

SLOT OWNERSHIP AND LEASING:

Ideas for a Self-Implementing European Reform

Airport slot policy in the European Union remains controversial and intricately regulated. In January 1993, the first EC regulation of slots, Regulation 95/93, was adopted under the assumption that it would soon be reviewed and amended or replaced. Subsequently a number of efforts at amendment failed and others have stalled or remain in partial stages of completion. The legislative history could fill several volumes, and there have been dozens of volumes of studies along the way, as policymakers tried to bridge conflicting positions.

This paper explores the idea of a different and more market-driven approach to slot ownership.

By Erwin von den Steinen

The conflicts regarding this issue basically all took their origins in the fact that some airports remain chronically congested. Economists might characterise this as an example of so-called “market failure.” That is, though airlines wanted to fly, enough new runways (more exactly enough new runways in the right places) were not getting built. Supply was not created to meet demand.

While physical constraints, environmental concerns and local social objections hindered new construction (lack of money was not a fundamental issue), many observers (ranging from academic economists to aviation industry professionals and a number of regulators) also believe that regulation has been part of the problem. That is, while regulation has been perceived a necessity to administer (in effect ration) scarce slots, its method of doing so has not led to an efficient use of limited resources or much less helped stimulate new supply.

In economics, scarcity determines value. No one is willing to pay directly for the air we breathe, because we cannot divide it up into healthy and unhealthy packages. While airport slots, as reservation rights to use airport capacity at certain times, can be (indeed are) broken up into packages -- the current system of regulation in Europe has also made it very difficult to identify and realise their value.

Valuing slots properly should, in a market system, facilitate their distribution to those who need them the most and stimulate creation of new slots as well.

Today's system may thus suffer from basic valuation flaws. Valuation, as implied above, also depends on a definition of property. In trying to take a narrower look at the slot policy problem this paper explores the idea of a different, that is to say legal, approach to slot ownership (as well as leasing and sub-leasing).



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Rights of slot ownership under present and contemplated legislation remain unclear and subject to complex conditions. Basically the slot holder today gets a government-administered license, allocated free-of-charge in accordance with public interest criteria, to use airport facilities at a particular moment in time. We can call this an “entitlement.”

Once awarded, the entitlement to the slot can be retained indefinitely, as long as the holder meets certain conditions. However, he is formally constrained from selling it, and if he fails to use it regularly or is unable to trade it, it reverts to the official slot pool. Meanwhile, the airport – which builds, maintains and operates the runways – is put in the position of a theatre operator who incurs all the costs of mounting a production but cannot sell tickets in advance. He can only charge people when they actually show up for the performance.

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

The European Union should define slot rights not as public entitlements but as private leases.

Capacity *per se* would thus always be owned by the airport (which creates it), and airports *would charge for each slot reservation*. An airport experiencing strong demand would set higher reservation fees than an airport with low demand. The latter might even offer general discounts or rebates on other services to users willing to make reservations commitments.

Consequently, slot users would be free to make contracts of varying terms for leasing reservations.

Moreover, they would no longer be constrained from subletting slots or transferring leases to other users. Such a reform, though fundamental in nature, actually requires changing just a few key rules.

The key building block would be to “unbundle” the present charging system for landing and taking off at airports and require a *separate reservations fee to identify and capture the value of slots*. At present, users pay no fees to airports for the future right to use the runway.

The market value of the reservation must somehow be internalised 100% into the charge for the actual use. Perverse incentives result. Now, an airline holding more slots than it actually needs at a congested airport is permitted (to a degree at least) to waste valuable capacity at no financial penalty. The operator, who could have rented the slot to someone else, is denied income and must raise his other charges to compensate for the loss.

Unbundling slot fees

Airports in the EU should publish for each traffic season an independent (unbundled) charge for a slot. Subject to appropriate oversight, each airport would be free to set/adjust its “reference slot fee(s)” designed to account for the independent cost and value of time. Airports congested at peak hours could and should establish varying peak and off-peak reference fees. Unless adjusted by a

lease agreement, these fees would be levied in full for all reservations made (say 10+) days in advance. Revenue collected from slot fees would of course work to reduce landing fees or other charges.

Principles governing the setting of charges

Airport slot fee rates would have to be consistent with pricing rules imposed by the Community, national and international law (e.g. bilateral air services agreements). In principle, slot 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).

Variances from the reference fees

Airlines and airports would be free in the case of slot series to negotiate variations from the basic fee *reflecting the economic value to the respective partner of the capacity commitment*, in a manner compliant with transparency and non-discrimination rules (see below).

Whether and how to regulate length of leases

This is a central policy question. 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 20-25 years] for new lease contracts.

Deregulated Subleasing

As compensation to airlines for loss of historic entitlements (so-called grandfather rights), subleasing would be deregulated. Operators could sublet slots or even sell leases (unless constrained by the specific terms of individual leases). Thus, they could realise temporary income by subleasing slots to others at times of slack operations, and the airports operating income (from landing and parking fees) would also benefit.

Open and Transparent Competition for Primary Leases

Regulation would require an open and transparent process, such as an

auction, 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.

Airport Product Liability

Since airports would receive new market power, it may be desirable to counteract 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. As with denied boarding compensation, procedures might then enable rebates to users. Similarly, regulation should also foresee institutional procedures for clawing back rents from an airport that raised slot fees to pay for growth but then failed to make needed investments.

Role of the Slot Coordinators

The Slot Coordinator (who administers scarce slots under current regulation) would no longer be a point of first contact. The slot seeker would first exhaust sublease possibilities and/or compete for available primary capacity. The Slot Coordinator would, however, exercise at least two vital functions: a) 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; b) he would also closely monitor conditions of market access.

