“US-EU Air Transport: Open Skies But Still Not Open Transatlantic Air Services.”

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ABSTRACT

The aim of this thesis is to fully present a current air transport regime between the United States and the members of the European Union, with the 2007 US/EU Open Skies Agreement as its most recent representation, and to analyze the impediments to the creation of a truly open transatlantic aviation area.

Deregulation of the domestic air transport in the United States and the subsequent U.S. policy of exporting deregulation via open skies bilateral agreements are compared and contrasted with the multilateral liberalization process in the European Union. That process resulted in the elimination of nationality requirements for ownership and of cabotage restrictions for Community carriers, allowing for their unrestricted access in the single European market.

The link to the consolidation in the airline industry is drawn through a consideration of U.S. antitrust regulation and E.U competition law, both of which provide a framework for acceptable airline business practices. The example of antitrust immunity grants for global alliances illustrates the basic principles of antitrust laws and their practical application to current developments in the international airline business.

The analysis leads to the conclusion that obstacles to cross-border airline mergers are not only related to their anticompetitive implications, but most importantly, are linked to the inherent restrictions in the international legal regime. In particular, controversial issues of foreign ownership and cabotage restrictions pose challenges to second stage negotiations between the U.S. and the EU in the quest for a fully open transatlantic aviation area.
Résumé

Le travail propose de démontrer l'évolution des régimes de transport aérien intérieur et international et l'examen du régime légal couvrant actuellement la zone trans-atlantique, avec une attention particulière pour l’accord « open skies » Etats-Unis – Union Européenne de 2007, celui-ci étant la représentation la plus récente de cette évolution.

Nous comparerons et mettrons en contraste la déréglementation du transport aérien intérieur des États-Unis et la politique américaine consistant à exporter cette déréglementation via des accords bilatéraux « open skies » avec le processus multilatéral de libéralisation de l’Union Européenne. Ce dernier a donné lieu à l’élimination de la nationalité comme critères de propriété et des restrictions sur le « cabotage ». De plus, ce modèle a donné l’accès total et non-restreint aux transporteurs de l’UE à travers le marché intérieur de l’Union.

Le lien avec la consolidation se fera par le biais d’un examen de la réglementation américaine « anti-trust » et des lois européennes sur la concurrence qui fournissent un cadre pour la pratique commerciale du transport aérien. Nous présenterons les principes de base des lois « anti-trust », leur application pratique et leurs développements actuels dans des domaines tels que les octrois (« grants ») d’immunité anti-trust aux alliances globales.

Nous démontrerons que les obstacles aux fusions internationales des compagnies aériennes ne sont pas seulement reliés à leurs implications anticoncurrentielles, mais sont avant tout liés aux restrictions propres au régime juridique international. Plus particulièrement, nous examinerons les questions controversées de la propriété étrangère et des restrictions de « cabotage » présentés comme des défis aux négociations de deuxième étape entre les États-Unis et l’Union Européenne et la création potentielle d’une zone d’aviation trans-atlantique entièrement ouverte.
INTRODUCTION.

A comprehensive first-stage U.S.-EU Air Transport Agreement signed April 30, 2007 1 ("2007 US/EU Agreement" or "Agreement"), became effective on March 30, 2008, thus establishing Open Skies between the U.S. and all 27 EU member states—two largest air transport markets in the world, together accounting for more than half of all global scheduled passenger traffic and 71.7 percent of the world's freighter fleet. 2 Under the Agreement, for the first time in the history of modern aviation, any U.S. or E.U. airline may fly between any city in the United States and any city in the European Union without restrictions on routes, the number of flights, or prices charged. 3 The Agreement, albeit historic, does not dismantle all the restrictions and regulations governing the transatlantic provision of commercial air services. Creation of a transatlantic aviation area that is barrier-free and open to competition is fraught with complex challenges.

This paper consists of three separate yet interrelated parts, which reflect the relationship between: (i) domestic removal of restrictions in the areas of market access, pricing and capacity (termed “deregulation” in the US or “liberalization” in the EU); (ii) evolution of international air transport regime, as represented by the liberalization of international Air Transports Agreements; and (iii) domestic and international antitrust (or competition) laws, affecting the competitors' behavior in the aviation sector. The relationships between the three parts will be demonstrated, as well as their role in the

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creation of a truly open transatlantic aviation regime.

There are other areas that are vital to the success of the globalized, open aviation regime, including air navigation and traffic management, airport infrastructure, safety and security standards and environmental protection (particularly in the area of fuel emissions). While the need for greater harmonization in these areas is noted herein, their detailed examination in relation to the transatlantic cooperation is a worthy topic for separate research.

Looking at the 2007 US/EU Agreement, it is obvious that it has tremendous potential for transforming air travel and trade across the Atlantic. Still, its scope is limited and its full extent and viability depends on the outcome of the second-stage negotiations between the parties that began on 15 May 2008. Critical to the success of these negotiations is a full understanding of the obstacles that still need to be overcome, including the most contentious provisions of the 2007 US/EU Agreement, to wit the prohibition against cabotage and limitations on foreign ownership and control rights. One of the objectives of this thesis is to demonstrate that these restrictions on commercial aviation are rooted in the international regime, but are mainly motivated by national policies of economic protectionism. Accordingly, removal of these barriers to free competition requires innovative approaches on both domestic and international levels.

PART 1 of this thesis will compare and contrast the processes of deregulation of the domestic air transport regime in the United States and air transport liberalization in the European Union. This examination of the deregulatory movements on both ends of the Atlantic, from their genesis to current policy objectives, shall help account for the role
of the protectionist impediments to the opening up of the international aviation regime, which will be discussed in PART 2.

The focal point of PART 2 is a detailed analysis of the very recent 2007 US/EU Agreement, in the wider context of the evolution of international Air Transport Agreements (ATA's), which may be contracted by states on a bilateral or multilateral basis. The section-by-section overview of the Agreement will illustrate both the progress in the removal of the regulatory restrictions, as well as the vestiges of the old system that are still perceived to hamper a truly open transatlantic aviation area. The controversial issues of opening up of the U.S. airlines to foreign investment and the lessening of cabotage restrictions will be extensively analyzed, with domestic and geopolitical considerations of both the United States and the European Union. Possible alternatives and proposals for reaching consensus will be presented and compared, including the solutions included in the most recent 2008 Air Transport Agreement between Canada and the European Union.

The final PART 3 of the thesis will complement the foregoing analysis with the economic and market perspectives. The aim of this part is to demonstrate the influence of the previously described, remaining regulatory restrictions, on the ownership structure of the carriers in the transatlantic market and on the very nature of competition therein. First, economic justifications for consolidation in the aviation sector will be analyzed, and regulatory differences between airline alliances and mergers will be examined. The persisting legal obstacles to trans-border mergers and acquisitions of the airlines will be shown to be primarily caused by the same foreign ownership restrictions that were fully
presented in the previous parts of this work. Subsequently, different forms of cooperative practices between the airlines will be described, from purely marketing arrangements to strategic and international alliances, reflecting a global trend of increased cooperation. Moreover, evaluation of the benefits and drawbacks of such alliances will be presented in light of their potential anticompetitive features.

Indeed, where competitors engage in anticompetitive behavior, antitrust, or competition laws intervene to safeguard fair and free competition in the deregulated markets. This final section of the thesis will consider how US antitrust regulations and EU competition laws have been applied to global airline alliances, including the grants of antitrust immunity. Airlines in the transatlantic market are also subject to additional sets of regulations and varying competition law regimes because of the application of extraterritoriality principles, which will also be considered in this part.

The thesis will conclude on a note of cautious optimism regarding the potential for true open skies in the transatlantic area given the already achieved, unprecedented level of liberalization of the international air services.

PART 1: DEREGULATION AND LIBERALIZATION OF AIR TRANSPORT REGIMES IN THE UNITED STATES AND THE EUROPEAN UNION.

Before turning to the international dimension of the legal regime governing the provision of commercial air services between the United States and the European Union, this thesis will first examine the deregulatory reforms that were undertaken in both jurisdictions. The United States was the first country in the world to deregulate its domestic air transportation by removing all economic controls over the airlines' entry and
operation in the market. Accordingly, the genesis of the deregulation movement and its contemporary repercussions shall be examined, with a view to identifying the roots of the protectionist policies that are still perceived to hamper opening up of the U.S. skies to international competition. Across the Atlantic, the Member States of the European Union adopted a different approach – that of gradual, but multilateral liberalization of air transport to create a single European market. The differences in both approaches will help explain the consequent drive by the European Union to eliminate all the nationalistic restrictions in the transatlantic aviation area.

I. EVOLUTION OF U.S. AIR TRANSPORTATION REGIME: REGULATION, DEREGULATION AND THE PRESENT.

1. 1938-1978 Era of Governmental Regulation.

In 1938 the U.S. Congress first regulated the airline industry by enacting the Civil Aeronautics Act of 1938 ("CAA of 1938"), which established a system of economic regulation under the auspices of the Civil Aeronautics Board ("CAB"). The later successor statute, the Federal Aviation Act of 1958 ("FAA of 1958") incorporated essentially the same economic provisions of CAA 1938, but greatly expanded federal power in the area of air safety oversight under the auspices of the Federal Aviation Agency ("FAA").

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5 Civil Aeronautics Act, Pub. L. No. 75-706, 52 Stat. 973 (1938) [CAA of 1938]

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The CAB was set up as an independent regulatory agency, which was empowered to promote the development and economic viability of the fledgling industry and to protect it from “excessive and unrestrained” competition. This was achieved through the CAB’s regulation of the major aspects of airline operations, including rates, routes and entry into the market, as well as antitrust and business practices. All the major (“trunk”) scheduled passenger service carriers were 'grandfathered' in their existing markets upon CAB’s formation in 1938 and any new applicants for certification were required to prove that a new entry was in the public interest and that additional competition would not harm the incumbent airlines. In this way, through its power to grant certificates of “public convenience and necessity” the CAB effectively restricted market access as it “prevented even a single major trunk carrier from entering the industry during the 40 years of its ironhanded rule.” As Dempsey observed, “the excessively rigid scheme established by the Civil Aeronautics Board...allowed the creation of an effective oligopoly.”

Rate regulation was another key component of the CAB’s regulation, which was ensured by requiring all proposed fares to be reviewed and pre-approved in order to

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9 Hardaway, Ibid. at 7, Dempsey& Gesell, “Air Commerce” Ibid. at 136.


ensure adequate profits for the airlines.\textsuperscript{13} It has been alleged that the regulation failed even in this respect, because if airlines made any profits it was due to the increased aircraft efficiency resulting from the development of the jet engine and improved technology, and not the result of the CAB's economic policies.\textsuperscript{14}

In addition, the CAB controlled competition between the airlines by issuing decisions on any proposed mergers and acquisitions, and many essentially anticompetitive inter-carrier agreements, such as for pooling of service or equipment, or relating to fares.\textsuperscript{15} This approval was conditional upon a finding that the transaction was not 'inconsistent with public interest,' and subject to the proviso that it would not result in a monopoly.\textsuperscript{16} Under the FAA of 1958 the competition was allowed “to the extent necessary to assure sound development of air transportation” and a 'public interest' test was still used to determine approval.\textsuperscript{17} Furthermore, the CAB had additional powers over determination of such issues as governmental subsidies, consumer protection and, initially, the establishment and maintenance of airports and airway navigational aids.\textsuperscript{18} Although this thesis focuses on the economic aspects of aviation regulation, it should be noted FAA's operational and safety functions have not been deregulated.\textsuperscript{19}

While some authors believe that “[u]nder economic regulation America enjoyed the world's finest system of air transport, one envied by every other nation,”\textsuperscript{20} yet by the
early 1970s the airline industry was in acute crises and the critics were mounting. Free market economists, who for years had been attacking economic regulation, increasingly blamed the governmental intervention for excessive capacity, unwarranted costs and inadequate profitability of the airline industry and called for a new order based on Adam Smith's *laissez-faire* ideology.\(^{21}\)

2. **1978 Deregulation of U.S. Domestic Airline Industry.**

According to Dempsey and Gesell, deregulation was an inevitable consequence of the increased governmental involvement as “[t]he pendulum of public policy, having been pulled so sharply toward the regulatory end of the spectrum, would soon come roaring back in the other direction.”\(^{22}\)

In Congress, hearings conducted by Senator Edward Kennedy's Judiciary Subcommittee in early 1975 seem to have pushed airline regulation onto the national agenda by dramatic revelations that regulated air fares were 40 to 60 percent higher than they would be without governmental intervention and thus cost consumers up to $3.5 billion in excess fares.\(^{23}\)

Within six weeks of his inauguration, President Carter avowed his support for increased airline competition and appointed Cornell University economist and a vigorous deregulation advocate, Alfred Kahn as Chair of the CAB, who criticized the traditional CAB regulation as having:

> “(a) caused air fares to be considerably higher than they otherwise would be; (b) resulted in a serious misallocation of resources; (c)encouraged carrier inefficiency; (d) denied consumers the range of price/service options they would prefer, and; (e) created a

\(^{21}\) *Ibid.* at 35-36, 184-86.

\(^{22}\) *Ibid.*

\(^{23}\) Bornestein & Rose, *supra* note 6 at 11, Hardaway, *supra* note 8 at 4
chronic tendency toward excess capacity in the industry.”

With favorable political forces united around the deregulation agenda, three pieces of legislation quickly followed, amending the FAA of 1958 and largely abolishing economic regulation of the airline industry, specifically the *Air Cargo Deregulation Act of 1977* (termed in Washington as the “Federal Express Act” both for its speed and identity of its principal sponsor), the *Airline Deregulation Act of 1978* [ADA of 1978] and the *International Air Transportation Competition Act of 1979.*

ADA of 1978 is most relevant to the analysis conducted herein, as it implemented deregulation of the U.S. airlines through removal of governmental controls over the market entry, capacity and frequency, as well as removal of price and tariffs control and finally the complete and unprecedented dismantling of CAB, the entire economic regulatory body, in 1984.

Deregulation and dismantling of CAB did not, however, eliminate all government oversight over the airlines, which, to this day, continue to be regulated in a number of ways with regards to safety, licensing and antitrust. Certification of new entrants, award of additional authority and of international routes (the latter subject to presidential approval) was transferred to the Department of Transportation (“DOT”), which was also

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26 Dempsey & Gesell, “Air Commerce” *supra* note 8 at 191.
29 Frequency refers to the number of flights during a specific time period (usually one week) over a specific route.
30 Dempsey & Gesell, “Air Commerce” *supra* note 8 at 191-92.
initially responsible for merger oversight (transferred to the Department of Justice [“DOJ”] in 1989). Safety regulation is mandated by international standards, promulgated by the International Civil Aviation Organization (“ICAO”), such as, *inter alia*, Annex 6 to the *Chicago Convention of 1944*, compelling every airline to obtain air operator certificate (“AOC”), which in the United States is issued by FAA. In addition, all domestic airlines must apply to DOT for a license, a remnant of market access regulation, in a form of *'certificate of public convenience and necessity,'* requiring a determination that the airline is 'fit, willing and able' to perform such transportation and that it is 'law-obedient.' Equivalent of such license is also required for foreign carriers, engaged in international service to the United States.

Moreover, U.S. airlines are controlled through antitrust laws, prohibiting collusion between competitors (e.g. price fixing), monopolization through mergers, or other anticompetitive practices, and are further restricted by *substantial ownership and control* requirements, limiting the foreign ownership to 49% of equity and 25% of voting shares.


The optimistic forecasts of deregulation architects seemed to be confirmed by substantial fare reductions and eleven newly formed airlines that had entered the U.S. market within first three years of deregulation. Economic literature abounds in studies

33 *Convention on International Civil Aviation*, 7 December 1944, 15 U.N.T.S. 102 [*Chicago Convention*]
36 Foreign ownership restrictions are discussed in detail in Part 2, section III.1.5 & antitrust laws are discussed in Part 3, section II below.
praising economic regulation and claiming that it allowed airlines more flexibility in their business management and cost structures (for example through development of yield management), created efficiency-driven hub-and-spoke networks, and facilitated the emergence of a new breed of low-cost low-fare airlines. Pels argues that since deregulation average fares have been declining in real terms and passengers seem to be better off by the airlines' adoption of the hub-and-spoke system.38

However, other commentators point out that the consumer price savings under deregulation have been overstated since pro-deregulation literature fails to mention the pre-deregulation trend of declining fares.39 According to Dempsey, except for the sharp fare declines in a period between 1976 to 79, fuel- and inflation-adjusted fares fell at a 30% faster rate in the decade preceding deregulation than in the decade subsequent to it.40 In addition, airline profit margins, which averaged 2.8% before deregulation fell to a – 0.6% under deregulation and “airlines in general have sustained unprecedented financial losses, with the market cycles hitting deeper troughs more frequently.”41

In a deregulated market frequent bankruptcies, as well as mergers and acquisitions, contributed to the demise of many incumbent as well as newly formed airlines.42 Furthermore, crises of rising fuel costs, hyper-inflation, business recessions, terrorism and wars all played their part in massive losses of the airline industry in

42 Larsen et al, supra note 10 at 27.
In this context it is not surprising that, for some observers, the era of the CAB’s regulation now seems to have been the golden age of airline prosperity.  

