each side claimed the high road and accused the other of pursuing narrow self interests.

Besides its hard ball advertising and congressional lobbying, Northwest formally opposed every interim petition that JAL and ANA submitted to DOT. FedEx did much the same and with rhetoric that became increasingly harsh and targeted.

The message from FedEx and Northwest was consistent: the petitions by JAL and ANA usually were within the existing bilateral, but until Japan was willing to extend beyond rights to Northwest that it (and DOT) believed were within the same existing bilateral, DOT should no longer try to cooperate with Japan. *Aviation Daily* provided a good example of this tactic when it summarized Northwest's filing to DOT in opposition to an application by JAL to increase its flights from three weekly to seven weekly between Tokyo and Kona, Hawaii. JAL contended that the existing bilateral authorized that expansion. Northwest did not disagree with this contention, but added:

Northwest does not dispute that JAL's requests are consistent with the U.S.-Japan Air Transport agreement, but Japan's refusal to allow Northwest—despite bilateral entitlement—to operate Seattle-Osaka-Jakarta service, including Fifth-Freedom Osaka-Jakarta traffic, should prompt DOT to deny JAL's bid... Japan's actions seriously injured Northwest by limiting its ability to serve Asia and precluding altogether Northwest's participation in the U.S.-Indonesia market.⁵

FedEx and JAL then exchanged public insults when FedEx opposed a routine JAL filing to DOT to renew JAL's Third and Fourth Freedoms to operate cargo service from Tokyo to Atlanta. FedEx, like Northwest, insisted that it was being denied the use of existing authority for beyond service through Tokyo, so DOT should not provide any unnecessary concessions. JAL retorted flatly that the authority sought by FedEx was not part of the existing authority, and that Third and Fourth Freedoms should not be held hostage to a dispute over the interpretation of Fifth Freedoms.

FedEx publicly described JAL's comments as "astonishingly inappropriate, misleading and arrogant." FedEx maintained that the bilateral permitted new beyond service from Tokyo—a position publicly taken by DOT in its approval of Northwest's beyond-rights complaint. JAL said it did not, and third/fourth freedoms should not be held hostage to Fifth-Freedom battles. JAL added that "Moreover, the latest filing [by FedEx to DOT] is ... almost unalloyed invective of the sort that has no place in an administrative proceeding, [and is] full of offensive representations." FedEx shot back that there was "no polite phrase for the deliberate and prolonged breach of a clear and valid bilateral commitment." Patience was wearing thin on both sides.⁶

Other U.S. carriers were more conciliatory. United supported JAL's Kona application as long as [DOT] concludes that the government of Japan is prepared to grant comparable approval to changes in U.S. carrier third/fourth freedom schedules. United added that sanctions against Japan and its carriers would only disrupt productive U.S.-Japan negotiations on which Japan, according to United, was showing signs of greater flexibility.⁷ A month later, United added that "It is not always reasonable to say 'no.' We had better explore or study what we can do." Delta took the conciliatory tone a step further on several occasions to praise DOT for its persistence and skill.

DOT then sharpened its own messages to Japan. In mid-February 1997, DOT simultaneously approved for 180 days the JAL application at Kona, but then issued an order in which DOT agreed with Northwest's July 1996 complaint: by failing to approve Northwest's request for beyond rights, Japan had committed a most serious violation of the existing bilateral by blocking Northwest's beyond service to Jakarta. DOT chose not to impose sanctions just yet, expressing hope that negotiations would settle the issue. However, the message was clear: DOT had only so many options under U.S. law, and if delays continued, DOT would be forced to take more aggressive action.

