

***"INTRODUCING FORMAL OWNERSHIP  
AND LEASING RULES FOR SLOTS"***

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***How to Make Slot Markets Work***

**by**

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## INTRODUCTION

Airport slot policy in the European Union remains controversial. Today's system, despite years of dedicated effort, may thus still suffer from inherent flaws. This paper explores the idea of a different formal approach to slot ownership (as well as leasing and sub-leasing) designed to simplify and, arguably, deregulate the commercial position of slots. The idea seems obvious, so it may well have come up before and been rejected for reasons that our discussion may quickly clarify. In the spirit of raising questions to stimulate debate, this paper presents or discusses:

- ◆ *The Problem*
- ◆ *A Proposed Solution*
- ◆ *Pros and Cons from the Standpoint of Key Stakeholders*
- ◆ *Concluding Observations: Issues of Transition*

### I. The Problem

I'll try to name the problem by way of offering you six propositions:

1. *A slot is a time-specified reservation of airport capacity.*
2. *For a commercial operator, such a reservation is a means of production.*
3. *When held recurrently across time slots acquire property attributes.*  
[Requiring an airline to surrender such slots thus constitutes a "taking."]
4. *Under current regulation, slot property value is difficult to realise. [EU "transfer"restrictions hinder if not forbid buying and selling.]*
5. *Such slot market as exists is essentially a **secondary market**; that is, financial transactions tend not to occur between suppliers and users.*  
[Primary slot rights, particularly in the congested markets, are allocated by a Slot Coordinator rather than being market-determined by transactions between suppliers (the airports) and users (the aircraft operators).]
6. *Deregulation (meaning here essential reliance on market forces to stimulate supply rather than using administrative allocations to distribute it) will not succeed without direct participation of producers in buying and selling.*

Thus, even if transfer restrictions on users were removed, as long as the EU defines a slot as a free entitlement to which the user retains title if he meets minimum use conditions, reforms of the type we shall be discussing are unlikely to work.<sup>1</sup>

## II. A Proposed Solution: Airport Ownership/Airline Leasing (Sub-Leasing)

Consistent with other international and European laws (including competition law), the European Union should define slot rights **not** as public entitlements but as private leases. Capacity *per se* would thus be owned by the airport, and airports would charge for each slot reservation. Slot users would, however, be free to make contracts of varying terms for leasing such reservations and NOT be constrained by regulation, as is now the case, from subletting slots or transferring leases to other users.

Specific elements or aspects of such a regulation might include:

1. **Unbundling of slot fees.** Consistent with user fee rules and precedents, EU airports would be required to publish for each traffic season an unbundled, non-refundable charge for a slot. Subject to appropriate oversight, each airport would be free to set/adjust its "reference slot fee".
2. **The reference slot fee.** Unless adjusted by agreement (see Point 3) this would be levied in full on all operations for which advance reservation was made. As user fee income, slot fees should work to reduce landing fees or overall user charges.
3. **Variations from the reference fee.** Airlines and airports would be free in the case of slot series (Repetitive Flight Plans) to negotiate variations from the basic fee *reflecting the economic value to the respective partner of the capacity commitment*, in a manner compliant with governing transparency and non-discrimination rules. (See also Point 7 below).

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<sup>1</sup> The Commission's new draft regulations not only protect existing grandfathered rights; they essentially create a new class of grandfathers. Each new slot awarded carries the same entitlement conditions.

4. **Principles governing the costing of leases.** As user fees, airport slot fee rates would have to be consistent with prevailing pricing rules imposed by national and international law (e.g. bilateral air services agreements) as adjusted from time to time. In principle, however, lease charges could be set to cover:
  - a) *Investment and debt-service costs.* An airport needing and willing to execute an expansion of capacity would presumably charge higher slot fees; and
  - b) *Fixed costs* (up to a certain point at least).
  
5. **Terms[length] of leases.** A central policy question is whether and how to regulate length of leases. Perpetual leases would be contrary to the spirit of the proposed reform. On the other hand, any specific time limitation will tend to be arbitrary. *As a hypothesis for discussion* it is suggested that: Framework regulation at the European level should set an outer limit [say 20 years] for new lease contracts.
  