4. Re-regulation or other proposals for change?

The critics of U.S. deregulation indicate that it was based on three economic assumptions about the airline market – inconsequential barriers to entry, insignificant economies of scale and market contestability – all of which have since been repudiated, even by their authors.  

Contrary to what the proponents of deregulation had assured, in post-deregulation reality the new entrants have faced enormous sunk costs, significant economies of scale inherent in airline operation, and incumbent carriers with market dominance often engaging in predatory pricing to drive off the new entrants.

Even the proclaimed father of deregulation, Alfred Kahn, admitted, 

“there is no denying that the profit record of the industry since 1978 has been dismal, that deregulation bears substantial responsibility, and that the proponents of deregulation did not anticipate such financial distress-either so intense or so long-continued.”  

Authors who believe that a lot of the present economic problems of the airlines stem from the systemic failures of the deregulation, propose some form of re-regulation, arguing that 

“[a]though government management of the economic marketplace is not the 

43 Ibid.  
44 Larsen et al, ibid. at 27, see also Dempsey & Gesell “Air Commerce” supra note 8 at 162 (under economic regulation America enjoyed the world's finest system of air transport, one envied by every other nation... service and safety were improving... prices were falling”).  
45 Dempsey & Gesell, “Air Commerce” Ibid. at 194.  
46 Ibid. at 312-320 (Sunk costs involve start-up costs in equipment, labor, operational, marketing, and airport constraints/ landing slots, training and safety programs, establishment of procedures, aircraft certification, etc.)  
ideal, it offers the chance to do what the Airline Deregulation Act could not – balance the marketplace forces where 'the value of work resolves itself in fair wages for the worker, at the same time provides reasonable profits for the capitalist, and the consumer pays, perhaps not a 'natural' but certainly not an inflated price for commodities.'

Similar sentiment was recently expressed by Robert L. Crandall, retired chairman and CEO of American Airlines, who commented on the poor results of three decades of deregulation, claiming that that “[a]irlines have special characteristics incompatible with a completely unregulated environment.” Crandall argues that market forces alone will not create sufficient conditions for the survival of the airlines. Similarly, he does not perceive industry consolidation as the ultimate solution, because “mergers will not lower fuel prices.” What Crandall proposes is more governmental involvement in such areas as price regulation, slot controls at congested airports, revised labor laws, amended bankruptcy status and a more accommodating stance toward industry collaboration. Crandall also advocates a need for a more comprehensive, well articulated national transportation plan aimed at:

• “encouraging the creation of more cost effective and energy sensitive transportation network,
• assuring safety, and courteous and on time service for consumers, and
• improving the financial performance and international competitiveness of America's airlines”.

Crandall claims that implementation of such objectives would require a major shift in the U.S. aviation policy that, for many years, has been concentrating on securing lower fares for consumers without regard to industry's overall viability.

48 Dempsey & Gesell “Airline Management” supra note 41 at 961.
50 Ibid.
51 Ibid.
According to Michael Levine, one of principal architects of deregulation, calls for re-regulation are misguided. Levine strongly rejects such calls, arguing that the industry “will need the kind of innovation and flexibility that government regulation would impede” in order to survive the economic downturns, as exemplified by fuel costs crises.\textsuperscript{52} He further argues that:

“re-regulation will get us the worst of both worlds... it will not be able to [lower fuel prices and stop the industry downturn] even if it slows it for a while. And trying to do so will simply postpone the inevitable adjustment and is a prescription for waste... from inefficient wealth transfers to politically powerful interests at the expense of the traveling public and the economy as a whole.” \textsuperscript{53}

In his earlier work, "Why Weren't the Airlines Reregulated?",\textsuperscript{54} Levine pointed out that lower fares and increased services that the industry has provided since deregulation, combined with the general lack of consensus and competing interests, have effectively neutralized the political will to see re-regulation made a reality.

On the other end of the spectrum of the debate are those experts who believe that the reforms undertaken by deregulation were not sufficient and that the U.S. airline industry should be even further liberalized. According to Hardaway, the continued oligopolization of airport resources serves as an example of insufficient deregulation, whereby restricting access to airport gates and slots effectively prevents new carriers from entering the market.\textsuperscript{55} Hardaway not only advocates reforming the airport resources as furthering the goals of deregulation. More importantly, he argues that opening up of the domestic market to foreign competition by adoption of cabotage\textsuperscript{56} would “lower fares,  

\textsuperscript{53} Ibid.  
\textsuperscript{54} Michael Levine "Why Weren't the Airlines Reregulated?" (2005) 23 Yale L.J.1 269  
\textsuperscript{55} Hardaway, supra note 8 at 5.  
\textsuperscript{56}\textit{Cabotage} is domestic or international service that lies entirely outside a carrier's home country. For full
increase productivity as well as the GNP of countries participating in cabotage agreements, foster competition, and achieve the goals set forth in the ADA.” 57 Similar argument has been advanced by McBay with respect to lessening of legislative restrictions on foreign investment in the U.S. airlines, currently limiting foreign ownership to 25 percent and severely restricting the right of control of any foreign investor. 58

II. LIBERALIZATION OF AIR TRANSPORTATION REGIME IN THE EUROPEAN UNION

1. Introduction/History.

While initiated by the U.S., reformation of air transportation is not an exclusively American phenomenon. The deregulatory movement in the United States, while unprecedented and sweeping in its consequences for the U.S. airlines, was initially conducted in the domestic market only and did not directly affect the international air transport regime. 59 On the other hand, liberalization of the air transport in Europe constituted an integral part of the wider, political process of the European integration. 60 The avowed goal and consequence of the European liberalization was “the removal of the restrictive system of air services bilaterals in the EU aviation market, which has arisen out of the 1947 Chicago Convention on International Civil Aviation.” 61

The European Union (alternatively referred to as 'EU' or 'European Community')

57 Hardaway, supra note 8 at 6.
or 'EC') is a unique economic and political partnership that started in 1957, when six countries (France, Netherlands, Belgium, Luxemburg, Italy and Germany) signed the Treaty of Rome thus laying foundations for a “Common Market,” based on four basic freedoms of movement – for goods, services, workers and capital. 62 The Common Market grew to twelve nations by 1986,63 was transformed into the European Union with the passage of the Maastricht Treaty in 1992, and expanded to 27 member states covering a large portion of the European continent. 64

2. Liberalization of European Air Transport: Three Packages.

In an attempt to achieve a single market for air transport, the European Union introduced legislative measures, so called 'packages' that liberalized its air transport sector in three stages, between 1987 and 1993.65

2.1 First Package (1987).

The first package, adopted in December 1987, introduced a more liberal regime on pricing, capacity and market access.66 Pricing was still regulated through introduction of two fare-zones, allowing carriers to charge discount fares (extending from 65 percent to 90 percent of referenced fare) and deep-discount fares (from 45 percent to 65 percent

65 Sanchez, supra note 61.
66 Ibid. Also see Doganis, “Air. Bus.”, supra note 60 at 38.
Although many rigid conditions were attached to these fares (e.g., advanced purchase requirement, minimum and maximum lengths of stay and age restrictions), within these zone carriers could set their prices freely without governmental restrictions. Capacity regulation was relaxed as equal sharing of capacity was abandoned in favor of an immediate 55-45 percent rule (from January 1, 1988 to September 30, 1989) and then a 60-40 percent split (after October 1, 1989).

Furthermore, the first package explicitly acknowledged that EC competition laws, set forth in the Treaty of Rome, did apply to air transport, reinforcing the European Court of Justice's (“ECJ”) earlier judgments. In the 1987 landmark ruling in *Nouvelles Frontieres*, the ECJ affirmed and extended its previous *French seamen* decision, by holding that (1) competition rules of the EC Treaty are applicable to air transport as fundamental provisions even before any specific air transport rules, (2) in absence of exemption under article 85.3 (now 81.3), coordination of tariffs at airline conferences is incompatible with article 85.1 (now 81.1) of the EC Treaty, and (3) since such exemption had not been granted French art. 330, and by extension entire regulatory system of

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73 Commission v. France,[French Seamen] C-167/73 [1974] E.C.R. I-359 (holding that general provisions of the EC Treaty did apply to maritime and air transport even before any specific transport policy was made as they were fundamental principles).

74 *Ibid.* at 36-45
approval of air fares, was incompatible with the EC Treaty. This holding was confirmed by the ECJ in *Belgium Travel Agents*, where it held that selling discounted tickets could not constitute an offense under any national regulatory regime as it was incompatible with art. 85 of the Treaty of Rome. In 1989, in *Ahmed Saeed case*, the ECJ further extended *Nouvelles Frontieres*, holding that (1) airline tariff agreements, regardless of whether they concern *intra*-community routes or third party airports, are within scope of art. 85 of *EC Treaty*, and (2) when such coordinated fares concern *intra*-community route they are automatically void as violation of art. 85, but (3) when they concern EU-third party routes they can be voided by the Member States under art 88 or by the Commission under art 89, (4) application of coordinated fares can constitute abuse of dominant position under art 86, which is applicable to the whole air transport sector and is not subject to any exemptions, and (5) national authorities are no longer allowed to encourage or approve tariff coordination, unless exemptions are possible.

In sum, these ECJ rulings established that EC competition rules applied to air transport and that it was a violation of these rules to maintain regulatory system, which involved approving tariffs without a prior exemption. In this way ECJ challenged the *Chicago*-based, IATA fare coordination system, and, as a result, the national governments

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75 Ibid. at 77.
77 Ibid. at 24.
79 *EC Treaty, supra* note 64, Art 81(ex 85); *Ahmed Saed, supra* note 78 at 19.
81 Ibid. at 29. *EC Treaty, supra* note 64, Art 84(ex 88) and Art 85 (ex 89),
82 *Ahmed Saed, ibid* at 34-38.
83 Ibid. at 33.
84 Ibid at 32.
85 Ibid.at 58.
were no longer permitted to legitimize such anticompetitive practices, even if sanctioned under international practice.

2.2 Second package (1990).

Three years later the Council adopted a second package, further liberalizing rules on pricing, capacity-sharing and market access. Pricing was even more flexible, as a 'normal class economy ticket' could be established from 95 to 105 percent of the reference tariff. The discount zone was narrowed to extend from 80 to 94 percent, while the deep-discount zone was expanded from 30 to 79 percent of the reference fare. In addition, many restrictions, which had limited the applicability of the discount zones, were eliminated, but remained in place for the deep-discount zone. Although pricing was still regulated as fares were subject to approval by the concerned Member States, for the first time in history the EC embraced the double disapproval system (i.e. both nations must disapprove the proposed tariffs else they become effective); first for tariffs that exceeded reference fare by at least 5 percent, and since 1 January 1993 the double disapproval system was expanded to apply to all fares. Moreover, Member States had to approve the fares of EC airlines if they were reasonably related to the carrier's long-term fully allocated costs, and the fact that the fare was lower than that offered by other airlines was not a sufficient reason for disapproval.

86 See Sanchez, supra note 61 at 106.
87 EC, Council Regulation (EEC) 2342/90 of 24 July 1990 on fares for scheduled air services [1990] O.J. L217/1, Art 4(3), where 'reference fare' was the average normal economy airfare on the route in question. Ibid. Art 2(1).
88 Ibid at Art 4(3)
89 Ibid. at Annex II. See also Dempsey, “European” supra note 59 at 58.
90 Council Reg. 2342/90, supra note 87, Art 4(1)
91 Ibid, Art 4(6), see Dempsey, “European” supra note 59 at 57.
92 Council Reg. 2342/90, supra note 87, Art 3(1)(4)
As to capacity allocation, the 60-40 percent ration was extended by 7.5 percent, so that, as of 1 November 1990, the capacity of a member state's airlines could reach as high as 67.5 percent, and the regulation specifically called for the Council to abolish all capacity limitations by 1 January 1993.  

Moreover, starting with the second package, all EU airlines were granted full third and fourth-freedom rights, but fifth-freedom rights were still offered only on conditional basis.  

2.3 Third package (1992).

The final stage of the liberalization, which have effectively created an 'Open Skies' regime for air services within the European Union, came into force on 1 January 1993 through the third package of measures. This package introduced: (i) free pricing, as airlines now have complete freedom to determine their fares subject to limited safeguards to prevent predatory or excessive pricing, and are no longer required to submit their fares to the national authorities for approval; (ii) free determination of capacity by the carriers, in principle free from governmental control but subject to checks and balances in case of abuse; and (iii) open market access- airlines from member states

93 EC, Council Regulation (EEC) 2343/90 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 [1990] O.J. L217/8, Art 11.
94 Ibid. Arts 4 & 8. Also see Sanchez, supra note 61 at 106-107. For full description of the freedoms of the air, see section III below.
95 See Doganis, “Air. Bus.” supra note 60 at 46.
97 Although Member States may require carriers to file tariffs with them for review up to 24 hours before the tariffs are scheduled to go into effect, provided that the filing process is nondiscriminatory. Council Reg. 2409/92, Ibid., Art 5(2).
can operate with full traffic rights on any route within the EU, including full *cabotage* rights since April 1997. 99

The above measures were accompanied by the harmonization of the criteria for granting of operating licenses and air operators' certificates by the EU member states and replacement of the traditional nationality requirements with the 'Community ownership.'100 In the latter respect the third package was revolutionary, as for the first time it explicitly allowed cross-border majority ownership, enabling the EU nationals or companies to set up, operate or buy an airline in any other EU Member state. 101

3. Creation of European Common Aviation Area ("ECAA"): Intra-European 'Open Skies'.

The EU liberalization has gone further than the US deregulation in that it has adopted a multilateral approach, affecting not only a single state but a whole region of all the member states of the European Union, and which has been even further extended to other non-EU countries.102 Most of the Community legislation was made applicable to Finland, Norway, Iceland, and Lichtenstein in 1992, and to Switzerland in 1999. 103 The most recent 2006 European Common Aviation Area ("ECAA") Agreement is another step in enlarging the internal air transport market to South-Eastern Europe.104


100 EC, *Council Regulation (EEC) 2407/92 of 23 July 1992 on licensing of air carriers* [1992] O.J. L240/1; “Nationality requirements” - related to “substantial ownership and effective control” - Section V.1.5.1 and “Community ownership” - Section III. V.1.5.2 below.

101 Doganis, “Air. Bus.,” *supra* note 60 at 47.

102 *Ibid.* at 47.


104 *Multilateral Agreement on the Establishment of a European Common Aviation Area (ECAA),* COM 2006/113. [2006 ECAA Agreement]
Agreement was signed between the EU, on one part, and Albania, Bosnia & Herzegovina, Bulgaria, Croatia, Macedonia, Iceland, Montenegro, Norway, Romania, Serbia and Kosovo (cumulatively called “ECAA partners”) on the other part. Under this Agreement companies and nationals of the signatory states have the right to establish themselves and pursue air transport and related activities anywhere in the ECAA area.  

In addition, the Agreement extends to ECAA partners all relevant EU legislation in the aviation sector, including Regulation 2408/92 on free market access. The parties agreed on the gradual implementation of the ECAA Agreement, recognizing that ECAA partners could not immediately implement entire community legislation. Full market access, including cabotage and right of establishment, will be introduced only upon successful implementation by the concerned ECAA partners of the entire aviation acquis, including all safety and security legislation. It also should be noted that the 2006 ECAA Agreement will not only liberalize air services between the EU Member States and the ECAA partners, but also among the ECAA partners.

The creation and expansion of ECAA has been, without doubt, the great achievement for the European air transport regime. However, it does not change the rules governing provision of air services between Europe and third countries, which are still largely regulated by bilateral air service agreements between individual European countries and states outside Europe.

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105 Ibid., arts 7-10.
106 Bombay, supra note 106 at 222.
107 Ibid.
108 Ibid. at 223-224.
109 Ibid. at 225.
4. 'Open Skies ' Case and Horizontal Agreements.

On 5 November 2002, the ECJ issued a long awaited Open Skies decision holding that eight EU Member States had violated the 'right of establishment' clause in the Treaty of Rome by concluding bilateral air transport agreements with the United States.\textsuperscript{111} The genesis of this case goes back to a tug-of-war between the European Commission and individual Member States that started in 1992 with the creation of single European market in air transport, and subsequent rejection by the transport ministers of the Member States (acting in the Council) of the proposal to vest negotiating power for future air transport agreements in the Commission.\textsuperscript{112} Finally, in the confrontational atmosphere the transport ministers agreed to grant to the Commission only limited power to negotiate “soft issues,” such as computer reservation systems, slot allocation, ground handling and air carrier ownership, while still withholding the “hard issues” of traffic rights and pricing.\textsuperscript{113}

The ECJ, in its landmark decision agreed with the Commission that the bilateral agreements, containing the traditional national ownership clauses, were illegal because they restricted service to air carriers 'substantially owned and effectively controlled' by their nationals and thus violated the right of establishment under art. 43 of EC Treaty on grounds of nationality.\textsuperscript{114} Such discrimination was considered illegal in the


\textsuperscript{112} Dempsey, “Evolution” \textit{Ibid.} at 181; Ruwantissa Abeyratne “The Decision of the European Court of Justice on Open Skies – How can we take liberalization to the next level?” (2003) 68 J. Air.L & Com. 485, 486-68 [Decision of ECJ]

\textsuperscript{113} Dempsey, “Evolution” \textit{Ibid.} at 181-84.

