

**Remarks for the General Administration of Civil Aviation of China (CAAC)  
at the Second Meeting  
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**Introduction**

Good morning, and thank you for hosting this Economic Dialogue between the United States Department of Transportation and the General Administration of Civil Aviation of China (CAAC). It is a great privilege to visit CAAC and continue our mutually beneficial work on a wide variety of issues and to extend our cooperation through the Aviation Cooperation Program (ACP) beyond safety to now include economic regulation and analysis.

We can already see benefits following the signing of the new U.S.-China air services agreement. The United States is preparing to announce six new route awards and we understand that a Chinese carrier has proposed non-stop service between China and Seattle.

This visit is an opportunity for the U.S. delegation to learn what China needs and to do a better job advising CAAC in its approach to deregulation of the Chinese aviation industry. I admire the way CAAC tackles problems, the preparation that has gone into these meetings, and the insightful questions that we have received.

I am reminded of a Chinese proverb: Deep doubts, deep wisdom; small doubts, small wisdom. Such is aviation deregulation.

China is at a crossroads today.

There are some similarities between China in 2007 and the United States in 1977, but there are many differences too. Then, and now, the aviation market is growing and serving as enabler of economic growth. Legacy carriers are increasingly challenged by newcomers. Congestion and air space management must be balanced with the desire to support more competition. Decision makers worry over the compatibility of free markets and safety and recognize the need to preserve and expand air service to rural areas. These are difficult questions.

Under regulation, the federal government controlled routes, services, and prices. Deregulation was opposed by many, including those in the government, who feared that it would lead to instability, harm the environment, and result in job losses.

Being at a crossroads is a benefit for China, because it can adopt regulations for its industry by writing on a clean slate.

I'd like to share some lessons from the U.S. deregulation experience, focusing on three specific topics of general interest: market access, customer service, and airport management. There are things the U.S. did right and also things we did wrong, yet other things are still works in progress.

Key principles were established by our Congress when the airline industry was deregulated and aviation policy is guided by our statute (40101). For example, the Secretary of Transportation has a number of goals. Safety is the highest priority, and preventing deterioration of safety levels is crucial. The Department seeks to ensure a variety of economic, efficient, and low-priced services for U.S. consumers. It encourages the payment of fair wages and existence of good working conditions for airline employees.

We rely on a competitive market to provide air service and encourage efficient and well-managed air carriers to earn adequate profits and attract capital, while avoiding unreasonable industry concentration and monopolies. Carriers are able develop service to major urban markets through the use of secondary airports and the Department ensures that all regions of the United States – including small, rural, and remote – have access to affordable, regularly scheduled air service.

The Department supports the development of civil aviation and a privately owned, viable industry in which its domestic carriers are strong competitors vis-à-vis foreign carriers. Another goal is the development of an expedited all-cargo network provided by private carriers. In conjunction with the Secretary of State, the Department develops a negotiating policy to support the greatest degree of competition compatible with a well-functioning international air transportation system, including the freedom of domestic and foreign air carriers to offer prices that correspond to consumer demand. We've seen carriers respond to these changes in demand, and the number of nonstop U.S. gateway cities has increased over time.

The FAA Administrator has similar goals, with safety and security as the highest priorities. The FAA encourages the development of civil aeronautics, including new aviation technology, and the operation of common systems of Air Traffic Control to maximize civilian and military safety. Continued and consolidated research and development for air navigation facilities also receive great attention.

A sound regulatory policy underlies all of these factors and illustrates the overriding and all-important lesson of the U.S. deregulation experience. The United States faced difficult regulatory and policy decisions and needed to rely on the marketplace for benefits. Deregulation, in general, has been a great success, with billions of dollars of economic benefit each year. In fact, airline deregulation spawned deregulation of the telecommunications, banking, energy, and other industries.

Arguably, the most difficult problem we face today in the United States is the looming threat of gridlock that increasing congestion imposes on our system. This issue stems not from “excessive” competition but from the absence of a marketplace for airspace usage – and I will return to this topic later.

With these principles in mind, let me turn to the three focal topics of these meetings.

### **Market Access**

The philosophy underlying the deregulated environment is that market participants should be given the maximum freedom possible, consistent with the overriding goals of safety, system efficiency, and protection of consumers against unfair and deceptive practices.

***What the U.S. did right.*** We abandoned regulation of routes, rates, and services. We let carriers charge prices, set routes and schedules, and determine the services they wanted to provide. These changes are the cornerstone of deregulation. We also preempted state and local regulation which could interfere with a single federal standard.

We remained vigilant over antitrust actions, thereby ensuring competition. We work closely with the Antitrust Division of the Department of Justice in this area. Conversely, we keep separate-- safety and economic regulation. A strong and independent safety agency will never subordinate its objectives to economic certification.

Distribution markets, via competitive computer reservation systems (CRS), spawned yield and revenue management models, price competition, and hub and spoke systems and increased the pace of deregulation.

We also separated economic fitness from predictions of success or failure. If we knew which models would work, we’re clearly in the wrong line of work! Rather, we encourage continued competition by allowing carriers that are fit, willing, and able to enter the market, thereby ensuring consumers are protected while allowing the market to determine success or failure of any given model.

Finally, we embrace Open Skies policies and continued liberalized of the global aviation industry. The United States is eager to sign an Open Skies agreement with any country prepared to adopt this level of open competition.

***What the U.S. could do better.*** Our investment regime is limiting. Currently, we allow foreign citizens to own a maximum of 25% of the voting control, which is a long-standing doctrine that, in my view, hurts the industry. Similarly, current bankruptcy law serves as an exit barrier to the industry and leads to competitive distortion.