Overriding Position of Competition Law

This proposal would in no way constrain the application of existing and future rules on competition. That is, consistent with the facts of a specific situation, authorities could still act to require dominant operators to divest slots if that were necessary to preserve competition. Airlines possessing dominant position in particular markets could be excluded from auctions or, turning it round, auctions might be reserved to airlines that have been denied access.



A WestJet Boeing 737 waiting for its "take-off slot" as an Air Canada A320 is in landing. Photo by: Charin deSilva

However, one-size-fits-all rules of new entrant preference should be removed if possible from slot regulation.

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 key stakeholders such as regulators, airports, and aircraft operators. The issue of market access, arguably, has been the key driver of slot policy and regulation.

The Regulators

The European Commission rightly saw that scarce slot 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 which basically removed historic political and administrative

constraints on market entry within the EC. The number of airlines eligible and interested in serving new markets expanded exponentially beginning in the 1990's. The rationing and allocation of slots as a pro-competitive measure (to make it practically possible for these new entrants to contest markets) has seemed unavoidable. Forced re-allocations from incumbent to new entrant operators were even considered.

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

1. *Evolution of public attitudes toward airport expansion.* Communities in Europe are becoming much more concerned about global competitiveness and the need to promote local jobs. The high paying services jobs that European economies hope to

hold and attract require improved airline travel and air freight access to global markets. Manufacturers' ability to deliver Stage 4 aircraft and prospects for reduction in pollutants could further ease resistance to new runways. Careful easing or at least simplification of the rules for airport expansion makes sense.

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.

Regulators should also consider that administered rationing, however mild, implies some level of market failure. They should act to ensure that regulation maximises market incentives for suppliers; the airports.

The Airports

Airports, despite a range of potential legal concerns, should look positively at the idea of owning their airport's runway capacity. They 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). Under this reform proposal, every slot reserved would require a payment, whether used or not. Airports would no longer have to price no-show costs into their landing fees.

Unlike landing fees, the slot fee would not be discounted on the basis of weight. A Cessna and a 747 would pay the same fee. Thus, reservations charges that could be high at congested airports would be more affordable for aircraft with large payloads. Thereby higher priority movements and greater traffic per operation should result.

Slot fee income could also be a source for establishing 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).

The Airlines

Airlines, whether incumbents or new entrants, would lose preferences that exist under today's law and, therefore, have the most to lose under this proposal. They could also have a great deal to gain, because the present system is seriously defective.

As an industry, airlines have a great interest in the creation of stronger incentives for airports to provide timely capacity. The most expensive slot is the one you do not have. Delay costs have been killing the industry for years. Delay results from the lag in infrastructure provision.

Second, while an independent slot fee could arouse fears of added costs through new charges, economic and financial analysis is likely to show that – if the new fees are correctly implemented – commercial operators, especially operators of large equipment, should pay less for airside airport services overall. The operators of small equipment would have to pay proportionately more. Moreover,

airlines having a large number of operations (through their new abilities under this proposal to sell blocks of slot leases) would, even at congested airports, enjoy new leverage to negotiate favourable terms.

Substitution of leasing arrangements would open the door for both parties – airlines and airports – 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.

Rights to transfer leases could, over time, establish a robust and dynamic secondary market for slots and thus strengthen the capital and asset base of airline leaseholders (just as underlying ownership of capacity strengthens that of airports). A carrier possessing a portfolio of transferable slot leases at strategic airports would improve its credit standing and lower its borrowing costs.

Having said this, there still remains the crunch question for today's slot holder (the grandfather): "Why should I accept transformation of entitlements that I waited for years to acquire?" Slots for a commercial airline are a vital piece of the production process.

Thus, to persuade airlines and any other actors in the system who might be sceptical, any reform claiming to be market-based might not only include a so-called "transition" period (often a euphemism for dying slowly), but also embody a fair market test. *Desirably it should sell itself.* The true test of the reform would be if airlines were given a reasonable choice between staying with the historic system of entitlements or switching to the new system.

As set forth in my Transition Plan, the proposed system would "sunset," thereby expiring at a date certain, unless voluntary market transformation had in the meantime made it vital and preferred.

Legislation might provide that if, after [say 15] years, most [say 75 percent] of airport slots across the Community had not converted to the new ownership/leasing model through voluntary actions in the market; that changes to the former rules would lapse, unless re-adopted by new legislation.

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Getting from Here to There: Ten Elements of a Market-Driven Transition Model

- 1 Existing rights to operate historic (grandfathered) slots continue; the new regulation does not take them away. However (though the landing fees would be lower), slots are no longer cost free. Indeed, slot holders must pay **in full** the prevailing reference slot fees for every reservation held, unless:
- 2 They choose to surrender their grandfathered slots for time-limited leases (pursuant to which they are free to negotiate individual conditions and acquire the right to sublet or even transfer leases without regulatory interference).
- 3 One-time conversion agreements (turning existing grandfather rights into leases) may be agreed between holders and airports without third party bidding. Maximum term for such conversions is [say 10] years.
- 4 Parties can execute fresh lease agreements at any time subject to competitive bidding procedures that can establish rights for up to [say 25] years.
- 5 EU restrictions against "transfers" (sales) of grandfathered slots remain in force.
- 6 Disposition of the new leased rights is, however, **fully** deregulated.
- 7 All new slot series coming available in slot pools must be leased subject to auction or other competitive bidding procedures except that:
- 8 "New entrant" preferences as established under current regulation remain effective (perhaps in the form of new-entrant-only auctions), as long as more than [say 50]% of a congested airport's slots are still grandfathered.
- 9 Once grandfathered entitlements at an airport fall below [say 50%] of total slot capacity, new entrant preferences are phased-out.
- 10 Nothing in the foregoing arrangements restricts the ability of the Commission under competition law to remedy defined problems of dominant position and contestability in specific markets.