\textsuperscript{114} See Abeyratne, “Decision of ECJ” supra note 112 at 488-89.
air transport sector as much as in any other part of the European market.\textsuperscript{115}

Since the court did not proclaim the existing bilateral agreements to be \textit{null and void}, they remained binding upon signatory states under international law, although unlawful under the EU law.\textsuperscript{116} However, the ruling did create a duty for all individual Member States to amend not only the accords concluded with the US, but all agreements concluded with third countries that contain the same standard nationality clause.\textsuperscript{117} The goal of such amendments is enabling “an EU carrier from one Member State to be designated by any other Member State for operations, under the applicable bilateral, between the territory of that other Member State and a third country.”\textsuperscript{118} A subsequent regulation provides standard clauses, which Member States may use to amend their third-country bilateral agreements so as to bring them into conformity with EC law.\textsuperscript{119} States that have bilaterals with multiple EU Members also have the option of “horizontally” amending all of their agreements through negotiations with the European Commission.\textsuperscript{120}

One of the immediate consequences of the ECJ decision was that the Commission finally received the negotiating mandate and, in June 2003, commenced the Community-level negotiations with the United States, aimed at replacing the previous bilaterals and creating 'open aviation' area.\textsuperscript{121} Eventually, the negotiations resulted in

\textsuperscript{115} Ibid. at 500-01.
\textsuperscript{116} Dempsey, “Evolution” \textit{supra} note 111 at 188.
\textsuperscript{117} see Peter van Fenema, “EU Horizontal Agreements: Community Designation and the 'Free Rider' Clause,” (2006) 31:3 Air & Sp.L. 172.
\textsuperscript{118} Ibid at 173.
\textsuperscript{120} Sanchez, \textit{supra} note 61 at 108, (citing European Commission Information Note (2005): “EU External Aviation Policy: Why Does EU Want to Modify Air Service Agreements Between Its Member States and Partner Countries?”)
\textsuperscript{121} Bombay, \textit{supra} note 106 at 214.
such an agreement between the United States and all members of the European Union, *U.S.-EU Air Transport Agreement signed April 30, 2007.*\(^{122}\) The details of this Agreement are analyzed in detailed in the following Part 2.

**PART 2: EVOLUTION OF INTERNATIONAL AIR TRANSPORT REGIME: FROM 1944 CHICAGO CONVENTION TO 2007 US-EU AIR TRANSPORT AGREEMENT AND BEYOND.**

> “The rules of the commercial game in international air transport are expressed in the first place in economic provisions of air transport agreements.”\(^{123}\)

This part of the thesis will analyze the evolution of international air transport regime as exemplified by the gradual liberalization of Air Transport Agreements, with particular attention to the 2007 US/EU Agreement. Detailed discussion of the main impediments to the full opening up of the international aviation regime, namely prohibition against cabotage and foreign investment restrictions, will include consideration of different geopolitical interests in the United States and the European Union. Finally, various proposals for breaking the stalemate in the negotiations between U.S. and E.U. will be reviewed and prospects for creation of single, liberalized Transatlantic Common Aviation Area will be evaluated.

**I. FOUNDATION AND EVOLUTION OF INTERNATIONAL AIR TRANSPORTATION REGIME.**

On international routes, airlines have traditionally operated within a very rigid framework set by the “Air Service Agreements” or “Air Transport Agreements” (“ATA”), which are agreements between two or more States governing the operation of international air services between their territories.\(^{124}\) The ATAs have been traditionally

\(^{124}\) Dempsey, “Evolution”, *supra* note 111 at 131, Birgit Kleyman & Hannu Seristo, *Managing Strategic
exchanged on bilateral basis, hence they are often referred to as “bilaterals.”

The importance and evolution of ATAs has to be understood in the wider context of the international aviation regime. Perhaps the most notable principle, pre-existing in the customary international law, confirmed in the Paris Convention of 1919 and reiterated in the Chicago Convention of 1944 is the principle of territorial sovereignty, giving each state, to the exclusion of all others, a unilateral and absolute right to permit or deny entry into its territory and to control all movements therein. According to Milde this provision is “a cornerstone of international air law and ...declaratory of general international law.” Specifically this state authority (also referred to as 'national interest' principle) precludes the operation of scheduled international air services over or into the territory of a state without its permission or special authorization. Moreover, such authorization is required for state aircraft (art 3(c)), pilotless aircraft (art 8), and aircraft carrying munitions (art 35(a)), with an exception carved out for a restricted freedom of civil, non-scheduled flights (art 5). The national interest principle, combined with the state's right to exclude foreign airlines from domestic point-to-point service (cabotage).

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125 Dempsey, “Evolution” ibid. at 132T.
127 Chicago Convention, supra note 33, Art 1: “every state has complete and exclusive sovereignty over the airspace above its territory.” Traceable to the Roman axiom cujus est solum, ejus est usquam ad coelum et ad inferos - whoever owns the land, owns the space above up to infinity and the space below. See Havel, “In Search” ibid.
130 Chicago Convention, supra note 33, Art 6);
131 Chicago Convention, Ibid., Art 7.
and to prohibit foreign citizens (and their airlines) from owning or controlling national air carriers,\(^\text{132}\) provide the basis for the legal regime established in 1944 at the Chicago Convention. This regime, explicitly reserving the power to regulate the international air transport to the individual governments, was succinctly summarized as “all commercial international air passenger transport services are forbidden except to the extent that they are permitted,” and it governs to this date.\(^\text{133}\)

Specifically, the international commercial air transport services are possible through the grants of access rights (known as “freedoms of the air”).\(^\text{134}\) The Chicago delegates drafted two agreements in an attempt to exchange these rights on multilateral basis, namely the “Two Freedoms” (or “Transit”) Agreement\(^\text{135}\) and “Five Freedoms” (or “Transport”) Agreement.\(^\text{136}\) The Transit Agreement, which to date has been ratified by over 120 nations, provides for multilateral exchange of the first and second freedoms, namely a privilege to fly across the territory of contracting states without landing (overflight right) and to land for non-traffic purposes (like refueling or maintenance).\(^\text{137}\) The subsequent three rights, which were included in the Transport Agreement, are called “traffic rights” as they include: the airline's right to carry traffic (passengers, mail and

\(^{132}\) Although not included in the text of Chicago Convention, but rather in both subsidiary accords, the Transit and Transfer Agreements, and later included in most bilateral ATAs as ‘ownership and control clauses.’ - see Section V.1.5 below.


\(^{134}\) Havel, “In Search” supra note 126 at 19, 35.


cargo) from its home state (country of registry)\(^ {138}\) to another country \((third\ freedom)\), to carry traffic from another country to its own home state \((fourth\ freedom)\) and to carry traffic between two countries outside its own home state, so long as the flight originates or terminates in its home state \((fifth\ freedom,\ often\ referred\ to\ as\ “beyond”\ rights)\).\(^ {139}\) The Transport Agreement, drafted mainly upon the insistence of U.S. delegation to the Chicago Convention, was signed and ratified only by a handful of nations and hence remains a dead letter.\(^ {140}\)

In the years since the Convention several other freedoms of the air have been identified, each further liberalizing the market access, including the right to carry traffic between two foreign states via its home state \((sixth\ freedom)\), the right to carry traffic between two foreign countries without any requirement to include on such service any point in its home state \((seventh\ freedom)\), the right to carry traffic between two points in the foreign country on a flight that originates in the airline's home state \((eight\ freedom,\ also\ known\ as\ consecutive\ cabotage)\), and finally a pure cabotage, or a stand-alone right to carry traffic between two points in the foreign country \((ninth\ freedom)\).\(^ {141}\)

The United States, which entered the Chicago negotiations as the world's strongest aviation power, both in terms of aircraft production and technological expertise, was unable to secure multilateral liberalization of the international civil aviation.\(^ {142}\) As a result, each state was left to negotiate a separate bilateral ATA with a government of each
country that its airline, or airlines, wished to serve. Consequently, numerous bilateral agreements between the United States and other nations were contracted following the Chicago Convention.

II. EVOLUTION OF ATAs FROM BERMUDA TO OPEN SKIES: US POLICY OF EXPORTING Deregulation WORLDWIDE.

The ADA of 1978, which deregulated the U.S. domestic airline industry, left international air transportation virtually untouched. As already described in the preceding section, the U.S. efforts to introduce a liberal, free-competition based international regime for commercial aviation failed at Chicago in 1944, forcing the U.S. to negotiate liberalization of the air traffic rights for its airlines serving the international markets on bilateral basis. On the other side of the Atlantic, the European Union was eventually successful in securing a single open aviation market between its member states, however in its relations with third countries, it likewise remained bound to the traditional regime of bilateral exchange.

It is impossible, and perhaps futile, to precisely classify all the existing bilateral ATAs due to the multiplicity of their clauses, differences in the formal structure and scope, or the degree of their liberalization or restriction. However, by concentrating on the last criterion, the degree of liberalization of commercial air services operation, we can distinguish three basic types of these agreements: Predetermination, Bermuda I and Open Skies.

144 Westra, *supra* note 3 at 165.
145 Havel, “In Search”, *supra* note 125 at 159.
147 Zylicz *supra* note130 at 140-41.
1. Bermuda I agreements.

*Bermuda I*-type agreements, termed after the first ever U.S. bilateral ATA, signed in Bermuda in 1946 with the United Kingdom, generally provide for “regulated freedom” of airline operations with regulated market access (specified route rights, but multiple designation of airlines and liberal *fifth freedom* rights allowed), *ex-post facto* capacity review and 'double-approval' of fares, and price-setting delegated to International Air Transport Association's [IATA] rate conference machine. The first *Bermuda I* agreement required reconciliation of virtually opposite aviation policies, namely UK's concept of “order in the air” versus the US's pursuit of “freedom in the air.” UK insisted on predetermination of frequencies, equal division of capacity, regulation of fares, ban on *fifth freedom* services, and an international body with executive power to administrate international air services, while the US advocated setting no limitations on frequencies and capacity, no regulation of fares, unlimited *fifth freedom*, and proposed a purely advisory function of the international bodies. The resulting *Bermuda I* was a compromise at both sides as “the US had to accept the capacity provisions and the rate-control mechanisms involving IATA and dual governmental approval, the UK had to accept plenty of U.S. *fifth freedom* rights, and both had to give way to arrive at a capacity formula and *ex-post* control which was acceptable to both sides.”

During the ensuing three decades *Bermuda I* became the prototype for bilateral

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148 *Air Services Agreement with the United Kingdom*, (United States, United Kingdom, 11 Feb., 1946) 60 Stat. 1499, T.I.A.S. No. 1507 [*Bermuda I*].
151 Stadlmeier, *supra* note 150 at 190.
ATAs throughout the world; the United States alone entered into Bermuda-I type agreements with most of the 75 nations with which it had aviation relations. Consequently, under Bermuda I system, airlines competed not on price but on “capacity and service frequency,” with the result that international air travel was beyond the means of majority of U.S. and European travelers.

Moreover, many post- Bermuda I bilateral agreements, mostly those entered between the nations other than the U.S., diverged from Bermuda I model by adding even more restrictive (and sometimes unpublished) provisions concerning capacity limitation, schedules, or even pooling agreements. Believing such agreements to be anticompetitive, the United States refused to sign bilaterals allowing such practices.

2. Predetermination agreements.

Predetermination (or British-type) agreements provide for more regulation in a form of limited traffic rights, single designation of airlines, predetermination of capacities, strict governmental control on prices, and imposition of other commercial conditions. Many post-Bermuda I agreements, while retaining the general framework of Bermuda-I, contain many predetermination clauses, and thus can be included in this type.

3. Open Skies Agreements.

Open Skies agreements are characterized by open market access (full grant of traffic rights - excluding cabotage, and open entry on all routes), unrestricted capacity and

152 Dempsey, "Evolution" supra note 111 at 146, Larsen et al, supra note 10, supra note 13 at 232.
154 Westra, supra note 3 at 166.
155 Zylicz, supra note 130 at 142, Dempsey, “Evolution” ibid. (Capacity limitation agreements are agreements between airlines restricting the number of seats or flights offered by each carriers, and pooling agreements are agreements under which the airlines share their costs and/or profits.)
156 Dempsey, “Evolution” Ibid.
frequency, freedom to set prices, enter into codesharing\textsuperscript{157} and other commercial opportunities. \textsuperscript{158} The first-generation of Open Skies agreements were liberal (often referred to as \textit{Benelux Model}) bilaterals, which were entered into by the U.S. in the late 1970's with Netherlands, Belgium and Israel, and which began easing restrictions on numbers of carriers, capacity and fares. \textsuperscript{159} In the 1990s the United States adopted a negotiating strategy of offering codesharing and anti-trust immunity approval to the airlines of states which agreed to market liberalization through the new generation of Open Skies bilaterals.\textsuperscript{160} First such agreement, a 1992 accord between the United States and the Netherlands, not only provided for unrestricted landing rights within each signatory's territory, but also resulted in an exemption for KLM from U.S. antitrust restrictions in its alliance with Northwest Airlines.\textsuperscript{161} Other bilateral Open Skies ATAs soon followed, not only between the United States and various members of the European Union. By 2008, the United States had signed Open Skies bilaterals with over 90 nations\textsuperscript{162} and, in 2001, concluded MALIAT Agreement, the first modern multilateral Open Skies agreement with Brunei, Chile, New Zealand and Singapore.\textsuperscript{163}

The already mentioned difficulty of precise classification of all bilateral ATAs is exemplified by many agreements that fall in-between the above three types, providing for

\textsuperscript{157} Codesharing is defined in Section VII.2 below.
\textsuperscript{158} Dempsey, "Evolution" \textit{ supra} note 111 at 162 (quoting “In the Matter of Defining 'Open Skies ’” (1992) \textit{DOT Order 92-8-13})
\textsuperscript{159} Dempsey, “Evolution”, \textit{ ibid}. at 152.
\textsuperscript{160} Dempsey, “Carving the World” \textit{ supra} note 39 at 250. Also see current U.S. Model \textit{Open Skies Agreement} published by the U.S. Dept of State online: <www.state.gov/e/eeb/rls/othr/2008/19514.htm> (visited on 29 July 2009)
\textsuperscript{162} 92 nations, as of June 12, 2008, (U.S. Dept. of State online: < http://www.state.gov >
\textsuperscript{163} Multilateral Agreement on Liberalization of International Air Transportation [MALIAT] online: <http://www.maliat.govt.nz/agreement/index.html> (In 2002, Peru & Samoa acceded to the agreement)
either more restrictive or more liberal modifications of the general model. *Bermuda II*, signed in 1977 after the UK denounced *Bermuda I*, was such an example, reducing the capacity and restricting U.S. *fifth freedom* rights, but providing for somewhat liberalized pricing and charter regulation.164 Under *Bermuda II*, only two U.S. airlines – American Airlines and United Airlines- were permitted to service London's Heathrow airport, and non-stop service from U.K to U.S. was restricted to a fixed number of 'gateway cities.' 165 At the other end of the spectrum, many ATAs signed by the United States in the 1990s cannot be considered as full fledged Open Skies due to varying degree of restrictions, such as limited exchange of traffic rights, even if they agree on unlimited capacity and free pricing.166

III. CASE STUDY: 2007 US-EU AIR TRANSPORT AGREEMENT – OPEN SKIES PLUS.167

On April 25, 2007, the United States and the European Union concluded a comprehensive and unprecedented ATA with all 27 member states of the EU. 168 The Agreement, which took effect on March 30, 2008, extends Open Skies principles to 11 EU countries where the United States had restrictive or no agreements, e.g. Greece, Ireland, Spain and the United Kingdom.169

The following analysis of the 2007 US/EU Agreement concentrates on the issues related to the economic regulation of the airline operations, specifically (1) market access (grant of traffic rights, designation of carriers and routes); (2) capacity; (3) fares, and (4)

164 *Agreement concerning Air Services, June 22, 1977*, British Command Papers, Cmnd 7016, Treaty Series No 76 (1977) [Bermuda II].
165 Westra, *supra* note 3 at 166.
166 Dempsey, “‘Evolution' supra note 111” at 163.
168 Alford & Champley, *supra* note 2 at 1.
169 Ibid.
ancillary - “soft rights.”


1.1 Grant of Traffic Rights.

Article 3.1: Each Party grants to the other Party the following rights for the conduct of international air transportation by the airlines of the other Party:

(a) the right to fly across its territory without landing;
(b) the right to make stops in its territory for non-traffic purposes;
(c) the right to perform international air transportation between points on the following routes:

(i) for airlines of the United States (hereinafter "U.S. airlines"), from points behind the United States via the United States and intermediate points to any point or points in any Member State or States and beyond; and for all-cargo service, between any Member State and any point or points (including in any other Member States);

(ii) for airlines of the European Community and its Member States (hereinafter "Community airlines"), from points behind the Member States via the Member States and intermediate points to any point or points in the United States and beyond; for all-cargo service, between the United States and any point or points; and, for combination services, between any point or points in the United States and any point or points in any member of the European Common Aviation Area (hereinafter the "ECAA") as of the date of signature of this Agreement; and

(d) the rights otherwise specified in this Agreement.