Within days of this order, DOT's Deputy Assistant Secretary for International Aviation Policy, Patrick Murphy, told the Institute for International Economics that the U.S. "is no longer prepared to sign a small deal satisfying the short-term needs of a few U.S. and Japanese carriers while...restricting future U.S. rights." Additional short-term needs for Japanese carriers will just have to remain unresolved until there is a breakthrough in our aviation relations. In short, JAL could forget another extension, as could ANA unless they and their government showed some movement.⁸

The European Union Enters the Equation. At this point in the negotiations, the key issue was whether Japan could sell its alternative of controlled competition by offering enough new slots at Narita and Osaka to appease U.S. carriers and DOT. Doing so would, to say the least, be diplomatically awkward. Japan had rejected applications for more Narita frequencies from carriers around the world because Narita was said to be operating at capacity. If so, how would the rest of the world react if Japan suddenly found slots for U.S. carriers?

The European Union (EU) made its position clear. If Japan offered new slots to U.S. carriers and let them jump the queue, the EU said Japan would be discriminating against European carriers, who were prominent in the queue into Narita. Competition Minister, Karl Van Miert, and Transport Minister, Neil Kinnock, reminded Japan that EU law authorized the European Commission (the EU's executive branch) to take retaliatory action against Japan's carriers, who were busy increasing their access to Europe.

Summary of the Line Up. Northwest continued to play hard ball and had managed to keep the congressional debate at least partly focused on broader issues, such as free markets. In addition, Northwest had found allies in Detroit, where U.S. auto manufacturers responded to general trade issues. However, Northwest was beginning to find itself alone among U.S. passenger carriers, with strong support only from Alaska Airlines, plus more distant support from America West. Even the position of FedEx was a bit ambivalent toward open skies; its focus was on beyond rights, under any label.

On the other side were the remaining large U.S. carriers for whom controlled expansion would be just fine in practice. Though some of those carriers preferred open skies in principle, controlled expansion likely would

accommodate any growth that they could realistically manage in Japan. Those carriers found allies in several major airport authorities, city and state governments, congressional delegations and trade organizations, for who controlled expansion would be adequate in practice.

DOT was somewhat caught in the middle. It had sought open skies as a general principle for a decade anywhere the opportunity presented itself. DOT saw little value in maintaining a regulatory structure that its career and political leadership under both Republican and Democratic Administrations had long felt was obsolete. Yet, DOT recognized that Japan would not accept full open skies. Instead, DOT needed to get what it could get. The challenge was to continue pushing as hard as possible for concessions but, at some point, not too hard.

Japan's Ministry of Transport also was caught in the middle. It needed to erase what it and its carriers had long perceived as second-class status under the 1952 bilateral. However, the Ministry could not seek the full equalization implied by open skies because its carriers, already bracing for the volatility that accompanies domestic deregulation, simply were not ready for it. In addition, the Ministry had to offer something in return for its qualified equalization; the U.S. would demand something substantial, even if it were short of open skies.

That "something" would require concessions on beyond rights for incumbents, plus enough new slots to satisfy all three groups of U.S. carriers with interests in the issue: incumbents; MOU carriers; and carriers seeking new entry in the U.S.–Japan market. However, the catch was that any new slots at Narita would create diplomatic issues for Japan elsewhere.

Finally, Japan faced a major long-term strategic threat if it offered too little or held out too long. U.S. carriers were entering codesharing agreements and the U.S. government was entering open skies agreements rapidly in the region. If Japan waited much longer, it might find it had forfeited its role as the hub between North America and East Asia; some U.S. carriers already were bypassing Narita en route to other destinations.

New Slots Are Found at Narita — Agreement

After nearly two years of debate and maneuvering, DOT proposed a compromise: take the unused slots allocated to U.S. cargo operators and let DOT or Japan allocate them to U.S. passenger carriers. FedEx, who agreed to let this proposal stand, accounted for nearly 40 such slots alone, while UPS and ABX added more slots. The difficulty, though, was threefold.

First, Japan would have to choose between the U.S. and the EU. Both the Transport and Competition Commissioners of the EU noted that the long-established practice required that any forfeited slots were to be placed in a truly international pool and, in this case, reallocated by Japan to those carriers already in line for new slots. The U.S. had no special claim to slots that its cargo carriers were not using.

