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Grancay, Martin

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A Brief Genesis of the North Atlantic Air Transport

Ing. Martin Grančay

Faculty of International Relations

University of Economics in Bratislava, Slovakia

`martin.grancay@euba.sk`

Abstract

The aim of our paper is to analyze civil aviation relations between the United States of America and the European Union - constituting the most important intercontinental air transportation market in the world. Air transport between the EU and USA was traditionally regulated by bilateral Air Service Agreements of rather protectionist nature. The change came after Jimmy Carter had become the president of the USA and started pushing towards liberalization. After 1992, USA and some European states signed bilateral Open Skies treaties, representing an even higher level of liberalization than during Carter's era. However, the European Court of Justice declared these treaties unlawful in 2002. This decision led to a general EU-US Open Skies Agreement signed in 2007. There have been ongoing negotiations on further liberalization; however their success is highly doubtful.

Key words: air transport, Open Skies, European Union, United States

Introduction

The United States of America and European Union are the most important air transport markets in the world and according to forecasts this situation will not change within the next twenty years.¹ Both regions have been acting as drivers of air transport liberalization. Whereas the United States led deregulation efforts from 1970s until 1990s, in the beginning of the 21st century it is the EU who takes over liberalization initiatives.

¹ Airbus: Flying by Nature..., 2007. S. 47.

The purpose of this paper is to research development of North Atlantic air transport liberalization from the end of World War II. until adoption of Open Skies Agreement in April 2007 and its entrance into force in 2008.

1. International civil aviation

Before proceeding to the genesis of North Atlantic air transport liberalization it is important to explain some of the basic principles of international civil aviation. Since the Chicago conference of 1944 international aviation relations have been governed by bilateral air service agreements (ASAs). ASAs contain a set of rules that regulate commercial aviation between signatory countries – they specify airports allowed to be flown to, they designate airlines, set capacity, frequency and pricing limits. To operate flights between 10 countries, a network of 55 bilateral ASAs is needed – every country has to sign an ASA with each country. Therefore there are several thousand ASAs in today’s world, ranging from highly protectionist to completely liberal. The only fully functional multilateral ASA is the common aviation market of the European Union, including all the 27 member states of the Union.

The most important factor in determining how liberal an ASA is, is market access. Market access is granted in terms of “freedoms of the air”. There are nine freedoms of the air. They are shown in the following table.

Table 1: Freedoms of the Air

<i>Technical freedoms</i>		
1 st freedom	To overfly one country en-route to another country.	B
2 nd freedom	To make a technical stop in another country.	B
<i>Basic commercial freedoms</i>		
3 rd freedom	To carry PCM from the home country to another country.	A-B
4 th freedom	To carry PCM to the home country from another country.	B-A
5 th freedom	To carry PCM from the home country to another country, then continuing to a third country.	A-B-C
<i>Derived freedoms and cabotage</i>		
6 th freedom	To carry PCM between two foreign countries with a stop in the home country.	B-A-C
7 th freedom	To carry PCM between two foreign countries without a stop in the home country.	B-C
8 th freedom	To carry PCM from the home country to another country, then continuing to another airport in the same country.	A-B-B
9 th freedom	Cabotage.	B-B

A – home country, B a C – foreign countries; PCM – passengers, cargo and mail

The first two freedoms of the air – also called “technical freedoms” – are included in all the ASAs and they constitute a right of an airline from the first country to overfly or to make a technical stop in another country. Freedoms three-five are “commercial freedoms”. They include a right to carry passengers from the home country to another country and back, and the right to carry passengers from the home country to another country with a stop in a third country. Freedoms six-eight are combinations of the first five freedoms. The ultimate freedom is called cabotage: it is a right of an air carrier to operate independent domestic flights in a foreign state.