As already discussed in Section I above, any airline's right to operate international air passenger service is possible only to such extent as is permitted by the rights, or privileges, that had been granted to the airline's home state by all of the concerned states. For example, when Air France (AF) intends to carry passengers from Paris to Seattle with a stop-over in Toronto just for refueling, government of France must first obtain from the government of Canada transit rights (first and second freedoms), which permit, respectively, overflight and non-commercial landing. Despite their technical nature, these rights can sometimes have substantial economic consequences, as countries that

170 Zylicz, supra note 130 at 138-39.
171 2007 US/EU Agreement, supra note 1, art 3.1
control large amounts of airspace, such as Canada or Russia, could block direct international routes.\textsuperscript{172} Although most countries involved in international commercial aviation are signatories to the \textit{Transit Agreement}, most bilaterals, including the 2007 US/EU Agreement, specifically provide for the exchange of transit rights as well.\textsuperscript{173}

While the first two freedoms facilitate transit, the next three freedoms, also known as the “traffic rights” are essential to international air commerce, because they grant permission to pick up and discharge passengers, cargo and mail.\textsuperscript{174} Referring to the above example, the \textit{third freedom} bestows upon AF the right to carry passengers from France to the United States, while the \textit{fourth freedom} to fly them back France. The \textit{fifth freedom}, the network-building freedom,\textsuperscript{175} allows AF carrying passengers from Paris to Seattle to make \textit{intermediate} stop in Toronto for discharge or pick-up of new passengers bound for the US (this is \textit{intermediate} fifth freedom traffic), or to take passengers in the US for further transit to a third state, Mexico (this is known as \textit{beyond} fifth freedom traffic). In both cases, France must have secured permission from all of the “intermediate” and “beyond” third states.\textsuperscript{176} Moreover, it is possible for AF to originate traffic from a country other than France, for example China, to transit through France and to continue to the U.S, where the passengers are discharged. This complex of access rights is know as the \textit{sixth freedom}, but in fact it is a combination of \textit{fourth freedom} (inbound) traffic from China to France under France/China bilateral, and continues as \textit{third freedom} (outbound) traffic from France to the U.S under the US/EU bilateral. If AF could offer direct service

\textsuperscript{172} Havel, “In Search”\textit{supra} note 126 at 35.  
\textsuperscript{173} 2007 \textit{US/EU Agreement}, Art 3.1(a) and (b)  
\textsuperscript{174} Oliver J. Lissitzyn, “Bilateral Agreements on Air Transport” (1964) 30:3 J. Air L & Com. 248.  
\textsuperscript{175} Havel, “In Search”\textit{supra} note 126 at 36  
\textsuperscript{176} Ibid.
from China to the U.S., without a transfer in France, it would be exercising a *seventh freedom* right. Furthermore, if AF could offer service from Paris via New York to Seattle, it would be exercising *eight freedom* (indirect cabotage), and when operating air services originating in New York (shuttle between New York and Seattle) it would be exercising a pure cabotage, or a *ninth freedom*.

The extent of rights granted under the bilaterals varies between different types of agreements, with a very limited exchange of *fifth freedom* under predetermination (or British-type) agreements, to more liberal grants under *Bermuda-I* type and finally full grant (except for cabotage) in the Open Skies agreements. The parties to the *Open Skies* agreements uniformly grant the first and second rights to each other,\textsuperscript{177} as well as “rights otherwise specified.”\textsuperscript{178}

The 2007 US/EU Agreement provides for a full exchange of all five freedoms between the United States and all 27 State members of the European Union, replacing the existing bilateral agreements with an Open Skies framework.\textsuperscript{179} The Agreement, by including “Community Carrier” concept, permitted EU airlines to operate to the United States from any point in the European Union, but it also effectively remedied the legal problems identified in the ECJ's “Open Skies” rulings, thus precluding need for any additional horizontal agreements between the EU Member States and the US.

Under Art 3.1(c)(i), U.S. carriers have the right to fly from any country in the European Union to the United States via 'intermediate points' in any EU Member states; likewise under art 3.1(c)(ii), EU carriers are free to fly from any point in the European Union to the U.S., without a transfer in France, it would be exercising a *seventh freedom* right. Furthermore, if AF could offer service from Paris via New York to Seattle, it would be exercising *eight freedom* (indirect cabotage), and when operating air services originating in New York (shuttle between New York and Seattle) it would be exercising a pure cabotage, or a *ninth freedom*.

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\textsuperscript{177} 2007 US/EU Agreement, art 3.1(a), (b)
\textsuperscript{178} Ibid. art 3.1(d)
\textsuperscript{179} Ibid., art 3.1(c)(i), (ii).
Union to any point in the United States without necessarily touching their home country.\textsuperscript{180} The seventh freedom has been granted only for cargo service, and cabotage rights remain excluded.\textsuperscript{181} Moreover, Article 22 suspends the highly restrictive Bermuda II agreement between the U.S and U.K., granting to U.S. airlines unlimited access to London's Heathrow Airport.\textsuperscript{182}

The controversy surrounding the Agreement has been spurred by the perceived imbalance of access between the U.S. and E.U carriers – while U.S. airlines are free to fly routes within Europe, E.U. airlines cannot do the same in the U.S. due to cabotage restrictions.\textsuperscript{183}

\textit{1.2 The case of cabotage or full exchange of 8th and 9th freedoms.}

Airline cabotage is “the carriage of air traffic that originates and terminates within the boundaries of a given country by an air carrier of another country.”\textsuperscript{184} The origin of the term “cabotage” stems from maritime law's concept of a state's right to reserve to itself the right to restrict all coastal navigation between two points within its territory for the exclusive use of its own subjects.\textsuperscript{185} Such exclusionary definition has been transferred to the international aviation regime by the Chicago Convention's acknowledgment of the right of each state “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.”\textsuperscript{186}

\begin{itemize}
\item \textsuperscript{180} Westra,\textit{ supra} note 3 at at 168.
\item \textsuperscript{181} 2007 US/EU Agreement,\textit{ supra} note 1, Article 3.6.
\item \textsuperscript{182} Ibid, Article 22.
\item \textsuperscript{183} Westra,\textit{ supra} note 3 at 171-2.
\item \textsuperscript{184} Hardaway,\textit{ supra} note 8 at 26.
\item \textsuperscript{185}I.H Philepina Diederiks-Verschoor, \textit{An Introduction to Air Law} (The Hague: Kluwer Law Int'l, 2001) at 18-19; Havel, “In search “\textit{ supra} note 126 at 49.
\item \textsuperscript{186} Chicago Convention,\textit{ supra} note 33, art 7; see Havel, “In search “ \textit{Ibid., also see} Hardaway,\textit{ supra} note 37.
\end{itemize}
The EU negotiators to the US/EU Agreement have urged the United States to grant to EU carriers not only the right to operate between the EU and US from any EU point, but also to extend that service to points within the US (consecutive cabotage or eight freedom right) as well as to enable them to operate air services between various points in the US (identified as stand-alone cabotage, or ninth freedom). The argument that EU officials have advanced to justify the grant of such cabotage rights for EU carriers is reciprocity-based, claiming that US carriers already enjoy similar rights within the European Union through their fifth-freedom grants from the individual EU Member States. To illustrate, a U.S. carrier could use the fifth freedom rights to pick up new passengers in London as an extension of a New York/London service and carry them onward to Frankfurt or Rome, for example. However, in order for an EU carrier service from London to New York to include enplaning new passengers in New York for continuing service to Los Angeles, eighth freedom rights would be required. While important from European perspective, such analogy of fifth freedom rights available to U.S. carriers with eighth freedom (cabotage) rights for EU airlines, has not been recognized by the U.S. negotiators.

Arguments supporting solutions to this perceived imbalance of access problem, as well as challenges to its legal validity, have become complex and politicized. Scholars

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8 at 6.
187 granted under the 2007 US/EU Agreement, supra note 1, art 3.1(c)(ii)
[Abeyratne, “Open Skies ”]
“What Is ‘Achievable” for the Second Stage?” (posted on 1 May 2009)
191 Ibid.
supporting the US position point out that such fifth freedom rights for the US carriers had been acquired through oftentimes arduous, quid pro quo bargaining process going back to “the 'olden' – some would say 'golden' days” of aviation.192 These rights, secured by the US in bilateral ATAs with individual European states, have remained binding under international law even after the ECJ's decision on their illegality under EU law in the “Open Skies ” rulings.193 It has been even argued that the 2002 ECJ rulings, and the EU Commission's subsequent statements indicating that EU member states would be required to terminate their bilateral agreements with the US, only undermined the position of EU negotiators. 194 Indeed, the threat of illegality of the previously negotiated bilaterals served to further underscore the necessity of reaching the new Open Skies agreement between the EU and US, whatever the cost.195

Furthermore, Wassenbergh observed that “in the absence of a single, unified sovereign EU airspace, the EU cannot consider operations between sovereign states within EU cabotage.”196 Consequently, the opponents of cabotage rights for the EU carriers persist that EU officials should not equate US carriers' fifth freedom rights within EU to cabotage so long as the EU remains a confederation of independent states, each accorded separate voice in both the United Nations and in the ICAO Council.197

192 Mendelsohn, supra note 150 at 522. See Also Abeyratne, “Open Skies ” supra note 189 at 30.
195Ibid.
1.2.1. Current State of Cabotage in the U.S.

Despite legislative deregulation of the domestic aviation regime and international liberalization fostered by the Open Skies agreements, the current laws in the United States remain hostile to the concept of domestic cabotage. The current U.S. cabotage rules stem from the 1920s Jones Act, which required that the goods shipped between U.S. ports had to travel on vessels owned and staffed by Americans, and which was later expanded to include all forms to transportation, including aircraft. Generally, cabotage rights may be granted in a form of exemption, but only on reciprocity basis and if it is determined that the grant is within the public interest and consistent with international agreements. In reality, any such exemptions granting domestic cabotage rights are impossible to obtain by the foreign carriers.

1.2.2. Advantages of Cabotage.

Many commentators believe that while the obstacles to granting domestic cabotage are formidable, the ensuing advantages for the U.S. carriers would be significant. The proponents of granting cabotage rights base their arguments on the economic principle of Comparative Advantage, first described by the English economist David Ricardo in 1873. According to that principle international trade always provides mutual benefit to all countries that participate in it since “a country can benefit from trade even if it is absolutely more efficient (or absolutely less efficient) than other

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200Hardaway, supra note 8 at 27, see 49 U.S.C.S §41703 (a)-(b).
201Ibid.
countries in the production of every good.” 203 According to that theory a specialization in production and exporting of a particular good allows the two trading countries to shift production toward their areas of comparative advantage. 204 It is argued that the theory still applies if more than two countries are involved in trade as “the more countries involved, the more efficient the trade. Thus, multilateral trade is more efficient than bilateral trade.” 205 Applying the theory of comparative advantage to the aviation sector, economists argue that when forced to compete with foreign competitors, offering renowned service and more profitable operations, the U.S. airlines would have to improve their operations in order to survive. 206

Moreover, it should be noted that in such competitive, open market environment the most suited to survive and thrive would probably be the airlines that have entered the U.S. market since deregulation, not the legacy carriers. 207 Such post-deregulation entrants as JetBlue or Southwest, often described as low cost or discount carriers, managed to survive and even grow despite the fierce competition from the legacy carriers because of their emphasis on efficient and resourceful business models. 208 For this reason the major carriers are increasingly withdrawing from the domestic competition with the low cost carriers and concentrating on reaping their profits on international routes. 209 The reasons for slow entrance of the discount carriers onto the international arena are multifold, from

203 Ibid.
204 Ibid.
205 Ibid at 37.
206Hardaway, supra note 8 at 33, see Christopher Elliott, “Let Foreign Airlines Fly Inside USA”, USA TODAY (18 Dec.2002) at 13A.
207 Hardaway, ibid. at 34.
209 Hardaway, supra note 8 at 34.
the operational reasons, such as lack of larger aircraft required for such services, to those more complex, like development of long-term planning and diplomatic traditions involved in international aviation. 210

While the precise nature of the the future transatlantic aviation regime has not been yet decided, the immediate consequences of the 2007 US/EU Agreement are already felt. Removal of restrictions on market access resulted in lower fares, new routes and more direct services, for example new Aer Lingus service between Ireland and the US,211 or more US airlines operating to London Heathrow airport, previously restricted to two US carriers.212

1.2.3. Opponents of Cabotage.

Despite presented economic underpinnings, which favor the adoption of cabotage, there are other considerations that still hinder the adoption of cabotage as a governing principle of the United States' aviation policy. 213 Among relevant factors are national security, prestige and public interest, as well as influence of domestic labor interests. While national prestige of having a flag carrier and public interest objective of maintaining adequate safety and service levels may be waning with increased deeper harmonization of worldwide standards, security still remains a paramount concern for the U.S. negotiators. The tragic events of September 11, 2001 prompted more than temporary increased security measures in the United States. 214 The “war on terror”

210 Ibid.
213 Havel, “In search” supra note 126 at 5.
declared by the Bush administration resulted in security-driven (or security-justified) federal legislation, such as USA PATRIOT Act of 2005\textsuperscript{215}, expanding the governmental search and surveillance powers, tightening of immigration laws and border security, as well as increasing intrusion on the Americans' civil rights.\textsuperscript{216} In this context allowing foreign interests to take over a strategic aviation industry would seem to be cutting against the dominant trends.

Furthermore, adamant opposition to granting domestic cabotage rights has been shown by the unionized labor, such as United States airline pilots, which have consistently opposed cabotage.\textsuperscript{217} As noted by Hardaway, similar resistance was exhibited during the 1970s to deregulation efforts, as the industry players knew that some carriers would not survive the changes. For this reason, Hardaway, along with other commentators, urges for more involvement of the labor representatives from both sides of the Atlantic, in order to have their concerns addressed and to bolster their confidence in the fully liberalized aviation regime.\textsuperscript{218}

\ \ \ \textit{1.3. Route Schedule.}

Grant of routes and of traffic rights on these routes essentially determines the opportunities for the designated airlines of both parties to operate. That is why detailed description of routes used to be the hard core of restrictive ATAs.\textsuperscript{219} \textit{Bermuda I-type}


\textsuperscript{217}Hardaway, supra note 8 at 29.

\textsuperscript{218}Ibid.

\textsuperscript{219}Stadlimeier, supra note 150 at 298.
bilateral agreements usually identified the city-pair routes to be served in an Annex appended thereto, which would be revised periodically with an exchange of notes. They also included a qualification that air traffic could be prohibited from areas so designated for national security reasons. One of the cornerstones of the air transport liberalization in the late 1970s was the deregulation of the route schedules, bringing an end to the enumeration of entry points, points in between, points beyond, combined with individually tailored combinations of third, fourth and/or fifth freedom rights for each single route thus established. Although flexible, the early liberal bilateral agreements still maintained “grant of routes” provision, either in the body of the agreement or in the Annex.

The Open Skies bilateral agreements introduced full route flexibility and unlimited fifth freedom rights for both parties, which is reflected in the uniform model for the grant of rights and routes for scheduled services in either direction. Consequently, the airlines in Open Skies markets enjoy greater operational flexibility, as they may operate flights in either of both directions and serve points in the points in the territory of the respective other Party, behind points, intermediate and beyond points in any combination and in any order. Moreover, they can combine different flight numbers within one aircraft operation, omit stops at any point or points, transfer traffic between its aircrafts at any

221 Stadlmeier, supra note 150 at 289-290.  
223 2007 US/EU Agreement, supra note 1, Art 3.1(c); see Stadlmeier, supra note 150 at 319.  
224 2007 US/EU Agreement, Ibid., art 3.2(a)  
225 Ibid., art 3.2(c)  
226 Ibid., art 3.2(b)  
227 Ibid., art 3.2(d)
point on the route, and finally serve points behind any point in its territory (anterior points) with or without change of aircraft or flight number, and hold out and advertise such services as through services.

1.4 Designation of Airlines.

The Bermuda I agreement provided for the designation of “an air carrier or carriers” for the specified route or routes, thus allowing for liberal multi-designation. However, many post-Bermuda I agreements modified this provision by introducing a single designation system; or even if multi-designation was permitted, states were typically in practice limited to the designation of only one of its flag carrier per city-route. The Bermuda II limited multi-designation (to not more than two airlines) on two North Atlantic routes and introduced single designation on other routes. Post-1978 liberal bilaterals returned to multi-designation without Bermuda II – type limits. It should be noted that until recently Open Skies agreements maintained this pattern of multi-designation, with a specific grant of the right to designate “as many airlines as they wished.” This, however, has been changed in the new 2007 US/EU Agreement, which eliminates the “designation” requirement altogether, thus enabling truly open access to all airlines of the contracting parties, subject only to the “authorization” requirement of Article 4, to be processed “with minimum procedural delay.”