6. **Deregulated Subleasing.** As a compensation to airlines for loss of perpetual grandfather rights, subleasing would be deregulated. Operators could sublet slots or even sell leases (unless constrained by the specific terms of individual leases).
  
7. **Open Competition for Primary Leases.** Regulation would require an open and transparent process for initiating or renewing primary leases, i.e. the grant of recurrent capacity from a supplier (airport) to a user (airline). The regulation should, however, be cautious about prescribing exact forms of competition. Auctions may be an advantageous mode for certain cases but not for others. Thus *it might be left open to the parties (lessors and lessees) themselves to decide how to bid the capacity subject to legal principles (standards).* Such principles might include:
  - a) *Timely transparency.* Leases are not final until interested parties have had reasonable opportunity to object or respond with counter offers.
  - b) *Rights of preemption.* Where a formal open auction procedure is not optimal (example: a big user wants a large, long term package), a competitor willing to match scope/performance terms and price should have rights to challenge/preempt the contract.

- c) *Rule of minimum scope.* It may be desirable to give direct oversight authorities power to exempt small and short term leases of capacity, especially at large and/or uncongested airports from bidding rules.
8. **Airport Product Liability.** Since this proposal would give airports new market power, it may be desirable to countervail ensuing risks by establishing product standards and liabilities. Illustratively, concrete penalties might be associated with selling slots you do not have. That is, if an airport with the realistic ability to operate say, 40 effective slots per hour, sells 44 hourly reservations and cascading delay often results, then users have not received the product they paid for. Analogous to denied boarding compensation, procedures might then enable rebates to users. Similarly, market framework regulation might foresee institutional procedures for recovering rents from a congested airport that raises slot fees to underwrite expansion but then reneges on making investments.
9. **Role of the Slot Coordinators.** The Slot Coordinator would no longer be a point of first contact for a slot seeker who would first exhaust sublease possibilities and/or compete for available primary capacity. The Slot Coordinator would, however, exercise at least two vital functions: 1) He would oversee slot and runway policy at the airport(s) under his jurisdiction, specifically approving or recommending (to higher authority) disapproval/modification of capacity plans; 2) he would also closely monitor conditions of market access. Operators who perceived denial of fair and equal opportunity to compete would file appeals with the Slot Coordinator as a point of first review.
10. **Overriding Position of Competition Law.** Just as provided in existing and draft EU Slot Regulations, the proposed reform would in no way constrain application of existing and future rules on competition. That is, consistent with the facts of a specific situation, authorities would still act to require divestitures (of slots) if they found that necessary to preserve competition. Thus, airlines possessing dominant position in particular markets could be excluded from auctions or, conversely, auctions might be reserved to airlines who have been denied access. Generic rules of new entrant preference should be removed if possible from slot regulation.

### III. Reaching Political Agreement: Considering the Pros and Cons for Key Stakeholders

Any change proposed will be "dead on arrival" if it fails to address the hopes and especially concerns of stakeholders. I shall focus on potential concerns of three groups:

- ◆ Regulators [and Politicians]
- ◆ Airports
- ◆ Aircraft Operators,

Recognising that there are significant internal differences of situation if not policy within these groups (as well as the existence of other important interested parties).

#### A. *Concerns of the Regulators*

Normatively, regulators should be concerned about implementing the standards of the Chicago Convention, namely safety (as paramount priority) followed by efficiency and fairness as well as, in the context of EU policy: Freedom of market access, consumer welfare, environmental protection, respect of competitive ground rules (e.g. preventing subsidies) and overall cost-effectiveness (including here public sector performance).

The issue of market access, arguably, has been the key driver behind the Commission's slot regulation policies. It saw rightly that scarcity allocation became a real issue as demand grew in major EU metropolitan areas with insufficient runways, as did competitive interest and ability to serve that demand through the workings of the revolutionary Third Package of air transport liberalisation. Rationing and allocation of slots as a pro-competitive measure has seemed unavoidable. Forced re-allocations were even considered.