2. The origins of US-EU aviation relations

In the decades following World War II, aviation relations between USA and western European countries were governed by traditional ASAs. The most important of them was the Bermuda I. agreement, signed between USA and United Kingdom in 1946. The agreement included multiple protectionist measures regarding designation of airlines, capacity and pricing limits. As a result of this agreement tariffs valid for international flights were set by the International Air Transport Association (IATA). It also included a list of gateway airports to be used in air transport services between USA and Great Britain, it introduced capacity sharing rules on a 50:50 basis and other protectionist measures. As an agreement between the two aviation superpowers of the era Bermuda I. soon became a template for ASAs everywhere in the world. In the 1970s there were approx. 1600 Bermuda-type agreements.²

An important breakthrough occurred in 1978 when the United States signed the first liberal “Open market” agreement with the Netherlands. This was a direct result of the US presidential election won by a liberal candidate Jimmy Carter. The change of US international aviation policy resulted from three main motives, as identified by Rigas Doganis:³

- **Consumerism** – is a movement aiming to enhance the rights of buyers in dealings with sellers. Carter’s election campaign was based on the promise to strengthen the position of buyers at the markets, which should lead to wider selection of

² BUTTON, K – TAYLOR, S.: International Air Transportation and Economic Development, 2000. P. 211.

³ DOGANIS, R.: Flying off Course, 2007. P. 52.

goods and lower prices. Applied to international air transport this means deregulation leading to more international destinations covered by US airlines and lower flight ticket prices.

- ***Belief in the invisible hand of the market*** – as a liberal, Carter deregulated domestic air transport, financial markets, telecommunications and other sectors of US economy. Seeing that domestic liberalization has positive effects on national economy, he expected liberalization of international economic relations to bring even higher benefits.
- ***Ambition to support US airlines*** – when Carter was elected president, the position of US airlines was poor – their share at the transatlantic market barely reached 40% and in some markets (the Netherlands-US, Scandinavia-US) it lied below 20%.⁴ Therefore, the main goal of Carter’s liberalization efforts was to improve the position of US airlines. Carter’s administration aimed to support the large national carriers whose place of business had been limited to the domestic market. These companies had a huge base of passengers and a potential of vast economies of scale when allowed to compete internationally. This proved to be a right strategy and after deregulation, numerous US airlines (Northwest, Delta, United and others) entered international markets.

The United States followed the program of open market agreements from 1978 to 1991. After the 1978 agreement with the Netherlands it concluded liberal ASAs with Belgium, Germany, Luxembourg and other countries. Open market agreements revoke all capacity and frequency restrictions on transatlantic air transport between signatory countries. They also liberalize price-setting rules – tariffs are no longer set by IATA, but rather by individual airlines on a double-disapproval⁵ or country-of-origin basis. Charter traffic is fully liberalized as well.

Comparing benefits open market agreements bring to signatory countries, we come to a conclusion that there is a small imbalance in terms of market access: whereas US airlines can offer flights to Europe from any airport in the USA, European airlines have access only to specified American airports. Moreover, there is the unlimited designation clause:

⁴ DOGANIS, R.: Flying off Course, 2007. P. 52.

⁵ The tariff set by an airline is examined by the governments of USA and the other country. The tariff is valid unless BOTH governments disapprove.

Technically it is reciprocal. However, taking into account that in the 1970s and 1980s there were only few European countries with more than one long-range airline, the advantages of this clause were almost entirely on the US side. Thus, unlimited designation supported US airlines and led to the situation marked by higher efficiency of US airlines compared to their European counterparts, which lasted until the crisis in 2000.⁶ Another controversial issue is the right of the 5th freedom. Although it is reciprocal, it is of significance for US airlines only. It allows US airlines to operate transatlantic flights to a European country with connecting flights to other countries beyond (e.g. Asian destinations or other European countries). For European airlines this right makes no sense, as there are no destinations beyond USA.