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228 Ibid., art 3.2(e)
229 Ibid., art 3.2(f) See Stadlmeier, supra note 150 at 320.
230 Stadlmeier, Ibid. at 195
232 Stadlmeier, supra note 150, at 283.
233 Benelux Model, supra note 223, granted each party “right to designate many airlines as it wishes to conduct international air transport in accordance with this Agreement and to withdraw or alter such designation.” (art 3.1).
235 2007 US/EU Agreement, supra note 1, Art 4.
1.5 Substantial Ownership and Effective Control.

Article 5.1: Either Party may revoke, suspend or limit the operating authorizations or technical permissions or otherwise suspend or limit the operations of an airline of the other Party where:

(a) for a U.S. airline, substantial ownership and effective control of that airline are not vested in the United States, U.S. nationals, or both, or the airline is not licensed as a U.S. airline or does not have its principal place of business in U.S. territory;
(b) for a Community airline, substantial ownership and effective control of that airline are not vested in a Member State or States, nationals of such a state or states, or both, or the airline is not licensed as a Community airline or does not have its principal place of business in the territory of the European Community;

The ATAs have traditionally included clauses requiring the airlines, chosen by either nation to serve international routes, to be under 'substantial ownership and effective control' of citizens of the designating state. In spite of the U.S. government's avowed policy of Open Skies, pursuing removal of all conditions on market access, capacity and pricing worldwide, all bilaterals entered into by the US, including the most recent 2007 US/EU agreement, contain ownership and control clauses.

As one author pointedly noted, “the airline industry is a paradox; in terms of its operations it is the most international of industries, yet in terms of ownership and control it is almost exclusively national.” Bilateral ATAs have traditionally contained “ownership and control” clauses that, although not specifically mandated under the Chicago Convention, persist as a relic from the Convention's construct of territorial sovereignty.

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236 Ibid, art 5.1
237 Bermuda I, supra note148, art 6.
238 2007 US/EU Agreement, supra note 1, Art 5.1 and Annex 4; See Generally Dempsey, “Evolution” supra note 111 at 176.
Convention contained a provision requiring that substantial ownership and effective control be vested in national of either party to the agreement.[emphasis added] This essentially discretionary provision was abandoned in practice and replaced by a formula requiring a state to designate only air carriers that are “substantially owned and effectively controlled” by such state or its nationals, and granting to each contracting state the right to revoke foreign carrier's traffic rights where this condition has not been satisfied. Moreover, the continued application of these traditional rules has excluded the air carriers from full access to foreign capital markets and from merging with, acquiring, or being acquired by foreign airlines.

Ownership and control of airlines was and still remains one of the most contentious issues in the negotiations between the United States and the European Union. The European Union has mostly insisted on abolishing the U.S. protectionist laws limiting the foreign voting rights in the U.S. airlines to 25%; in comparison the EU has a 49% ceiling on such rights. For this reason, when U.S. and EU negotiators reached a preliminary Open Skies agreement in November 2005, the EU made its final approval conditional on a proposed regulatory change that would relax U.S. restrictions on foreign investors’ control of the operation of U.S. airlines. Under the rule proposed by the U.S. Department of Transportation (DOT) foreign investors from Open Skies partner nations would be granted a greater role in the management of U.S. carriers - they would be free

241 Gertler, supra note 123 at 71.
242 Bermuda I, supra note 148. See Dempsey, "Evolution" supra note 111 at 175.
243 Dempsey, “Evolution” Ibid. at 176.
244 Abeyratne, “Open Skies,” supra note 189 at 25.
to make 'operational decisions' on such issues as rates and routes, but they would still be prohibited from having control over “security, safety and defense issues related to the airlines.” 246 The proposed DOT rule was submitted to Congress for comments, however after fierce opposition by the labor unions and some carriers, it has been withdrawn from consideration due to labor and aviation security concerns. 247 Subsequently, it became apparent to negotiators on both sides of the Atlantic that “a major change in the U.S. rules governing control of U.S. airlines is simply not in the cards.” 248

While the final 2007 US/EU Agreement includes, in Article 5, the standard requirements of “substantial ownership and effective control,” it also adds a new Annex 4, “Concerning additional matters related to ownership, investment and control,” which includes certain binding assurances to the benefit of EU investors in the U.S. airlines.249 Under the Agreement, EU investors may hold up to 25 percent of voting equity and up to 49.9 percent of total equity in a U.S. carrier.250 Ownership by EU nationals of 50 percent or more of the total equity of a U.S. airline shall not be presumed to constitute control of that airlines, subject to a case-by-case analysis. 251

U.S. investors can participate as minority shareholders in any EU carrier, provided that the airline is majority-owned and effectively controlled by EU Member States and/or nationals of Member States. 252 However, the Annex includes a provision reserving

247 Ibid.
248 Westra, supra note 3 at 171,(citing statement by lead US negotiator John Byerly)
249 See Information Note, supra note 247 at 7
250 2007 US/EU Agreement, supra note 1, Annex 4, art. 1(a)
251 Ibid, art 1(b),
252 Ibid, art. 2.
to the EU and its Member States the right to limit investment by U.S. nationals in the voting equity of EU carriers “to a level equivalent to that allowed by the United States for foreign nationals in U.S. airlines.”

In addition, the Annex safeguards the rights of foreign investment in the Community airlines by ECAA investors, whereby the Community airlines owned and controlled by ECAA citizens will be treated by the U.S. as EU nationals. Furthermore, it also provides that the U.S. shall not object to the operations to the United States of third countries' airlines owned and controlled by EU investors and provides for a mechanism to update the list of such third countries.

1.5. 1 United States: legislative and policy considerations.

While US negotiators and many US industry leaders favor, in principle, the full relaxation of foreign ownership restrictions on a reciprocal basis, it seems that overcoming the remaining hurdles would require a major change in US law and policy. Changing the restrictive ownership and control clauses is not, however, a simple matter of contract renegotiation. Aside from the international evolution of ATAs, domestic US legislation has, over the years, restricted the maximum level of foreign ownership of US air carriers. The Air Commerce Act of 1926 provided that an airline could only be registered in the US if owned and controlled by US citizens, requiring US citizens to hold at least 51 percent of the airline's voting stock and two-thirds of the airline's board.

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254 *Ibid*, art 3. Also see Information Note, supra note 246 at 7
255 2007 US/EU Agreement, supra note 1, Annex 4, art. 2.
256 Dempsey, "Evolution" supra note 111 at 176.
membership. The Civil Aeronautics Act of 1938 raised the minimum US holding of voting stock from 51 percent to 75 percent, and this was carried over into the Federal Aviation Act of 1958. While various proposals have been made for the amendment of the FAA of 1958 to bring the minimum US stock holding to 49 percent, no such amendments have been enacted to date. However, DOT has authorized foreign ownership of non-voting equity up to 49 percent as satisfying the statutory requirements.

In addition to the above numerical benchmark, another, qualitative standard has been used by the DOT to prevent foreign investors from exercising “effective control” of the U.S. companies. This substantive limitation was pronounced by CAB in 1971 in Daetwyler, Foreign Permit, where it concluded that a corporation nominally meeting the bare minimum percent of ownership or directorship held by the US citizens cannot qualify as a US citizen, and consequently as an air carrier, where control in fact lies in foreign citizens. This effective control test is still part of the DOT’s citizenship review process, as evidenced by DOT’s tentative denial of Virgin America's application for an operating certificate in 2006. In its show-case order the DOT concluded that Virgin America (VA), in which eccentric British entrepreneur Richard Branson held only a minority stake, remained under his 'actual control.'

258 Ibid, see Dempsey, "Evolution" supra note 111 at 176.
259 CAA 1938, supra note 5, § 1(13)
260 FAA 1958, supra note 7, § 107(7) & (10).
261 Dempsey, "Evolution" supra note 111 at 176.
262 Ibid. at 176.
263 Gertler, supra note 123 at 72-73.
264 Daetwyler, Foreign Permit, 50 CAB 118 (1971)

DOT found relevant in its determination included Branson's and Virgin Group's pervasive involvement in the creation of VA, their ability to influence the carrier's board decisions, funding provided to the carrier, as well as restrictive name-brand licensing agreement. The DOT finally approved the VA's application but only after it had submitted a revised proposal, reducing foreign investment, loosening restrictions in its branding agreement and removing Branson's veto authority over key business decisions. 266

1.5.2 European Union: “Community Ownership”

The European liberalization, in addition to removing all capacity and price controls, went one step beyond and ensured open and unrestricted market access to any routes within the EU for all airlines from any member state. 267 The European single aviation market was not accomplished by a complete 'de-nationalization' of European airlines, but rather by replacing the traditional concept of nationality with that of 'Community ownership.' 268

The ownership and control requirements within EU have been laid down during the 'third package' of legislative measures in 1992, specifically in the Council Regulation 2407/92, 269 which mandates the following requirements for a 'Community carrier': (a) the airline must be established in the territory of the designating Member States, (b) the airline must have a valid Operating License in accordance with Community law, and (c) airline must be majority owned and effectively controlled by Member States and/or

267 Kosta Iatrou & Mauro Oretti, Airline Choices for the Future: From Alliances to Mergers (Aldershot, Ashgate, 2007) at 8; Generally see discussion in section II of Part 1 supra.
269 Council Regulation 2407/92, note 100 supra.
nationals of Member States.  

‘Effective Control’ is defined as:

“a relationship constituted by rights, contracts or any other means which, either separately or jointly and having regard to the considerations of fact or law involved, confer the possibility of directly or indirectly exercising a decisive influence on an undertaking, in particular by: (a) the right to use all or part of the assets of an undertaking; (b) rights or contracts which confer a decisive influence on the composition, voting or decisions of the bodies of an undertaking or otherwise confer a decisive influence on the running of the business of the undertaking.”

‘Ownership’ is not defined in the Regulation. However, in Commission Decision 95/404/EC the Commission referred to the concept of ownership of an undertaking

“which is essentially based on the notion of equity capital. Holders of such capital normally have the right to participate in decisions affecting the management of the undertaking as well as to share in the residual profits or, in the event of liquidation, in the residual assets of the undertaking after all other obligations have been met…If capital does not confer upon its holders any of the two above mentioned rights to an appreciable extent, it must generally be disregarded in determining the ownership situation of an undertaking.”

The ownership and control requirements of Council Regulation 2407/92 are assessed by the Commission on a case-by-case basis. All licensed air carriers are requested on a regular basis to demonstrate that they are in compliance with these requirements. The general rule is that majority ownership requirement is complied with if 50 percent plus one share of the capital of an air carrier is in EU hands at all times.

2. Pricing.

*Article 13.1: Prices for air transportation services operated pursuant to this*
Agreement shall be established freely and shall not be subject to approval, nor may they be required to be filed.\(^{274}\)

The *Bermuda I*, as well as most post-*Bermuda I* agreements, contained “double approval” pricing provisions, whereas proposed fares, initially set by the airlines, had to be filed by the carriers at least 30 days prior to their introduction, and approved by the governments of both contracting states.\(^{275}\) Under this scheme fares were set with “due regard being paid to all relevant factors, such as costs of operation, reasonable profit and the rates charged by any other air carriers,” and could not be “unfair or uneconomic.”\(^{276}\)

Prior to 1960, most *Bermuda-I* type agreements contained an explicit endorsement of the IATA rate-making machinery, identifying procedures to be followed upon a failure of IATA to reach consensus.\(^{277}\)

The liberal bilaterals introduced pricing flexibility with two types of pricing regimes. Under a *country-of-origin* provision the country of origin set the fares, thus limiting the control of the proposed fare only to the state in whose territory the flight originated.\(^{278}\) Even more liberal was *double-disapproval* pricing provision, under which both states had to disapprove the fare before it could be rejected, effectively eliminating unilateral blocking of fares.\(^{279}\) In addition, in *Benelux*-type liberal agreements, each nation promised to prohibit predatory or discriminatory prices or practices, acknowledged that consumers should be protected against prices that are unduly high because of abuse of dominant position, and that airlines should be protected from artificially low prices.

\(^{274}\) 2007 US/EU Agreement, supra note 1, art 13.1  
\(^{275}\) *Bermuda I*, supra note 148, Annex II, para (a) and (c); Dempsey, "Evolution" supra note 111 at 149, “Law & FP” supra note 24 at 59.  
\(^{276}\) *Bermuda I*, ibid., Annex II, para (e) and (h) respectively.  
\(^{277}\) Dempsey, “‘Evolution” supra note 111”at 149, Haanappel, “Bilaterals” supra note 140 at 255-57.  
\(^{278}\) Dempsey, “Evolution” Ibid. at 155-56.  
\(^{279}\) Ibid.
attributable to government subsidies or supports.\textsuperscript{280}

The second-generation \textit{Open Skies} bilaterals introduced free price determinations, subject only to the prohibition of predatory pricing.\textsuperscript{281} Similarly, the 2007 US/EU Agreement provides for complete freedom of the airlines to set their prices, without any governmental approval or filing,\textsuperscript{282} recognizes the adverse effect of governmental subsidies on “fair and equal opportunity of airlines to compete,”\textsuperscript{283} and affirms the importance of competition and consumer protection.\textsuperscript{284}

3. Capacity.

\begin{quote}
\textit{Article 3.4:} Each Party shall allow each airline to determine the frequency and capacity of the international air transportation it offers based upon commercial considerations in the marketplace. Consistent with this right, neither Party shall unilaterally limit the volume of traffic, frequency or regularity of service, or the aircraft type or types operated by the airlines of the other Party, nor shall it require the filing of schedules, programs for charter flights, or operational plans by airlines of the other Party, except as may be required for customs, technical, operational, or environmental (consistent with Article 15) reasons under uniform conditions consistent with Article 15 of the Convention.\textsuperscript{285}
\end{quote}

The general principle espoused by \textit{Bermuda I}-type of capacity control, was that of “fair and equal opportunity for the carriers of the two nations to operate over the designate routes,”\textsuperscript{286} while taking into consideration “\textit{interest of the air carriers of the other government... so as not to affect duly the services which the latter provides on all of part of the same route.}”\textsuperscript{287} Such capacity determinations were complex, vague and
difficult to implement. In contrast, the predetermination-type clauses necessarily involved prior consent of both states, fixing in advance the total capacity, which was usually equally divided (50/50 split) between the airlines of both contracting states. In making their determinations the governments would consider, inter alia, estimated traffic between the two states, frequency, scheduling and the types of aircraft.

Post-1978 liberal bilaterals removed capacity-control restrictions, allowing airlines to set their capacities, frequencies and aircraft types freely; in relevant provisions each state pledged to avoid limiting frequency or capacity, to maintain just, reasonable and non-discriminatory user charges, and to eliminate discriminatory and unfair competitive practices. Airlines were also free to establish offices, perform their own ground-handling and freely remit currencies. Modern Open Skies agreements, including the 2007 US/EU Agreement, reinforced the wording of the first liberal bilaterals by explicitly providing the right of airlines to freely determine their frequencies and capacities, based upon commercial considerations in the marketplace.


Although such rights are often termed as “soft rights,” they are essential to the commercial operation of the airlines as they afford them such commercial opportunities,

288 Ibid., ¶6; Dempsey, “Law & FP” supra note 24 at 55.
289 See Cheng, supra note 150 at 55.
291 Benelux Model, supra note 223, art 5.
292 Ibid., art 11.
293 Ibid., art 5.
295 2007 US/EU Agreement, supra note 1, art 3.4
and as such are integral part of the US/EU Agreement. The enumerated ancillary rights of the airlines from the signatory states include the right to:

- establish their own offices in the territory of other contracting states for the promotion and sale of air transportation and related activities;\(^{296}\)
- bring and maintain their specialist staff (managerial, sales, technical, operational etc);\(^{297}\)
- perform their own ground-handling (self-handling) or select among competing agents for these services;\(^{298}\)
- sell air transportation directly or through sales agencies/other intermediaries;\(^{299}\)
- freely convert and remit currencies, and to pay for local expenses, including fuel in the local currency or other freely convertible currencies;\(^{300}\) and last, but not least to
- enter into cooperative marketing arrangements.\(^{301}\)

In the 2007 US/EU Agreement the cooperative marketing arrangements have even been further expanded by allowing for broader entry into cooperative marketing arrangements like codesharing, franchising and leasing\(^{302}\).