Thus serious deregulation would seem difficult for European politicians and regulators to consider. Yet three broad assumptions could, if shared, lead to rethinking:

1. *Belief that evolving public attitudes can help make the supply of new slots more elastic.* Communities in Europe are becoming much more concerned about global competitiveness and the need to promote local jobs. Meanwhile levels of objection about airport noise seem to be stabilising, perhaps even receding. Manufacturers' ability to deliver Stage 4 aircraft and prospects for reduction in pollutants will further ease resistance to new runways.

2. *Awareness that better use of existing capacity can also be stimulated by market forces.* The entry of low cost carriers has made airports notably more competition-oriented, and the public is responding.
3. *Recognition of the potential merits of an individual case rule (as opposed to a fixed general standards rule) to justify intervention in market allocation processes.* Under this assumption, arbitrary "new entrant" preferences in law would be phased-out. Alternatively, any aircraft operator -- ranging from a corporate jet (arguing that airports in major business areas need to keep open a reserve of "x" slots for individual flights) to a network carrier (challenging slot deals of rivals) would be offered efficient paths of appeal.

Regulators should also consider that administered rationing, however mild, implies some level of market failure. If behavioural trends show potential for increasing supply side elasticity, then policy makers should remove barriers to market incentives for suppliers.

#### B. *Concerns of Airports*

Airports should certainly find interest. They could still interpose a range of concerns. First, they might question the utility of new user fees if the result was a 1:1 reduction of landing fee charges.

Second, airport lawyers could be concerned by the liability risk of tailoring arrangements with key users without simultaneously getting a clear conditioning of the like-treatment requirements in law for all other users (e.g. Article 15 of the Chicago Convention regulating non-discriminatory access to aviation infrastructure).

Overall, however, there seem to be persuasive, if not compelling, arguments for airports to favour establishment of their formal ownership of airport capacity. These include:

1. *Reducing the risks that rents will go inefficiently to others.* Airports and their owners (typically local communities) cannot be interested in having a slot series granted by a third party becoming a permanent free entitlement of user(s). Slot sales in a deregulated secondary market would, moreover,

exercise cost-push effects at the congested airports, as purchasers of expensive slots push these costs through to consumers (e.g. citizens of the owning community) and probably at a time when the airport itself needs new income for needed capital investment.

2. *Reducing the wastage of lost slots.* Under this proposal, every slot reserved would require a payment, whether used or not. If ticket-holders fail to show up for the performance, airports would now be assured at least some income and would not have to price no-show costs into their landing fees.
3. *Enhanced capabilities for internally generated capital investment.* As demand increases, slot fee income can also increase. It should be made possible to establish capital reserves to fund growth cost-effectively and to avoid or minimise seeking subsidies from the public sector (typical in many countries, notably including the United States).

#### C. *Concerns of the Aircraft Operators*

A large question is to what extent a diverse universe of aircraft operators -- ranging from individual pilots to new low-cost carriers, to historic state-owned international system carriers -- can possess a commonality of concerns? Or are conflicts of situation among operators so deep that the state must arbitrate to arrive at solutions in the public interest?

We are not going to settle this question today. However, perhaps we can agree to a hierarchy of concerns among all the operators; that is, given that slots are a means of production, the first concern of any operator is his own access to them. Competitors' problems, while perhaps not unwelcome, come second. Moreover, I believe one can make a practical case that if everyone has enough, implying a surplus of infrastructure capacity at the margin, everyone may be better off. Put another way, the scarcity affecting you adds to general congestion pressure and thus affects me.

Therefore (even though this may contradict the theology of professional user organisations like IATA) I would argue that all, repeat all, users as a class would be better off if there were margins of capacity in airport (and even air traffic control) infrastructure. This would

be especially true if we also had an institutional/market structure where such providers competed at least to some degree putting market pressure on costs.

How to get to such a system is of course a major question (discussed in the concluding Section), but one must begin by trying to agree that **stimulating slot supply in the context of increased airport competition really should be a central policy focus of user interest.**

Next of course comes the crunch question for the once-and-future grandfather -- the slot "owner" or custodian -- as presently foreseen in regulations: Why should I accept transformation of entitlements that I have laboured (and/or waited) years to acquire?

We shall probably not settle this question today either.