Generally speaking, open market agreements had a positive impact on transatlantic air transport. The number of passengers increased dynamically (for example between 1987 and 1993 it rose by 47%, whereas the growth of domestic US market in the same period was only 6%)⁷ and the prices of flight tickets declined considerably. However, not all the European countries took part in the open market initiative. The United Kingdom, Denmark, Greece and some other countries decided to stay out. Paradoxically studies show that European airlines from countries with liberal ASAs with USA lost their market share in 1984-1990, while airlines from countries with protectionist ASAs gained market share.⁸ This can be explained with unlimited designation enabling fast growth of the second generation of US air carriers. On the other hand, airlines from the most liberal European countries had to invest heavily in research and development and come up with new ideas almost constantly in order to remain competitive with their US counterparts. This led to higher flexibility, better innovation capability and finally to their better market position today. We can mention Air France, Iberia, KLM or Lufthansa as examples, in contrast with bankrupt Alitalia or Olympic Airlines.

⁶ R. Doganis analyzes why European governments allowed unlimited designation to be a part of their ASAs with USA. He comes to a conclusion that the only two US airlines operating transatlantic flights in the 1970s (TWA and Pan American) were weak and completely unaggressive. Therefore European governments didn't see the unlimited designation clause as a threat to their own national carriers. They didn't expect the new generation of US airlines to take use of it and become the most competitive airlines in the world.

DOGANIS, R: *The Airline Business*, 2006. P. 33.

⁷ ROBYN, D. – REITZES, J. – MOSELLE, B.: *Beyond Open Skies...*, 2005. P. 53.

⁸ BUTTON, K.: *Toward Truly Open Skies*, 2002. P. 15.

3. The “Open skies” era

Open market agreements stopped short of full liberalization. They still contained some minor designation and pricing restrictions. Moreover, they didn't include provisions which would enable code-sharing between European and American airlines. Code-sharing was still considered illegal under US law.

In 1992 US government introduced an era of “Open skies” agreements. It was strongly supported by airlines like American, Delta or United who realized previous liberalization through open market agreements was the main factor behind their international success.

In the late 1980s the US domestic market was close to saturation. To ensure further growth US airlines had to focus on international markets. Knowing their competitive advantage in liberal marketplace was higher than advantages of European airlines (thanks to the bigger size of internal market leading to lower unit costs), US air carriers and scientific community executed pressure on US Department of Transportation to accelerate liberalization.

In 1992 the first open skies agreement was signed between USA and the Netherlands. Three years later 7 other EU-member states followed.

The measures included in open skies agreements can be analyzed in four points:⁹

- ***Free market competition*** – no restrictions on number of designated airlines, capacity, frequencies and types of aircraft. Unlimited fifth freedom rights.
- ***Pricing determined by market forces*** – a fare can be disallowed only in specified circumstances and only if both governments concur (double disapproval).
- ***Fair and equal opportunity to compete*** – all carriers of both countries may establish sales offices in the other country and can convert and remit earnings in hard currencies at any time. Airlines are free to provide their own ground handling services. User charges cannot be discriminatory.
- ***Optional seventh-freedom all-cargo rights*** – provide authority for an airline of one country to operate all cargo-services between the other country and a third country, through flights that are not linked to its homeland.¹⁰

⁹ MICCO, A. – SEREBRISKY, T.: Competition regimes and air transport costs..., 2006. P. 29.

The following table compares typical open market and open skies agreements.

Table 2: “Open market” and “Open skies” agreements

	OPEN MARKET (1978-1991)	OPEN SKIES (1992-2008)
<i>Market access</i>	Multiple designation <i>US airlines:</i> from any point in the US to specified pts. in foreign countries <i>EU airlines:</i> access limited to a number of US points	Multiple designation Unlimited
<i>Freedoms of the air</i>	Extensive 5 th freedom rights	Unlimited 5 th freedom rights Optional cargo 7 th freedom rights
<i>Capacity</i>	No frequency or capacity controls Break of gauge permitted in some agreements	No frequency or capacity controls Break-of-gauge rights granted
<i>Tariffs</i>	Double disapproval or country of origin rules	Free pricing
<i>Code-sharing</i>	Not part of bilateral	Permitted

Source: BUTTON, K. – DREXLER, J.: *The Implications on Economic Performance in Europe of Further Liberalization...*, 2006. P. 50.