**IV. BEYOND 'OPEN SKIES': TRANSATLANTIC COMMON AVIATION AREA [TCAA] AND OVERCOMING REMAINING OBSTACLES.**

To summarize and complement the discussion in the preceding section, the new

\(^{296}\) *Ibid.*, Art. 10.1  
\(^{297}\) *Ibid.*, Art. 10.2  
\(^{298}\) *Ibid.*, Art. 10.3  
\(^{299}\) *Ibid.*, Art. 10.4  
\(^{300}\) *Ibid.*, Art. 10.5, 10.6  
\(^{301}\) See *Think Tank on Multilateral Air Transport Liberalization: Free Trade in the Air* (Report of the Think Tank, Jan. 1991); See Also Alford & Champney, *supra* note 2.  
\(^{302}\) *Ibid*; 2007 *US/EU Agreement, supra* note 1, art 10.8, 10.9, and Ann. 5.
2007 US/EU Agreement advances liberalization of transatlantic air services by adding the
following new provisions:303

✔ Open Skies between the United States and the EU and all its 27 member states;

✔ Broader entry into cooperative marketing arrangements for code sharing, franchising, and leasing;

✔ Creation of a cooperative joint committee to further airline deregulation;

✔ For EU carriers, the ability to route flights between any EU member state and the United States without touching the home country (for example, a German Lufthansa flight can go from Paris to the US, without having to pass through Germany);

✔ US agreement that purchase by an EU carrier or investor of a controlling share in a carrier (passenger or cargo) from third countries that have Open Skies agreements with the U.S. - such as Switzerland, Liechtenstein, members of ECAA, Kenya, or African countries – would not jeopardize the acquired airlines‘ rights to operate in the United States;

✔ Authorization for EU carriers (scheduled and charter, passenger and cargo) to carry certain Fly America traffic except for the transportation funded by the U.S. Department of Defense;304 and

✔ For EU cargo carriers, the ability to route flights between third-party states and the United States without touching the home country, and between the United States and members of the ECAA.

303Alford & Champley, supra note 2 at 2.
304 2007 US/EU Agreement, supra note 1, Annex 3. Under so called 'Fly America' policy, officials or others traveling on behalf of the US government are required to fly on US airlines or on US carrier code-shared flights operated by foreign airlines. See Doganis, supra note 73 at 45.
The following provisions reflect compromise and will need to be reevaluated in the second stage of negotiations:

✗ Investment in U.S. airlines: Restatement of U.S. policy (25 percent cap on voting equity, 25 percent-minus-one-share regulatory cap on non-voting equity). The United States will consider foreign requests to hold larger shares of non-voting equity, including combinations in which the total of voting and non-voting equity exceeds 50 percent;

✗ Guarantees for U.S. investors to participate as minority shareholders in any majority-EU-owned airline (effectively including minority shares of state-owned firms)

1. Transatlantic Common Aviation Area and Second Stage Negotiations.

The 2007 US/EU Agreement obviously advances the liberalization agenda by granting unrestricted access between all US and EU cities to the airlines of all contracting parties, and it provides a basis for a future of closer integration across the Atlantic. From the U.S. perspective, the 2007 US-EU Agreement has been a successful conclusion of its Open Skies bilateral policy, vigorously pursued by the United States since the 1970s. On the other hand, the EU's avowed goal has been to achieve a truly “open” aviation area, with unlimited cabotage rights and elimination of restrictions on foreign investment and ownership on both sides of the Atlantic. 305 The EU authorities have espoused the idea of a Transatlantic Common Aviation Area [TCAA], where the EU and US policies would be “molded to create a single, liberalized North Atlantic common aviation area.” 306 TCAA

305 Ibid. at 2-3.
would provide for unrestricted right of establishment of the US and EU carriers and would contain liberalized airline ownership rules, a liberalized policy with respect to the leasing of aircraft and a harmonized competition/antitrust law regime. In that respect the results of the first stage of negotiations are incomplete as the main points of contention, namely the issues of cabotage and foreign ownership restrictions, have been largely unresolved in the Agreement.

Since the Agreement so apparently favors the United States, it might be asked why the EU negotiators were willing to accept such unbalanced terms on cabotage and meaningless enhancement in foreign investment rights?

First, promise of certain concessions by the US side undoubtedly played some role in bringing EU negotiators back to the table after withdrawal of the previously described DOT proposal. When the U.S. delegation flew to Brussels in January 2007 it confirmed its proposal to partly open U.S. government-funded Fly-America travel to EU carriers, reiterated its support for granting antitrust immunity to U.S. and EU carriers entering into airline alliances, and shifted the dialogue on foreign investment rights from a focus on “control” to a focus on “ownership.” Westra submits that the most decisive, in gaining EU support to finalize the Agreement, was the US proposal to allow EU nationals greater than 50 percent ownership of US airlines, although it excluded traditional majority shareholder control rights and was to be granted on case-by-case

307 Ibid.
309 Westra, supra note 3 at 172.
310 See Section V1.5 on Substantial Ownership and Effective Control.
311 Westra, supra note 3 at 172.
Another motivating factor for the EU negotiators was the expected economic value of even such incomplete transatlantic Open Skies accord. According to the press statement, issued by the EU Commission in March 2007, it was expected that the Agreement would “provide for 34 percent increase in transatlantic air passenger traffic, generate up to $16 billion in economic benefits over five years and create a total of 80,000 new jobs on the two sides of the Atlantic.”

Finally, but perhaps most importantly, the EU negotiators viewed the proposed 2007 Agreement as a first stage - the starting point in a series of aviation agreements with the United States. The 2007 US/EU Agreement reflects this understanding in Article 21, committing the contracting parties to a schedule of further, “second stage negotiations”, to be commenced “not later than 60 days after provisional application of this Agreement.” A detailed list of the items to be discussed during the second stage of negotiations, with a strict timetable and a special Joint Committee to foster and monitor their development, was set out in the Agreement. The issues of priority interest include “further liberalization of traffic rights,” and “additional foreign investment opportunities.” Accordingly, “in the second stage of negotiations […] EU cabotage rights within the United States, along with broader foreign investment control rights, will

312 Ibid at 173.
313 Ibid.
315 Westra, supra note 3 at 173.
317 2007 US/EU Agreement, supra note 1, Arts. 18, 21; see Havel, “Open Skies” supra note 309 at 2.
318 2007 US/EU Agreement, supra note 1, Art 21(a) and (b) respectively.
presumably be issues for discussion.”

The second stage negotiations, which commenced in May 2008, only reminded the EU negotiators that removing ownership and control rules would be extremely difficult in the U.S. Notwithstanding, it should be noted that the Agreement contains an exit or suspension provision, enabling EU member states to suspend any or all of the rights specified in the Agreement if the consensus on a second stage accord cannot be reached within a specified framework. Under the Agreement, it is a binding obligation of the parties to “review their progress towards a second stage agreement” no later than 18 months after negotiations begin (approximately by December 2009), and the suspension right might be invoked if no Stage Two agreement is reached one year later (by the end of 2010).

2. Proposals for breaking a stalemate in the Second Stage of Negotiations.

Instead of concentrating on the disputed issues, various alternative proposals and broader range of strategies should be reviewed, which would eventually enhance freedom of investment and advance a second stage agreement.

One of such proposals includes using the Australia/New Zealand model, which allows freedom of foreign investment in any airlines as long as it is not designated in international transportation (in other words, foreign investors could acquire full interest in the airlines flying only within the US points).

Another suggested approach is to change the conceptual framework so that it can

319 Westra, supra note 3 at 173.
320 HAVEL’S BLOG, supra note 181 ( posted on 4 July 2008)
321 2007 US/EU Agreement, supra note 1, Art. 21.3.
323 See von den Steinen, supra note 317, at 54.
foster mutual consent on both sides of the Atlantic. Erwin von Steinen proposes a new framework of public interest policy based on quality control, termed Quality Control Regulation, which would entail a wider and deeper set of reforms in such areas as environmental protection (including emissions reduction), security and safety standards. The author argues that these issues, while already pursued on international scale, should be reinforced and made more effective by inclusion in the new second stage Agreement, going beyond the form of traditional ATA.

This type of broader approach has been also advocated by the EU authorities. The UK Transport Secretary, Geoff Hoon, recently called on the European Union and the US to “work together to create a safe, sustainable and viable aviation industry to meet today’s economic and environmental challenges.” Mr. Hoon recognized that among the priority items on the US-EU agenda are both the “commitment to complete stage two of the EU-US Open Skies negotiations by June 2010, with the headline objective of liberalising all foreign ownership in airlines to give European and American air carriers a bigger home market and the ability to operate like any other competitive international company,” as well as reaching “an agreement [...] on a clear approach to climate change in aviation, involving new fuel efficiency standards and meaningful global emissions goals.”

On more cautious note, the majority of American commentators agree that achieving airlines' ownership and control liberalization is even less likely following the November 2008 election of President Barack Obama who, as a Democratic Senator and

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324 Ibid. at 44.
325 Ibid.
327 Ibid.
presidential candidate, espoused consistent pro-labor positions, including opposition to changes to US cabotage and ownership and control laws. That does not rule out, according to Goldman, achieving a substantial and mutually beneficial second stage Agreement, focusing on "a substantial expansion of 7th freedom traffic rights; arrangements for mutual recognition of each side's greenhouse gas emissions/cap and trade regimes; resolution of the contentious environmental dispute on regulation of aircraft noise near airports; and the harmonization of transatlantic security rules."329


Following the historic, yet limited 2007 Agreement with the United States, the EU authorities recently negotiated and initialed a new and more far-reaching agreement with Canada.330 This Agreement envisions a progressive removal of all investment and cabotage restrictions between the two sides.331 Such liberalization will proceed in a series of phases, commencing with the same rights as those contained in the 2007 U.S-EU Agreement, then granting Canada seventh-freedom rights for cargo carriage once it raises its foreign investment cap to 49%, and ultimately resulting in rights of full ownership and control of each side's carriers by the other's nationals.332 While there is no definite timetable for each phase, below is a table summarizing the proposed changes in

328 Goldman, supra note 323 at 1-2, HAVEL'S BLOG, supra note 191, “What Is 'Achievable' for the Second Stage?” (posted on 1 May 2009)
329 Goldman, ibid. at 4.
330 Agreement on Air Transport between Canada and the European Community and its Member States, (initialed on 30 November 2008 in London, formal signatures to take place as soon as possible following the authentication of all language versions and the finalization of the relevant internal decision-making procedures) online: <http://ec.europa.eu/transport/air/international_aviation/country_index/doc/canada_final_text_agreement.pdf> [2008 EU/Canada Agreement]
331 HAVEL'S BLOG, supra note 191, “The Future of Foreign Ownership Caps” (posted on 10 Feb. 2009)
332 Ibid.
comparison to the 2007 US-EU Agreement.

Table 1: **COMPARISON OF 2007 US/EU AGREEMENT AND 2008 EU/CANADA AGREEMENT**

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<tr>
<th></th>
<th>2007 US-EU Agreement</th>
<th>2008 EU-Canada Agreement</th>
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| **Regulatory Conversion** | - Article allowing for greater cooperation in the area of airport security, including joint inspections  
- Competition article promoting closer cooperation between the authorities  
- Joint Committee to oversee implementation | - one-stop security and close cooperation  
- mutual recognition of safety standards  
- strong article on environment cooperation  
- innovative trade mechanism allowing for measures to be taken in case of discriminatory practices and unfair treatment  
- Joint Committee to oversee implementation |
| **Traffic Rights**    | Full opening between EU-US, Community designation, 5th, 7th cargo, limited 7th passenger rights for EU airlines. (Art 3)  
Additional rights to be negotiated in second stage negotiations. | Linked to opening up of investment regime (see below)  
First phase: Full opening between EU and Canada. EU airlines can fly from all points in the EU to Canada (Community designation). Right to take cargo between the other party and a third country on services starting or ending in its home country (5th freedom rights).  
Additional rights in the second phase: Right to take cargo between the other party and a third country without connection to its home country (7th freedom rights). Right to take passenger traffic for Canadian airlines between EU Member states if flight starts or ends in Canada (intra-community 5th rights).  
Third phase: Full 5th freedom rights (Right to take traffic from the other party to a third country if the flight starts or ends in Canada for Canadian airlines or in the EU for EU airlines). |

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### Ownership and Control

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<th>Phase</th>
<th>Description</th>
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<tr>
<td>Fourth phase</td>
<td>Full rights, including the right to take traffic between points in the other party.</td>
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<th>Ownership and Control</th>
<th>Fourth phase: Full rights, including the right to take traffic between points in the other party.</th>
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<tr>
<td>Ownership and Control</td>
<td>Gradual opening up of investment and control regime</td>
</tr>
<tr>
<td>EU side reserves the right to bring EU investment by US citizens down to 25% limit in the future. Ongoing negotiations on second stage agreement</td>
<td>First phase: no change of current regimes</td>
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<td></td>
<td>Second phase: Increase to 49% of foreign investment</td>
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<td></td>
<td>Third phase: Right to set up airlines in the territory of other party</td>
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<tr>
<td></td>
<td>Fourth phase: Right to own and to control 100% of airlines of the other Party.</td>
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</table>

Once the 2008 Canada-EU Agreement has been implemented it will be interesting to see what effect, if any, it will have on the ongoing second stage negotiations with the U.S. The proponents of further liberalization argue that the U.S. carriers, like their Canadian counterparts, should benefit from access to foreign capital. 334

In conclusion, while the 2007 US/EU Agreement has tremendous potential for transforming air travel and trade across the Atlantic, its full extent and viability depends on the outcome of the second-stage negotiations. Unfortunately, Hardaway's comment that “[i]t remains to be seen whether Open Skies is the beginning of a wave of liberalization or merely a blip on the radar screen” is still relevant. 335

### PART 3: AIRLINE CONSOLIDATION AND ANTITRUST IN THE OPEN MARKETS.

> “If the aim of transport deregulation and 'Open Skies' is to encourage much greater competition, then competition rules appear to be necessary to ensure that the increased competition is effective and is not undermined by anti-competitive practices or the abuse of dominant market positions.” 336

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334 HAVEL'S BLOG, supra note 332
335 Hardaway, supra note 8 at 28.
336 Doganis, “21st Cent.” supra note 70 at 42.
Both the U.S policy of proliferation of Open Skies agreements and the creation of a single, open European aviation market, have had an enormous significance for the liberalization of air transport industry worldwide. At the same time, as the international regime is becoming more liberalized, the airlines feel more compelled to join forces in order to obtain a stronger and more competitive position. 337 It has been speculated that the most immediate effect of the new Open Skies agreement between the U.S. and the E.U. would be another wave of mega-airline mergers, thus affecting the competitive landscape. 338 Hence, potentially anticompetitive behavior of the competitors requires the oversight of antitrust/competition laws.

There is yet another factor contributing to the web of variables that are affecting the international aviation, namely the industry's response to the economic downturns. It should be noted here that the airline industry is currently facing a worldwide financial crises, brought about by sky-rocketing, record-level fuel prices in the first half of 2008, and global economic recession that has been officially recognized in the second half of the same year. 339 While the recent and unexpected decline in the fuel prices resulted in some relief for the airlines, its effects have been quickly checked by the consumer demand and prices falling across-the-board during the recent months (as of writing this thesis in May 2009). With a projected global airline industry loss of $9 billion for 2009, deteriorating demand, collapsing yields, broken consumer confidence, and pandemic

fears, the prospects for the survival of many airlines are rather grim. It is not surprising that with the drops in traffic and profitability, “airlines are shedding jobs, terminating unprofitable routes and parking passenger jets to make it through the deep worldwide economic recession.”

Understandably, the airline industry is meeting the challenges of the global economy by consolidation and inter-carrier cooperation. Accordingly, the justifications for such trends and resulting anti-competitive concerns will be examined in this last Part of the thesis.

I. AIRLINE MERGERS AND GLOBAL ALLIANCES.

1. Airline Economics: to Consolidate or Cooperate?

The goal of the Open Skies regime, as described in the preceding sections II and III of Part 2, is to afford airlines the opportunity to compete internationally without restrictions on market access, prices and capacity. At the same time it is generally believed that “the process of globalization will inevitably lead to further consolidation of the [airline] industry.”

There are strong economic justifications for the airlines' drive towards consolidation of their business activities, which include: (1) achieving greater economies of scale, scope and density, (2) cost reduction by sharing expenses, joint procurement or consolidating redundant operations; and (3) revenue improvement by reducing the level

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340 IATA forecasts 2009 industry losses of US$9 billion, with an operating loss of US$1.7 billion. This would be the first operating loss since 2003 when the industry recorded an operating loss of US$1.4 billion and a net loss of US$7.5 billion. In comparison, the industry net loss for 2008 was US$10.4 billion, and 2008 operating profit was US$1.5 billion. For 2007, the net profit was US$12.9 billion and operating profit was US$19.7 billion. Ibid.


342 Cheng-Jui Lu, supra note 338 at 54.
of competition wherever possible as markets are liberalized.\footnote{Doganis, “Air. Bus.), supra note 60 at 86-99.} In the airline industry such goals have been pursued either by airline cooperation (in a form of global alliances) or consolidation (through mergers and acquisitions).