Second, U.S. carriers complained that, since the slots at issue were designed for cargo carriers, they offered arrival and departure times that were simply

brutal for passenger traffic. “Too bad” was Japan’s basic response—U.S. carriers and DOT could sort that out among themselves. Third, with a total of 50 slots, the unused cargo slots at Narita would not do the job.

In the end, Japan chose to risk angering the EU; Japan took the offer **and** actually improved its earlier offer:

An unlimited number of U.S.–Japan points for two incumbent carriers from each country, which meant ANA would become an incumbent along with JAL, Northwest and United;

An orderly expansion of beyond rights for U.S. incumbents in exchange for more beyond points for Japanese carriers;

New beyond authority for non-incumbent U.S. carriers;

A substantial increase in frequencies for nonincumbents;

The U.S. could designate two new MOU carriers immediately and could add a third MOU carrier in two years;

Expansion would include some price flexibility to enhance competition; and

U.S. MOU carriers would get a total of 150 new round trips a week, in addition to unlimited expansion for incumbents.

Any number of factors could explain why Japan seemingly agreed rather suddenly after two years of back-and-forth. First, DOT made clear that its patience was running out—a major advance would be required, and soon. More importantly, the environment was beginning to bypass the negotiating chips enjoyed by Japan’s Ministry of Transport. Japan had to defend its role as a regional hub. In addition, U.S. and Japanese carriers were already negotiating alliances that made carriers on each side of the Pacific, but especially in Japan, reassess their position.

Finally, Northwest and Continental had announced a domestic alliance, in which the fourth and fifth largest carriers in the world would coordinate routes, ticketing, etc., complete with Northwest taking a 14-percent equity stake in Continental. This predated the American-U.S. Airways and United-Delta alliances, which emerged only after the negotiations. Northwest could live with expansion, given the improvement in its own position and the new prospects enjoyed by Continental, provided that Japan accepted this new same-country codeshare without penalizing either carrier’s slots. Japan later did so.

OK, Who Won?

Who won and who lost is not the most diplomatic question to ask, but the honest answer is almost diplomatic: everyone—well, nearly everyone. Japan won in that it held off open skies and unlimited competition between U.S. and Japanese carriers. Japan also won by equalizing beyond rights and by adding an incumbent carrier. In addition, Japan secured a codeshare with Northwest for the weakest of its three established carriers (JAS). These were no small achievements by the government on behalf of its national carriers; Japan enhanced its position as an equal in a relationship between sovereigns.

The U.S. also won. DOT had brought home far more new slots than any observers had thought possible throughout most of the negotiations. DOT also had won unlimited Third and Fourth Freedoms for United and Northwest, while adding substantial beyond rights for each. In addition, DOT added two new incumbents immediately and a third after two years, with new slots and some Fifth-Freedom rights for good measure.

Among the Japanese carriers, ANA clearly was a winner, with new incumbent status, unlimited Third and Fourth Freedoms to and from the U.S., and assurances of new Fifth-Freedom rights. Meantime, ANA had added itself to the Star Alliance.

United also was a winner. Besides securing an important alliance partner in ANA, United also had won unlimited Third and Fourth Freedoms, and was assured of new Fifth-Freedom rights. In the end, United could use its established position in Japan to pursue any level of realistic growth that it might entertain. In the meantime, by playing a rather moderate role during the negotiations, United had avoided making enemies in Japan and may even have made a few friends.

Similarly, all three U.S. MOU carriers had clearly won. They were assured of a significant number of new slots to accommodate any realistic growth. In addition, American was about to close a deal with JAL, while Continental could expand in its own right and piggyback on its new alliance with Northwest. Similarly, Delta could expand in its own right and could piggyback on its yet-to-be-announced alliance with United. In addition, like United, Delta's low-keyed but conciliatory statements during negotiations had avoided making enemies in Japan.