Probably the most important issue dealt with in open skies agreements is code-sharing. American antitrust laws have traditionally classified code-sharing as an inadmissible anti-competitive practice. However, airlines from countries with a valid open skies agreement with USA may receive an exception. For many countries this was the crucial argument when considering joining the open skies wave. A good example might be found in Germany. German national carrier – Lufthansa wanted to code-share with United Airlines. In order to receive antitrust immunity, Lufthansa exercised strong pressure on German government that finally led to conclusion of open skies agreement in 1996. Other examples of successfully granted antitrust immunity include KLM-Northwest and SAS-United. On the other hand, airlines from countries unwilling to enter into open skies arrangement with USA did not receive immunity (e.g. the proposed British Airways-American Airlines alliance).

Numerous studies have been conducted, analyzing impacts of open skies agreements on North Atlantic aviation. The US Government Accountability Office observes a rise in the number of transatlantic passengers from 28 Mio. in 1990 to 51 Mio. in 2000 and attributes a large part of the increase to liberalization.¹¹ The Brattle report, elaborated on

¹⁰ A model text of open skies agreements can be found at <http://www.state.gov/e/eeb/rls/othr/ata/114866.htm>.

¹¹ US Government Accountability Office: *Transatlantic Aviation...*, 2004. P. 11.

behalf of the European Commission, quantifies this impact at 10%.¹² The main reason behind the increase was a birth of alliances enabled by easy access to antitrust immunity.¹³ US Department of Transportation conducted a study comparing trends in transatlantic flight ticket prices at liberalized markets with trends at more protectionist markets. It comes to a conclusion that between 1996 and 1999 the decrease in flight ticket prices reached 20.1% at open skies markets while it was only 10.3% at markets governed by more restrictive ASAs.¹⁴ Micco and Serebrinsky study impacts of open skies agreements on air transport costs and on international trade. According to their estimates air transport costs fell 9% in the first three years when open skies agreements were in effect, providing thus for a 7% increase in share of air transport at total cargo transportation.¹⁵

Opponents of open skies agreements included chiefly weak, inefficient, predominantly government-owned airlines. These were afraid of not being able to compete with US airlines under the rules of free market. As a result of the opposition of their national airlines some EU-members decided to reject open skies offers and retain status quo in their aviation relations with USA.

As demonstrated in the following table, out of 27 member states of the Union 11 didn't adopt an open skies agreement with USA by 2007, among them some of the most important aviation markets in Europe – Spain and United Kingdom.

Table 3: Extent of Open skies coverage in 2007

COVERED	NOT COVERED
Austria, Belgium, Czech Republic, Denmark, Finland, France, Germany, Italy, Luxembourg, Malta, Netherlands, Poland, Portugal, Romania, Slovakia, Sweden	Bulgaria, Cyprus, Estonia, Greece, Hungary, Ireland, Latvia, Lithuania, Slovenia, Spain, United Kingdom
<i>TOTAL: 16</i>	<i>TOTAL: 11</i>

Source: ALFORD, E. – CHAMPLEY, R.: *The Impact of the 2007 U.S.-EU Open Skies Air Transport Agreement*, 2007. P. 2.

Probably the biggest setback was unwillingness of the UK to participate in open skies initiative. The US-UK market is by far the most important transatlantic air transport market and London-Heathrow is the busiest airport in the world by international

¹² Brattle Group: *The Economic Impact of an EU-US Open Aviation Area*, 2002. P. vi.

¹³ STOBER, A.: *Who Soars in Open Skies?*, 2003. P. 125.

¹⁴ US Department of Transportation: *Transatlantic Deregulation – the Alliance Network Effect*, 2000. P. 3.

¹⁵ MICCO, A. – SEREBRISKY, T.: *Competition regimes and air transport costs...*, 2006. P. 27.

passenger traffic. Since 1977 Anglo-American aviation relations were regulated by a restrictive ASA called Bermuda II. The agreement limited access to transatlantic traffic at Heathrow and Gatwick airports only to 4 airlines – 2 from each side of the Atlantic – British Airways, Virgin Atlantic, American Airlines and United Airlines. Furthermore, it contained a list of so-called gateway airports – the only American airports open for transatlantic service to Britain. Other measures included strict capacity and pricing limits and elimination of the 5th freedom rights for US airlines.