A global (or international) airline alliance may be broadly defined as an agreement between two or more airlines operating in a commercial relationship or jointly operating activities in various fields.\footnote{Cheng-Ing Hsu & Hsien-Hung Shih, “Small-world network theory in the study of networks connectivity and efficiency of complementary international airline alliances” (2008) 14:3 J. Air Tran. Mgmt 123.} The precise definition of alliance is difficult just because, as ICAO Air Transport Director noted, “the nature and scope of alliances vary so widely.”\footnote{Iatrou & Oretti, supra note 268 at 2.} The main difference between alliances and mergers is that alliances do not affect legal ownership as every alliance partner remains independent company, whereas mergers lead to creation of a new, single entity.\footnote{Ibid. at 21.}

Since the 1990s airlines have been actively engaged in the process of alliance-making, extending cooperation in the global alliances to levels of integration approaching joint ventures or even mergers. However, many believe that while alliances may have succeeded in increasing traffic and expanding networks, they have not led to sufficient cost reduction and operational synergies.\footnote{Ibid. at 20.} Recent research, conducted by Iatrou and Aldamari, has confirmed that as the airline industry matures in terms of markets and players, there is increasing evidence that revenue gain has reached its ceiling and current priorities focus on cost-savings through efficiencies.\footnote{Ibid.}

Thus driven by economic efficiency, airlines strive towards greater consolidation;

\footnote{343 Doganis, “Air. Bus.”, supra note 60 at 86-99.}  
\footnote{345 Iatrou & Oretti, supra note 268 at 2.}  
\footnote{346 Ibid at 21.}  
\footnote{347 Ibid. at 20.}  
\footnote{348 Ibid.}
from this perspective, alliances, even with global dimension, are often seen as a second-best choice to straightforward merger. As pointed out by Iatrou and Oretti, “the attractiveness of mergers lies precisely in the promise they hold, that is to deliver the efficiency that may result from commercially powerful and financially viable airlines as well as from a far more competitive and supple global airline industry.”

Other authors, however, negate the beneficial effect of mergers by pointing to their anticompetitive implications. Study conducted by Brueckner and Pels in 2003, in wake of the first major cross-border European merger between Air France and KLM, explored its effects followed by a consolidation of two competing international alliances. The results of the analysis show that, although the airlines benefit through higher profits, the consumers have been harmed through reduced competition and increased fares, and the creation of the mega alliance have lead to a new collusion on transatlantic inter-hub routes that were previously served by competing US and European carriers from different alliances.

Irrespective of the arguments as to pros and cons of consolidation, in most other industries the economic pressures towards larger size, wider marketing reach and globalization have resulted in mergers and acquisitions of companies domestically and internationally. But the question of whether to cooperate within global alliance network or consolidate via corporate merger with a foreign carrier is not a simple matter of choice for the airlines in the transatlantic sector. Although the merger of Air France and KLM in

349 *Ibid* at 20.
351 *Ibid* at 40–41.
2004 was a landmark event as the world's first cross-border merger of two major carriers, it was only possible within the framework established by the European Union's abolition of nationality restrictions and creation of the “Community ownership.”

Foreign ownership and control restrictions, still persisting in the domestic and international air transport regulatory regimes, have limited and distorted the form of cross border airline cooperation. As discussed earlier in section III of Part 2, the clause in the 2007 US/EU Agreement, requiring that the airlines be 'substantially owned and effectively controlled' by nationals of their own state (in the case of the US airlines) or any EU Member State (in the case of the Community airlines), constitutes effective and still impregnable barrier to transatlantic airline mergers and acquisitions. For this reason, the remainder of the following analysis shall be devoted to the development and legal consequences of the global alliances as they constitute the only, currently viable, form of international cooperation between the US and the Community airlines.

2. **Creation of Global Airline Alliances.**

Airline alliances have developed from a wide range of inter-airline agreements, most of which are commercial in nature and include cooperation in such areas as:

- code-sharing - allows one carrier to market its product as another's by sharing their two-letter designator codes in the computer reservations system (CRSs), so that an interline flight deceitfully appears to be an on-line connection. This results in the advantage of offering pseudo on-line connections and the potential to draw greater

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353 Iatrou & Oretti, *supra* note 268 at 86.
354 As presented in detail in Section V.1.5.2 above, the EU replaced 'nationality' ownership and control with 'Community' ownership and control, and accordingly, the merger between KLM and AF was between two “Community” carriers.
traffic as a result of having one carrier listed in the CRSs, on timetables and in advertisements, rather than two connecting carriers;

• blocked space arrangements - leasing or reservation of a specific number of seats by one airline for its passengers to be flown in aircraft operated by another airline;

• frequent flyer program alliances - allow passengers to earn points on one airline and fly on another. This benefit can be exchanged between carriers on a cent-per-mile-redeemed or reciprocal basis;

• pooling agreements - divide revenue derived from the joint operation of a route by two or more carriers on the basis of a predetermined formula;

• joint fare agreements - enable carriers to agree on the through-connecting interline fare, which is usually lower than the sum of their respective point-to-point fares;

• dry and wet leases - former is aircraft lease and latter aircraft and crew lease;

• sharing various airport functions, such as ticketing, boarding, catering, cleaning, fuel, maintenance, baggage handling, joint sales offices and telephone centers, and e-commerce joint ventures; and

• revenue equity ownership. 356

Different configurations of the above described forms of cooperation may lead to different forms of alliances, from marketing alliances, based on purely commercial arrangements to strategic alliances, which resemble a joint-venture, where “the partners co-mingle their assets in order to pursue a single or joint set of business objectives.” 357

Moreover, airline cooperation in the alliance may be confined to city-pairs, or expanded

356 Dempsey, “Carving the World” supra note at 249, 252-53; also see Doganis, Air. Bus., supra note 60 at 78-80.

357 Doganis, supra note 73 at 65., Doganis, Air. Bus., supra note 60 at 79.
to reach regionally and globally. The most significant alliances in terms of network expansion and achieving economies of scales are those with a global scope, linking two or more large airlines operating in geographically distinct markets, ideally on different continents. Global alliances usually involve code-sharing on a large number of routes, as well as schedule coordination, joint sales offices and ground handling, combined frequent flyer programs, joint maintenance activities, and may also include mutual equity stakes.

The number of new alliance agreements has increased every year since 2001, and the top three global alliance groups, Star Alliance, SkyTeam and oneworld, collectively account for over half of the world's passenger traffic. The main features of the major global alliances, as of this writing, are compared on Table 2.

358 Dempsey, “Carving the World” supra note 39 at 249.
359 Doganis, “Air. Bus.,” supra note 60 at 82, Iatrou&Oretti, supra note 268 at 68.
360 Doganis ibid.
361 Established in 1987, Member Airlines: Air Canada, Air China, Air New Zealand, ANA, Asiana Airlines, Austrian, bmi, EgyptAir, LOT Polish Airlines, Lufthansa, Scandinavian Airlines, Shanghai Airlines, Singapore Airlines, South African Airways, Spanair, SWISS, TAP Portugal, THAI, Turkish Airlines, United and US Airways. In addition 3 Regional member carriers Adria Airways (Slovenia), Blue1 (Finland) and Croatia Airlines enhance the global network. Source: Star Alliance, Facts & Figures, online: http://www.staralliance.com/en/press/facts_figures/index.html (May 2009)
364 Ibid.
Table 2: COMPARISON OF THE MAJOR AIRLINE ALLIANCES (2009)

<table>
<thead>
<tr>
<th>Alliance</th>
<th>Star Alliance</th>
<th>Sky Team</th>
<th>oneworld</th>
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<tbody>
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<td>Members</td>
<td>21 (22 in Fall 2009)</td>
<td>11 (10 in Fall 2009)</td>
<td>10</td>
</tr>
<tr>
<td>Countries</td>
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<td>169</td>
<td>142</td>
</tr>
<tr>
<td>Destinations</td>
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<td>905</td>
<td>727</td>
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<tr>
<td>Daily Departures</td>
<td>17,000</td>
<td>16,786</td>
<td>8,368</td>
</tr>
<tr>
<td>Annual Passengers (million)</td>
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<td>465</td>
<td>329.8</td>
</tr>
<tr>
<td>Employees</td>
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<td>356,998</td>
<td>295,532</td>
</tr>
<tr>
<td>Aircraft</td>
<td>3,332</td>
<td>2,496</td>
<td>2,629</td>
</tr>
</tbody>
</table>

3. Evaluation of benefits and drawbacks.

With record-high fuel prices and potentially less consumer spending, airlines strive to cooperate to eliminate excess seat capacity and improve revenue management. From the airlines' perspective, the larger the network, the greater are its economies of scale and its ability to command a greater market share at higher yields.\(^{365}\) Alliances, therefore, provide opportunities for the allied airlines to extend their networks, increase passenger traffic and consequently improve profitability.\(^{366}\)

For consumers, the costs and benefits of the worldwide network of airline alliances are arguable. While proponents of globalization allege significant consumer benefits, the critics point to less competition and higher fares in alliance-dominated non-stop city-pairs.\(^{367}\)


The consumer benefits derived from airline alliances include (1) one-stop travel

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366 Hsu & Shih, supra 345 at 123.
367 Dempsey, ibid, at 250
purchase services, (2) joint frequent flyer benefits, (3) reciprocal airport lounge access, (4) seamless connectivity of passengers and luggage, and (5) coordinated arrival and departure scheduling. According to Reitzes and Moss, codesharing arrangements and other alliance functions facilitate network effects by, *inter alia*, coordination of schedules, route expansion, and increased flight frequency that collectively lead to the increased traveler convenience, access to low volume markets, and loyalty to particular carriers or alliances.

There is a growing body of both theoretical and empirical literature documenting the welfare benefits of the airline alliances. For example, Brueckner presents a theoretical model demonstrating how international alliances are likely to lead to lower prices and increased traffic on interline routes (ie. those linking the networks of two alliance partners). The empirical study, conducted among Star Alliance carriers, found that alliance membership and codesharing lead to notable reductions in interline fare, further magnified by antitrust immunity. According to the author, when combined, these three forms of cooperation lead to a substantial 27 percent reduction in interline fares.

### 3.2. Anticompetitive Concerns

According to Doganis, alliances have an inherent risk of becoming anti-
competitive irrespective of whether their scope is route-specific, regional or global.\textsuperscript{374} Such anti-competitive behavior may result in: (1) elimination or reduction of competition in overlapping gateway-to-gateway markets; (2) foreclosure of rival access to alliance-dominated hubs; and (3) insufficiency of end-to-end competition between alliances, also known as "interalliance" or "systems" competition.\textsuperscript{375}

While previously described network effects foster operational and costs efficiencies for the airlines, they may also hamper competition by creating dominance at certain hubs, especially when coupled with strategic consolidation that expands the size of the network.\textsuperscript{376} For instance, the dominant carrier may stifle competition by changing timings of its own flights, increasing frequencies or selective fare reductions, thus making the new entrant's services less attractive. As explained by Doganis, “slot dominance in itself creates a barrier to entry for new carriers or for those withing to start competing on an existing route, even if those dominating the slots have no malign intentions.”\textsuperscript{377}

In addition, the larger alliances may exclude independent airlines through carefully crafted exclusive use agreements, denying them the ability to participate in interline movement and resulting in market segmentation.\textsuperscript{378} Dempsey explains that historically, airlines have transferred passengers and their baggage between carriers- a process known as interlining. Under regulation, U.S. carriers were required to interline passengers between them. Today they no longer are, with the result that large, dominant

\begin{footnotesize}
374 Doganis, “Air. Bus.,” \textit{supra} note 60 at 105.
375 Reitzes & Moss, \textit{supra} note 370 at 295-96
376 \textit{Ibid.} at 299.
377 Doganis, “Air. Bus.,” \textit{supra} note 60 at 106.
378 Dempsey “Carving the World”\textit{supra} note 39 at 250 (“Though airlines have created seamless connectivity within their alliances, they have erected high and impenetrable walls outside them.”)
\end{footnotesize}
carriers often refuse to facilitate connections with competing non-affiliated carriers. This results in less competition and higher fares in alliance-dominated non-stop city-pairs.

The above concerns resulted in the involvement of the antitrust authorities on both sides of the Atlantic, often imposing certain conditions on the approval of these alliances. Such conditions usually include the surrender of slots to potential competitors, as will be discussed in Section II below. On the other hand, according to recently published study by Gayle, the three-way code share alliance between Delta/Continental/Northwest, which received approval from the U.S. Department of Transportation in 2003, did not appear to facilitate collusion on price or traffic levels in the carriers' overlapping markets. Gayle's conclusion, which was reached after a empirical analysis of both traditional and virtual code-sharing, supports the DOT's decision to approve the alliance despite the fact it involved an unprecedented number of overlapping routes.

3.3. **The Airlines Perspective**

As already explained in Section I, forming alliances seems inevitable in the current international airline regime, because global alliances actually enable airlines with different nationalities to behave as a single economic entity without going through the process of merger and acquisition. 

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380 *Ibid.* at 250


airlines to enter alliance are similar to the incentives flowing from adoption of a hub-and-spoke network, *to wit* reduction of costs associated with economies of scale.\(^{384}\) Many industry analysts and economists argue that, on balance, positive effects of alliances outweigh the negative, anticompetitive effects.\(^{385}\)

While pointing to the economic efficiencies of the alliances, airlines are anxious to persuade the public that their marketing agreements, especially those cemented by equity investments, reveal a commitment to a long-term relationships.\(^{386}\) Unfortunately, the empirical data suggests a poor record of success; airline alliances have been found unstable and have often lasted relatively short times, as “ephemeral arrangements of convenience that may be displaced by fresh marketing strategies with the new travel season.”\(^{387}\) In the mid-1990s it was estimated that less than one-third of the international alliances in the airline industry had been successful.\(^{388}\) Research by Andersen Consulting concluded that alliances in general misfire because firms fail to recognize the following five 'truths':

- alliances are more like diplomatic and pragmatic pairings than exclusive bilateral marriages;
- integration for alliances is very different from that of mergers;
- not one governance model fits all alliances as goals, duration and resource contribution and values may differ dramatically;
- alliance expertise needs to be spread throughout the organization, not just based on a small cadre of experts; and finally
- alliance performance can be measured, including intangibles of trust and culture.\(^{389}\)

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\(^{384}\) Pels, *supra* note 38 at 3.


\(^{386}\) Havel, “In search” *supra* note 126 at 116.


\(^{388}\) *Ibid.*

\(^{389}\) Kleyman & Seristo, *supra* note 124 at 180
Despite well grounded criticisms, proliferation of global alliances has become essential for increasing number of carriers, desiring to strengthen their competitive advantage, extend their networks, access new markets and improve revenues. 390 Kleyman & Seristo summarized the estimates presented by the airlines and consultants concerning the expected financial benefits of joining alliance and concluded that:

• in broad alliance arrangements revenue enhancement varied between 1 and 7 percent;
• expected cost reduction was typically between 1 and 2 percent;
• expected profit improvement was around 10 percent. 391

II. EXTRATERRITORIALITY, ANTITRUST LAWS AND IMMUNITY.

Cooperation between the airlines in the global alliances is often scrutinized and limited not only by the antitrust or competition authorities of their own home states, but also by those of other countries, regions or international institutions, imposing their own competition law regimes. Consequently, this section shall examine the antitrust and competition laws that are applicable to the airlines competing in the transatlantic market, in particular by looking at the extraterritorial effects of the antitrust immunity granted to the airline alliances.

1. Extraterritoriality in the Airline Industry.

As explained in preceding sections, the airlines often enter into international joint ventures and other cooperative agreements in order to rationalize their operations, increase their market coverage, and strengthen their competitive position in the marketplace. But as they do so, they may face different competition regulations and

390 Hsu & Shih, supra note 345 at 126.
391 Kleyman & Seristo, supra note 124 at 150-51.
policies from individual states or regional authorities. A proposed code-sharing or an equity alliance may be subject to a series of different regulations by national authorities and regional or international competition regimes due to the “extraterritorial application of competition/antitrust law.” In accordance with the effects doctrine the antitrust or competition authorities may apply their own competition laws to certain international economic activities that have a negative impact on their domestic/regional market even if they are conducted by foreign entities and/or such conduct occurs entirely within the foreign market.

In the EU-US context, two separate regimes, namely, EU law and policy on the one hand and US law and policy on the other, govern the behavior of alliances which have an "EU-US dimension." Airline conduct can be characterized as having an EU-US dimension when it affects air transport in all of the following markets: the EU domestic market, the US domestic market and the transatlantic market connecting the two domestic markets.

Conflicts and consistencies can easily arise when the airlines are forced to satisfy different competition laws, administered by different set of authorities. While the US and EU competition regimes share certain similar anti-competitive practices, they have different ideologies and consequently, have often issued divergent remedies in cases of antitrust immunity for transatlantic airlines alliances.

393 Ibid, see also Cheng-Jui Lu, supra note 338 at 71-72.
394 Cheng-Jui Lu, ibid. at 71.
395 ICC Policy Statement, supra note 393.
396 Ibid.
397 Cheng-Jui Lu, supra note 338, also see Doganis “Air. Bus.” supra note 60 at 117.