What we can say is that: a) as long as the market fails to generate needed supply, scarcity administration will need constantly to adjust to a moving situation, and the quality of any public entitlement may be fragile; whereas, b) if the market becomes robust, a narrowly-formulated entitlement to use an expanding supply of infrastructure will lose relevance.

Finally, experience has demonstrated that grandfathering the slot simultaneously fathers rules that make its use and disposition inflexible. These constitute a serious cost for individual players as well as for overall market efficiency. They diminish the value of slot entitlements operationally as well as in an asset sense. Substitution of leasing arrangements would give both parties, airlines as well as airports, recourse to a wide and established body of commercial laws under which respective rights and benefits of lessors and leaseholders could be negotiated under strong civil protections.

The negotiation of transferability or sub-lease rights would strengthen the capital and asset base of airlines as well as airports. For example, a carrier possessing a portfolio of attractively priced, long term, transferable slot leases at strategic airports would improve its credit standing and lower its borrowing costs. Moreover, in a liberalised market environment one could imagine innovative and interesting arrangements.<sup>2</sup>

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<sup>2</sup> Illustratively, airlines might seek to cap favourable slot charges at a fixed price across time, while airports might prefer agreeing discounts against the reference fee (subject to annual adjustment). An airport with unused capacity might also price landing fee costs into slot fees (instead of vice versa as at present) meaning that it would waive or reduce the landing fee when the slot was actually operated.

#### IV. Conclusions and the Issue of Transition

Conclusions of this paper really have to come in the form of questions, such as:

- ◆ Can the introduction of demand-related pricing of slots (which many analysts favour) provide market benefits as long as a slot series once granted remains a permanent entitlement of the user(s)?
- ◆ If not, is reform of ownership and leasing rights a potential catalyst or even pre-condition for stimulating elasticity of supply?
- ◆ Are there potential show-stoppers in the political or regulatory landscape, or simply fears of the unknown, which cannot be overcome?
- ◆ If the idea of slot ownership reform is not flawed *a priori*, is it sufficiently interesting to merit needed legal and economic policy studies of the potential cost/benefits as well as the feasibility of various implementation strategies?
- ◆ Finally, is ownership reform an all-or-nothing proposition, or could it be tested on a voluntary basis as part of an obviously needed transition strategy?

**Issues of Transition: Elements of a voluntary "Strawman" transition model:**

1. Grandfather rights may continue; however, holders pay **in full** the reference slot fee,<sup>3</sup> unless, pursuant to negotiated alternative arrangements:
2. They choose to surrender their grandfathered slots for time-limited leases.
3. Airport/User agreements converting (irrevocably) existing entitlements **cannot** be challenged by third parties. Maximum term is [say 12] years.
4. Parties can execute fresh agreements at any time subject to open counter-bidding procedures that can establish rights for up to [say 20] years.
5. EU restrictions against "transfers" of traditional entitlements remain in force.
6. Secondary disposition of leased rights is, however, **fully** deregulated.
7. New slot series coming available in slot pools must be leased subject to auction/other counter-bidding procedures except that:
8. "New entrants" preferences as established under current regulation remain effective (perhaps in the form of closed auction rights), as long as more than [say 50]% of that airport's slots still operate as grandfathered entitlements.
9. Once grandfathered entitlements at an airport fall below [say 50%] of total slot capacity, new entrant preferences are phased-out or abolished.
10. Nothing in the foregoing arrangements restricts the ability of the Commission under competition law to remedy defined problems of dominant position and contestability of markets.

Finally, a *conditional, effectiveness period* (a form of "sunsetting") could be an aspect of this Strawman model. That is, legislation might provide that if, after [say 10] years, a solid majority of airport slots across the EU [say, 60]% had not self-deregulated; that is, if users had continued to hoard their grandfathered slots, that changes to the *status quo ante* would lapse after [say, 4] years unless adopted by new legislation. On the other hand, should we have experienced a "takeover" by the market (to be narrowly defined as the voluntary liquidation of grandfathered entitlements below a level of "x" percent) then the new property relationships would stay. The sun could then keep rising over them each day.

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<sup>3</sup> See Part II of this paper.