***Work in progress.*** Thirty years later, the global aviation industry is not fully liberalized, but the United States has over 75 Open Skies agreements and additional bilateral

agreements. Our classification of aircraft operations (commuter versus foreign versus scheduled versus on-demand air taxi, etc.) has led to some confusion in the market.

### **Service Quality Management**

The philosophy underlying the deregulated environment is that very few airline customer service policies should be regulated. We do not specify a particular level of standard service – carriers can provide meals or not, regardless of the length of the flight. They are free to offer amenities like pre-reserved seats, or not. They can permit passengers to board in any order the carriers choose, and they are free to offer any compensation in the event of a cancelled or delayed flight.

Instead, we rely on information and disclosure for consumers; the Department requires carriers' policies be transparent to consumers. For example, we require conditions of carriage, or contract, be available at the time of booking and at the airport. We require carriers to report statistics about delays, lost baggage, complaints, and flight cancellations to the Department, where we compile a monthly scorecard that is made available to the public.

The only exceptions apply to very specific rules: the provision of a certain level of compensation for bumped flights; the disclosure of full fares, including fees and surcharges that can be calculated in advance, when the fare is quoted; the publication of a realistic schedule and on-time performance history; and accommodation, such as wheelchairs, for passengers with disabilities. In general, this approach has worked reasonably well.

We find that most problems in customer service actually stem from delays in the system. Our philosophy is to rely on market forces as much as possible to solve these problems, because prescriptive rules tend not to work as well. For example, in 1999 there were tremendous problems with customer service. At the Department's request, the largest U.S. airlines adopted a code of conduct with 12 specific promises:

- 1) Offer the lowest fare available at the time
- 2) Notify customers of known delays, cancellations, and diversions
- 3) Provide on-time baggage delivery
- 4) Support increased baggage liability limit
- 5) Allow reservation to be held / cancelled
- 6) Provide prompt ticket refunds
- 7) Provide proper accommodation for disabled and special needs passengers
- 8) Meet customers' essential needs during long aircraft-occupied delays
- 9) Handle bumped passengers with fairness and consistency
- 10) Disclose policies associated with travel itinerary, cancellation, frequent flier programs, and aircraft configurations
- 11) Ensure good customer service from code share partners
- 12) Be more responsive to customer complaints.

Most problems related to customer service stem from delays in the system, which lead to delayed and cancelled flights, lost baggage, and customer frustration.

Both the United States and China are dealing with these problems. I noted with interest CAAC's announced decrease in flights to/from Beijing. In the U.S.' experience, we have questions about the efficacy of measures that including capping or limiting operations. Currently, we are trying to find a better way to handle our own problems.

In a 1978 speech, which I encourage you to read, Alfred Kahn, the "Grandfather of U.S. Airline Deregulation," made three key points:

- It is simply inconsistent with deregulation to limit flights, so don't do it;
- Competition can help with congestion by encouraging the use of secondary airports and increasing the load factor per landing; and
- Congestion and delay are market problems. For example, in most areas of the economy, you pay for what you use. If it were free to attend a movie, theatres would be crowded. If bicycles and cars had the same price, there would be even greater congestion on the roads.

The same problem exists with airspace usage, and we haven't done a good job of addressing it. Because the cost of airspace in the U.S. is the same for small and large aircraft, we've created an incentive for firms to fly as many flights as possible. Currently, the Department is thinking about changing its policy for the marketplace for airspace.

### **Airport Management**

The philosophy underlying the deregulated environment is that there should be limited federal involvement in the operation of airports. Ownership should, and does, occur at the local level.

Following World War II, the government transferred excess military airfields to state and local governments to provide public airports. Most are owned by local government entities, such as port districts.

There are some federal funds available to these airports; the funds are tied to passengers (enplanements) and specific airports and projects. The FAA has discretionary authority to allocate the remaining funds to identified needs at airports. Airports are also able to charge reasonable fees to facility users, including landing fees.

In return for federal funds, they must give assurance that the charges are without discrimination and the money so raised will remain within the airport. However, the Department and the FAA are not authorized to determine reasonable fees charged to non-aeronautical users.

In the United States, almost all commercial service airports are owned by local governments and operate in the private sector. At medium and large hub airports,

employees of private companies provide about 90 percent of total services, including baggage handling, cleaning, retail, and ground services. In some cases, airlines or other tenants will privately finance their own facilities; examples include major terminals in Chicago, Cincinnati, Detroit, and New York.

FAA approval is required for the sale or lease of a commercial airport, whether the new owner is public or private. Very few private transfers are proposed, and some are rejected due to legal and economic impediments. The FAA considers airport revenue to include lease income, so it can only recover reimbursed costs. These requirements have removed the financial benefit of sale to the private sector, hence the limited sales.

The FAA's role in economic policy making is associated with airport financing. Airports can receive federal and state grants, but the bulk of income comes from passenger facility charges (PFCs), airport bonds, and income revenues. The airport obtains approval from the FAA to collect fees, and bonds are the single largest source of capital. An airport that receives federal grants must use revenue exclusively for airport operations and improvements.

Federal law directs the Secretary of the Department of Transportation to determine whether fees are reasonable. Both airports and airlines can request investigation of fees. While DOT determines reasonableness, it does not set the fees. There are five general principles used in cost-based system:

- 1) Local airports and users determine fees via negotiation
- 2) Legal prohibition against discrimination of fees and charges
- 3) Legal requirement that rates and fees be fair and reasonable
- 4) Legal obligation to use fees as part of airport self sustainment
- 5) Requirement that revenue be used to benefit the airport

## **Conclusion**

In the United States' experience, we have found the best approach is to allow market forces to determine airport and airline operations. The government should step in with regulation only when necessary.

Thank you, and I would be happy to take questions.