The antitrust laws have been the cornerstone of commercial and industrial developments in the United States since the late 19th Century.\textsuperscript{398} Enshrining the free market philosophy, the first antitrust statute, the \textit{Sherman Act of 1890},\textsuperscript{399} prohibited both cartels (‘trusts’) and conduct calculated to create monopolies, in order to preserve the competitive forces in the marketplace.\textsuperscript{400}

The antitrust laws applicable to the airline industry include, principally, the antitrust laws (the Sherman Act and the Clayton Act\textsuperscript{401}), as well as the unfair and deceptive competition laws (embedded in the Federal Aviation Act).\textsuperscript{402} Moreover, the ADA of 1978, which amended the FAA of 1958, explicitly provides that deregulation was not designed to condone unfair methods of competition, or deceptive, anticompetitive and monopolistic practices.\textsuperscript{403}

\textsection 1 of the Sherman Act prohibits all conduct in restraint of trade,\textsuperscript{404} whereas \textsection 2 proscribes monopolies and attempts to monopolize, combine or conspire to monopolize trade or commerce.\textsuperscript{405} Certain categories of behavior are so plainly anticompetitive that

\begin{itemize}
\item \textsuperscript{398} Barlow, \textit{supra} note 15 at 41.
\item \textsuperscript{399} \textit{The Sherman Antitrust Act} (2 July 1890) 26 Stat. 209, codified at 15 U.S.C. \textsection 1–7.\textsuperscript{[Sherman Act]}
\item \textsuperscript{400} Ibid. Paul Rand Dixon, President Kennedy’s FTC Chairman, referred to US antitrust laws as the \textit{Magna Carta} of capitalism, ensuring economic and personal freedom and the necessary complement to \textit{laissez-faire} capitalism and the teachings of Adam Smith. See Charles Mueller, “Antitrust Law: the \textit{Magna Carta} of the free enterprise system,” 27 Antitrust L & Econ. Rev. (1996)
\item \textsuperscript{402} The Congress also enacted the \textit{Robinson-Patman Act of 1936}, which applies to the sale of goods, not services, and the \textit{Federal Trade Commission Act of 1914}, which specifically excludes air carriers from its reach. See Dempsey & Gesell, “Airline Management”, \textit{supra} note 41 at 687.
\item \textsuperscript{403} Dempsey & Gesell, \textit{ibid.} at 687.
\item \textsuperscript{404} Sherman Act, \textit{supra} note 400, \textsection 1 Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is declared to be illegal.
\item \textsuperscript{405} Sherman Act, \textit{supra} note 400, \textsection 2: Every person who shall monopolize, or attempt to monopolize, or combine or conspire with any other person or persons, to monopolize any part of the trade or commerce among the several States, or with foreign nations, shall be deemed guilty of a felony, and, on conviction thereof, shall be punished by fine not exceeding $10,000,000 if a corporation, or, if any other person,
they have been deemed to be *per se* violations of § 1. All practices falling within this category, including price fixing and market sharing arrangements, are presumed illegal even if they have no actual anticompetitive consequences. All other anti-competitive conduct is subject to the *rule of reason*, finding violation only if the purpose and effect of that conduct results in 'unreasonable or undue restraint of trade'.

§ 7 of the Clayton Act prohibits mergers that may substantially lessen competition or create a monopoly. § 7a of the Clayton Act, often called the Hart-Scott-Rodino (HSR) Act, requires prior notification of large airline mergers to DOJ (or, in case of other industries, to both the FTC and DOJ) The standards used by DOJ to evaluate the economic effects of mergers can be found in “Horizontal Merger Guidelines” issued jointly with FTC on April 2, 1992. The underlying theme of the Guidelines is that “mergers should not be permitted to create or enhance market power or to facilitate its exercise.”

3. **E.U. Competition Laws.**

The basic EC competition laws are contained in Articles 81(ex article 85), 82 (ex 86), 86 (ex 90), and 88 to 90 (ex 92 to 94) of EC Treaty and the EC Merger Regulation.

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$350,000, or by imprisonment not exceeding three years, or by both said punishments, in the discretion of the court.

406 Barlow, supra note 15 at 47.

407 Ibid, Dempsey & Gesell, “Air Commerce”, supra note 8 at 270.

408 Dempsey & Gesell, *ibid.* at 272, Barlow, *ibid.* at 44. The doctrine was first announced in *Standard Oil Co of NJ v. United States*, 221 US 1, 64-65 (1911), where the inquiry was directed to the question of whether the challenged contracts are 'unreasonably restrictive of competitive conditions.' *ibid* at 54-55.


410 *Ibid.*, §0.1

Article 81(1) EC prohibits all agreements that “may affect trade between member states and which have as their object or result the prevention, restriction or distortion of competition within the Common Market.” Such practices as price fixing and market sharing agreements are 'in particular' prohibited and automatically void, as thus equivalent to *per se* violations in the United States. 412

Article 82 EC prohibits the abuse of a dominant position within and affecting the internal market.413 Unlike art 81 violations, abuse of dominant power under article 82 cannot be exempted.414 In addition, article 86 prohibits Member States from granting special or exclusive rights that enact or maintain in force any measures that are contrary to EC law, and articles 88 to 90 prohibit state aid that may distort competition. Finally, the EC Merger Regulation prevents the creation or strengthening of a dominant position.415


4.1 United States.

Airline alliance agreements that are in restraint of competition may violate §1 of the Sherman Act, as well as §2 when the alliance, or one or more of its members, acquire a monopoly at certain airports (hubs) or over routes. 416 Nevertheless, since the international air transport in the United States has long been considered to be in 'public

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412 Article 81(2) EC. See Dempsey, “European” supra note 59 at 16.
413 Article 82 EC states: “Any abuse by one or more undertakings of a dominant position within a common market or in a substantial part of it shall be prohibited as incompatible with the common market in so far as it may affect trade between Member States.”
415 See Cheng-Jui Lu, supra note 338 at 88.
416 Cheng-Jui Lu, supra note 338 at 192.
interest,' international airline alliances may be exempted from the application of antitrust laws under the grant of antitrust immunity.\textsuperscript{417} Such immunity allows for the deepest level of cooperation, enabling the airlines to avoid the foreign ownership restrictions, jointly set prices and allocate capacity on those international routes covered by the immunity grant, and, in effect, act as one entity.\textsuperscript{418}

While the Department of Justice (DOJ) has primary responsibility for enforcing the antitrust laws in the United States, also in the transportation industry, jurisdiction over 'unfair and deceptive' practices by the airlines resides in the Department of Transportation (DOT).\textsuperscript{419} This authority has allowed the DOT to examine and approve inter-carrier agreements, including global alliances. DOT which may exempt an agreement, or entire alliance from the application of antitrust laws, when “public interest” so requires and the agreement, if anticompetitive, is nonetheless “necessary to achieve important public benefits” and the need “cannot be achieved by reasonably available alternatives that are materially less anticompetitive.”\textsuperscript{420} On this basis the industry has enjoyed numerous grants of immunity for market alliances between domestic and foreign airlines, approved by DOT since the early 1990s.\textsuperscript{421} In contrast, domestic code-sharing agreements could never receive such antitrust immunity.\textsuperscript{422}

In addition, the U.S. government has used antitrust immunity as a carrot to

\begin{footnotes}
\footnotetext{417}{Reitzes & Moss at 303, Cheng-Jui Lu, \textit{ibid.} at 192.}
\footnotetext{418}{See Reitzes & Moss, \textit{ibid.} at 303-304.}
\footnotetext{419}{Dempsey & Gesell, “Air Commerce” \textit{supra} note 8 at 273., Dempsey & Gesell, “Airline Management” \textit{supra} note 41 at 689 (Every other industry in the US economy is subject to the oversight of the Federal Trading Commission [FTC], established in 1914 to investigate and prohibit “unfair methods of competition.” Airlines are not; nor are they subject to the deceptive practices regulation of the individual states, under the broad construction of the preemption provision of the ADA of 1978. )}
\footnotetext{420}{49 U.S.C. §41309(b) (2002), see Dempsey & Gesell, “Air Commerce” \textit{supra} note 8 at 255.}
\footnotetext{421}{Reitzes & Moss at 303-304}
\footnotetext{422}{\textit{Ibid} at 329.}
\end{footnotes}
promote international aviation liberalization, by making a grant of immunity conditional on the existence of an Open Skies agreement with the foreign carrier's home country.\textsuperscript{423} This approach stemmed from the U.S. government's belief that liberalization of the international regime was enough to safeguard adequate competition.\textsuperscript{424} The DOT approved the first immunized alliance in 1992, between Northwest and KLM (Wings), after the Netherlands entered into first true Open Skies bilateral agreement with the United States. Similarly, DOT's approval of immunity for Star Alliance followed Germany's entry into an Open Skies agreement in 1996.\textsuperscript{425} In fact, out of the three major alliances, the only one that has not yet been 'immunized' by DOT is BA/AA “oneworld," largely due to the absence of an "Open Skies " agreement with the United Kingdom (as well as the unwillingness of the carriers to surrender some of their Heathrow slots to competitors).\textsuperscript{426} Now, since the UK is one of the signatories of the 2007 US/EU Agreement, it is expected that the oneworld's application for antitrust immunity, currently pending before DOT, may finally be approved.\textsuperscript{427}

In May 2008 SkyTeam alliance partners received expanded immunity allowing them to "coordinate their transatlantic fares, services and capacity as if they were a single carrier." The DOT also clarified that the approval is unrelated to Delta's and Northwest's merger plans, which are subject to a separate review.\textsuperscript{428}

Most recently, on July 10, 2009, DOT granted final approval for antitrust

\begin{footnotes}
\item[423] Ibid. at 304-305.
\item[424] Doganis, “Air. Bus.”, supra note 60 at 112.
\item[425] Ibid.
\item[426] HAVEL'S BLOG, supra note 191, "Slots and the Ongoing oneworld Application" (posted on 2 Feb. 2009)
\item[427] Ibid.
\end{footnotes}
immunity to Continental Airlines for its participation in the Star Alliance, and approved a new joint venture among four of the alliance’s members (Air Canada, Lufthansa, United and Continental) to be called Atlantic Plus-Plus. Under the venture, the carriers will jointly arrange capacity, sales and marketing, as well as share revenues in international markets. DOT concluded that granting antitrust immunity to Continental to join the alliance and approving the joint venture was in the public interest because it would support increased levels of service in international markets served by the carriers, give consumers more travel options, shorter travel times, and reduce fares. In addition, important consideration in the DOT's decision was the fact that the U.S. has Open Skies agreements with all of the home countries of the carriers involved.

4.2 European Union

Since May 2004 the European Commission has enhanced enforcement powers to review and apply the EC competition rules to air transport between EU and third countries, enabling it to examine the impact of global alliances on all routes that may affect trade between the Member States, without having to separate procedurally the intra-Community from the third country routes. Similarly, this also applies to the Commission's assessment of aviation mergers under the EC Merger Regulation, which does not make distinction between the intra-Community and air traffic between the EU

430 Ibid.
431 Ibid.
and third countries. 433

The Commission may grant negative clearances, declaring that a particular conduct does not fall under definition of Article 81(1) EC, and if it does, the Commission may still grant an exemption under Article 81(3), but only if such conduct has beneficial effect for the economy 434 as well as for the consumers,435 and as long as the resulting restrictions on competition are indispensable and do not lead to the elimination of competition in the substantial part of the products in question.436 Such exemption must be granted prior to the intended practice and it necessarily involves weighing of overall benefits against overall anti-competitive effects, in principle market by market.437

In comparison with the DOT's policy of granting antitrust immunity, the Commission's role in the airline industry can be described as more interventionist. 438 In its decisions the Commission has espoused a general belief that alliances or mergers result in a significant reduction of competition in the relevant markets, and accordingly, the merged or partner airlines are forced to give up airport slots and, in some cases, route licenses to encourage and facilitate entrance of the new competing carriers.439 Unlike the U.S. DOT, the Commission has not considered the existence of the Open Skies bilateral, or the liberalized single European market, as a sufficient assurance of competition. 440 The Commission has persisted in its approach of using slot surrender as a regulatory tool with

433Ibid.
434 'contributes to improving the production or distribution of goods or to promoting technical or economic progress 'Ibid, Art 81(3)EC.
435 'allowing consumers a fair share of the resulting benefits' Ibid.
436 Ibid.
437 Faull & Nikpay, supra note 146 at 1585; Also See Pace, supra note 415 at 75-94 for in depth analysis of the Article 81 EC.
438 Doganis, supra note 70 at 112.
439 Doganis, ibid. at 112.
440 Ibid.
regards to the approval of global alliances. For instance, its 1998 approvals of British Airways-American Airlines (BA-AA) alliance, and the Lufthansa-United Airlines alliance were conditioned on release of the substantial amount of slots without compensation. In addition, alliance partners were required either to refrain from pooling their frequent-flyer programs or to allow other airlines to participate in them.  

In summary, the current situation where the US and Community airlines have to satisfy different competition rules and authorities in their own countries, as well as those of the European Union, results in confusion and redundant costs for all the involved parties. While it is clearly difficult to harmonize the competition rules for air transport in all the individual countries, such convergence should be one of the top priority items during the ongoing second round of negotiations between the US and EU.

CONCLUSION.

The goal of this thesis was to present a current air transport regime between the United States and the members of the European Union, with the 2007 US/EU Open Skies Agreement as its most recent representation, and to analyze the impediments to the creation of a truly open transatlantic aviation area.

The undertaken analysis revealed the interlocking web of relationships between the deregulation or liberalization of the air transport regimes, both domestic and international, and the extent of antitrust or competition laws affecting the behavior of the airlines competing in the transatlantic market for commercial air services. In addition, extra-legal factors contributing to the complexity of the legal analysis were considered, such as the relationship between the aviation market and the global economy, influence of

441 Ibid. at 112-114.
protectionist sentiments, and interplay between the domestic and international policy considerations.

The legal analysis began in PART 1 with comparison of the processes that led to deregulation of airlines at both sides of the Atlantic. Section I presented the developments in the United States, as it was the first country in the world to deregulate its domestic air transportation by removing all economic controls over the airlines' entry and operation in the market. Across the Atlantic, the Member States of the European Union adopted a different approach – that of gradual, but multilateral liberalization of air transport to create a single European market, which was presented in section II.

The EU liberalization has gone further than the US deregulation in that it adopted a multilateral approach, affecting not only a single state but a whole region of all the member states of the European Union, and which has been even further extended to other non-EU countries with the creation of the European Common Aviation Area. The ECAA Agreement, creating the intra-European open skies, was revolutionary as it not only removed all capacity and price controls but also authorized open and unrestricted market access to any European routes for all signatory states' airlines. It is significant that the single European aviation market was not accomplished by 'de-nationalization' of European airlines, but rather by replacing the traditional nationality requirements with the 'Community ownership.' This approach effectively removed any cabotage concerns among the Member states and explicitly allowed cross-border majority ownership, enabling the EU nationals or companies to freely operate, set up or buy an airline in any other EU Member state.
In PART 2 the analysis was undertaken at the international level, first by examining the foundations and evolution of international air transport regime in Section I, then in section II, by comparison of differences between major types of bilateral agreements. In section III, the detailed analysis of the most recent 2007 US/EU Agreement traced the removal of regulatory restrictions in the areas of market access, pricing and capacity. Furthermore, the hotly debated issues of foreign ownership and cabotage restrictions were examined both in section III, in the context of the 2007 Agreement, and as challenges to achieving a fully open Transatlantic Aviation Area in section IV.

It was demonstrated that, in spite of the U.S. government's avowed policy of Open Skies, all Air Transport Agreements entered into by the United States to date, including the 2007 US/EU Agreement, contain ownership and control clauses. It was also presented that the U.S. insistence on such foreign ownership limitations, along with the prohibition of cabotage, has hindered the airlines' access of to foreign capital and effectively prevented any possibility of cross-border mergers and acquisitions in the transatlantic aviation market. The mergers between the airlines of the EU member states are only possible within the framework established by the European Union's abolition of nationality restrictions and creation of the “Community ownership.” For this reason, the formation of global alliances constitutes the only, currently viable, form of cross-border cooperation between the US and the Community airlines.

Accordingly, after defining the legal constraints on the operation of the transatlantic air services, this thesis turned in PART 3 to these very operations, as
conducted by the airlines and controlled by the governments. Increased trends of cooperation in the global airline alliance networks and desire for further consolidation through mergers, were presented in section I from both perspectives - of the airline industry and the affected consumers. The link to the consolidation in the airline industry was further drawn through a consideration of U.S. antitrust regulation and E.U competition law, both of which provide a framework for acceptable airline business practices. The example of antitrust immunity grants for global alliances illustrated the basic principles of antitrust laws and their practical application to current developments in the international airline business.

In conclusion, the 2007 US/EU Agreement obviously advances the liberalization agenda by granting unrestricted access between all US and EU cities to the airlines of all contracting parties, and it provides a basis for a future of closer integration across the Atlantic. While the precise nature of the future transatlantic aviation regime has not yet been decided, the immediate consequences of the 2007 US/EU Agreement are already felt. Removal of the restrictions on market access has apparently resulted in lower fares, new routes and more direct services between the Old and New Continents.

At the same time, elimination of foreign ownership and cabotage restrictions, as the remaining barriers to a truly open transatlantic aviation area, will be a challenging and delicate task, one that requires innovative approaches on both domestic and international levels. It is certainly not an impossible task, as ultimately, this author agrees with Abeyratne that, when all is said and done, “every argument against Open Skies is an argument in favor of protecting some airline or other against competition.”

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