Other U.S. carriers also won, such as TWA and Hawaiian. They were virtually assured of gaining new MOU status, especially after U.S. Airways chose to stop pursuing MOU designation. Alaska, too, came out well. Its partner, Northwest, already was dominant in the U.S.–Japan market, and Northwest had gained unlimited Third and Fourth Freedoms, plus expanded Fifth-Freedom rights. Alaska could sell tickets throughout its market not only to Japan but to a growing number of Fifth-Freedom destinations in Asia via Northwest.

Finally, even Northwest won. It had played hard ball but had helped push Japan to make important concessions, such as unlimited Third and Fourth Freedoms and expanded Fifth Freedoms. Northwest could build on its dominant

position in the U.S.-Japan market. However, Northwest had three worrisome outcomes. First, even if its insistence on open skies were only a negotiating position, Northwest had come up short of its stated goal and thereby appeared to have lost. Second, Northwest also had some fences to mend, both in Japan and in the U.S. Even after negotiations were concluded, Northwest's public statements remained negative and aggressive. Given Northwest's tactics and its shrill voice during the negotiations, Japan's Ministry of Transport and even DOT might hesitate before doing Northwest any favors for some time.

Third, the agreement adds unlimited flights for four incumbents, including ANA, plus expansion for three U.S. MOU carriers and three new U.S. MOU carriers. The sum of these flights should at least double capacity. If demand cannot support this supply, expansion may create enough new capacity to force some future market shakeout. This is not what Northwest had in mind.

If so, the American-JAL and United-ANA alliances could cut into Northwest's market share in a glutted market. However, the same risk faces existing and new MOU carriers and Northwest starts from a strong position, given its existing infrastructure in Japan. On balance, Northwest emerged in good shape.

Finally, major airport authorities and their allies clearly won, with new flights to and from Japan. Similarly, the Midwest Aviation Coalition and Access Japan also won by establishing themselves as effective lobby groups in major trade issues.

CONCLUSIONS

The core issues of expansion versus open skies, plus the issue of beyond rights, affected different carriers differently. Modest expansion would have accommodated growth plans for the three MOU carriers from the U.S., while talk of adding ANA as an incumbent and adding three MOU carriers from the U.S. satisfied another block of carriers. The incumbent U.S. carriers, especially Northwest, had other interests to protect, and each acted accordingly. Constituent airport authorities and local and state governments also lined up according to their interests.

This produced two opposing coalitions on the Japan-U.S. negotiations. Each coalition was a temporary marriage of convenience among airlines, airport authorities and governments whose interests were comparable or at least compatible. However, because each issue can affect each organization differently, members of each coalition are likely to oppose each other on tomorrow's issue. The guiding principle is not some high-level normative value, such as the sanctity of open markets. Instead, like firms in other fields, airlines compete in the politics of regulation to acquire the economic value and competitive advantages that regulatory outcomes can create.

ENDNOTES

1. Five Freedoms of the Air:
 1. First freedom rights grant a foreign carrier the right of innocent passage to fly over another country without landing.
 2. Second freedom rights grant a foreign carrier the right to land in another country for purposes of refueling and maintenance without offering commercial service to or from that point.
 3. Third freedom rights allow a foreign carrier to pick up traffic outside its home country to be disembarked in its own country of registry.
 4. Fourth freedom rights allow a foreign carrier to pick up originating traffic from its own country for transport into another country.
 5. Fifth freedom rights allow a carrier to pick up or disembark traffic enroute.
2. Open Skies agreement.
An agreement between two or more national governments that leads to freer trade in aviation services through the elimination of entry barriers and/or the prohibition of government regulation of routes and capacity.
3. *Aviation Daily*, June 27, 1996.
4. *Aviation Daily*, August 4, 1997.
5. *Aviation Daily*, January 8, 1998.
6. *Aviation Daily*, February 18, 1997; February 19, 1997; March 28, 1998.
7. *Aviation Daily*, January 9, 1997.
8. *Aviation Daily*, February 18, 1997.