As Bermuda II. agreement was in direct contradiction with interests of US airlines, the US government made numerous attempts to renegotiate the conditions; however, only some partial changes were achieved. Thus, Anglo-American air transport market remained governed by highly restrictive rules until 2008, when a general US-EU Open Skies Agreement entered into force.

We believe that although open skies agreements were advantageous for countries on both sides of the Atlantic, from a long-term perspective it was a smart strategy of US policy-makers aiming to improve the position of US air carriers on transatlantic market. Some analysts call this strategy “divide and conquer.”¹⁶ The practice of negotiating separate agreements with EU-countries led to fragmentation of internal aviation market of the EU on the basis of nationality clauses. We can demonstrate this on the following example: in 1995 USA signed open skies agreements with Finland, Austria and Belgium. Each of these agreements was a bilateral, granting traffic rights only to airlines of the two respective signatory countries. US airlines received a right to offer flights to any of the aforementioned countries. However, Finnair could only offer flights between USA and Finland, Austrian between USA and Austria and Sabena between USA and Belgium. European airlines didn’t receive rights of the 7th freedom that would allow them to operate services between USA and a European country other than their home country. This led to fragmentation of the European internal aviation market.

Another problem (exactly as with open market agreements) was granting of the 5th freedom rights to US airlines. According to our opinion, the best description of the situation was offered by a director of the DHL cargo company, R. Steisel: “The economic reality is that fifth freedom rights in Europe are more equivalent to giving US airlines

¹⁶ ZHANG, A. – ZHANG, Y.: Issues on liberalization of air cargo services..., 2002. P. 279.

cabotage rights, not just fifth freedom rights. For instance, FedEx, a US cargo carrier, can transport its shipments from Charles de Gaulle airport in France to Frankfurt on the route between the US-Charles de Gaulle-Frankfurt, whereas DHL or TNT as European carriers, could not transport cargo from New York to Los Angeles on the route Brussels/Liege-New York-Los Angeles. This enables FedEx to organize its European distribution system from its European hub of Charles de Gaulle, whereas DHL and TNT are forced to subcontract their US airlines operations to a US carrier”.¹⁷

The European Commission was well aware of the situation. Understanding the threat separate open skies agreements might constitute for internal market, it asked the Council for a right to negotiate a general EU-US bilateral open skies agreement. After all the requests were rejected (in 1990, 1992 and 1995), the Commission appealed to the European Court of Justice in 1998.

4. The 2002 European Court of Justice judgments

The Commission took legal action against seven EU members that had signed an open skies agreement with USA. There were two main arguments supporting the position of the EC:

- the EC has exclusive rights to negotiate international air service agreements on behalf of the EU, because separate approach by member states would harm the competition;
- nationality clauses contained in the open skies treaties violate the Community law, especially the right of establishment contained in art. 43 of the Treaty establishing the European Community¹⁸.

On the same grounds the EC also took legal action against the UK and its restrictive Bermuda II. agreement.

In November 2002 the European Court of Justice decided that by entering into open skies relations with USA “the Kingdom of Belgium [and the other states as well] has failed to fulfill its obligations under Article 5 of the EC Treaty (now Article 10 EC) and Article 52

¹⁷ BUCHAN, D.: Open Skies and Deregulation – The Coming Revolution, 2003. P. 5.

¹⁸ Art. 43: “...restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State shall be prohibited. Such prohibition shall also apply to restrictions on the setting-up of agencies, branches or subsidiaries by nationals of any Member State established in the territory of any Member State.”

of the EC Treaty (now, after amendment, Article 43 EC).¹⁹ Thus, the ECJ ruled that nationality clauses violated Community law. On the other hand, the ECJ played down the argument of the EC that it is the only entity entitled to negotiate air service agreements.

The judgment of the ECJ was widely considered to be dichotomical – it contained two different aspects, each of them in favor of a different party. First, it confirmed that nationality clauses were illegal. This could possibly have wide implications on hundreds of ASAs signed by the member states, as almost all of them contained a nationality clause. However, the Court didn't authorize the Commission to renegotiate these ASAs. The dichotomy caused legislative uncertainty and in the weeks following the judgment it was almost impossible to predict any future steps.

Seven months later, in June 2003 the Council authorized Commission to start negotiations with USA, with the aim to establish a transatlantic common aviation area. The most important milestones of these negotiations can be seen in the following table.

Table 4: Countdown to Open skies

DATE	ACTION
2002, 5 th November	ECJ Open skies judgments.
2003, 5 th June	Commission agrees authorization to open skies negotiations.
2003, 1 st October	Negotiations begin.
2004, 11 th June	The Council rejects the first draft of the agreement.
2007, 2 nd March	Draft agreement initialed in Brussels.
2007, 22 nd March	Agreement approved unanimously by the 27 EU transport ministers.
2007, 30 th April	Agreement signed at EU-US summit in Washington D.C.
2008, 30 th March	Agreement enters into force.

Source: Oxera: *Slots Trading under Open Skies, 2007 and multiple other sources.*

The first draft agreement, submitted in October 2004, was rejected by the Council on the grounds of falling behind expectations and being too disadvantageous for European airlines. After eleven rounds of negotiations the agreement was finally signed on April 30th 2007 in Washington D.C. It entered into force on March 30th 2008.

5. US-EU Open Skies Agreement

The US-EU Open Skies Agreement, in force since March 30th 2008 includes the following most important measures:²⁰

¹⁹ Judgement of the Court 61988J0471 of 5th November 2002, case C-471/98.

²⁰ See HASAN, M.: *Transatlantic Open Aviation Area...*, 2008. P. 2.

- all the US and EU airlines can operate flights between any point in the EU and any point in USA;
- US accepts the Community air carrier concept i.e. airlines owned by nationals of any EU member state have the same rights and obligations;
- no capacity or frequency limits on transatlantic flights;
- free pricing;
- unlimited code-sharing for both sides;
- alliances between US and EU airlines qualify for antitrust immunity.

Even a brief look at the provisions of the Treaty would allow us to claim it forms a huge step on the way toward full liberalization of the North Atlantic air transport market. However, there are some measures which make the Treaty more advantageous for USA than for the EU. One of the most important problems – as we have already mentioned in section 3 – is the 5th freedom issue. Although technically it is reciprocal, it is of no use for European carriers. Whereas US airlines can operate 5th freedom services between two European countries, European carriers have no access to US internal market. What is more, European negotiators didn't succeed in their attempts to abolish Fly America program.²¹ In contrast to these setbacks for Europe, American negotiators achieved their primary objective – unrestricted access to Heathrow airport.

Currently, negotiations on the second stage of open skies agreement are in progress. The main goals include unlimited access to US internal market and suspension of airline ownership barriers. Taking into account current global economic crisis and negative signals from the Obama administration, full liberalization of transatlantic aviation market remains utopia.

Conclusion

We believe the US-EU Open Skies Agreement can become a template for multilateral ASAs in other regions of the world. Similar projects can come into existence in South-East Asia or Latin America. Another possibility is enlarging the US-EU agreement to include further countries, for example Canada. However, we do not expect global liberalization of air transport to come forward. Economic and national security interests

²¹ Under Fly America Act only US airlines are eligible to carry government-funded traffic.

of individual countries are stronger than a vision of collective benefits. It is one of the reasons the General Agreement on Trade in Services (GATS) specifically excludes air transport from liberalization. Moreover, the GATS itself is highly controversial and has a wide range of opponents.²² Global economic crisis is another factor that hinders liberalization efforts. Therefore, it should be of no surprise when we claim that the implicitly set goal of the European Commission to liberalize global air transport will not be fulfilled within the next decade.

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²² LIPKOVÁ, Ľ. et al: *Medzinárodné hospodárske vzťahy*, 2006. P. 364.

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