Slot trading in the EU

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Slots are a bundle of rights that allow airlines to take off, land and use other infrastructure at a given airport. They are a key input into the downstream provision of air travel services. Many major carriers therefore view slots as a particularly valuable 'asset', especially at congested airports such as London Heathrow. For example, British Airways has 3,800 slots a week at Heathrow (roughly 40 per cent of those available), which are estimated to have a value in excess of €3 billion.

However, the demand for slots at some European airports vastly exceeds supply, with the scarcity of slots seen as a major obstacle to full liberalisation of the transatlantic air transport market. The issue is particularly apparent at Heathrow, where there is a severe shortage of airport slots available for potential new entrants – that is, carriers who, in light of the Open Skies agreement signed between the United States and the European Union, might otherwise challenge incumbent carriers by offering their own transatlantic services to and from Heathrow. Open Skies may have granted carriers the legal right to fly in and out of Heathrow, but it has not facilitated actual access for potential new entrants.

In response to the problems caused by congestion and the illiquidity in slots, the European Commission, stakeholders and other regulatory bodies have been discussing formalising a market approach to slots to ensure that scarce airport capacity is allocated efficiently. In light of this, it is important to ask what role competition law has in promoting the most efficient allocation of this scarce resource and whether competition law can deal with anti-competitive behaviour arising out of the use of market mechanisms, however configured, for slot allocation and trading.

OPEN SKIES

The Open Skies agreement will allow any EU-based airline to fly directly to any US destination and vice versa (as of 31 March 2008). In particular, European airlines will no longer be restricted from scheduling transatlantic flights to American cities solely from their home country as was required under previous bilateral arrangements.

In terms of Heathrow, Open Skies will supersede the 1977 'Bermuda II' bilateral agreement between the US and UK which permits only British Airways, Virgin Atlantic, American Airlines and United Airlines to fly between the US and Heathrow. It should be noted that the Bermuda II agreement only covered Heathrow. Other airports in the UK were open to any US carrier.

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In theory, the privileged position of this small group of carriers will be terminated by Open Skies: any US or EU carrier will be entitled to fly directly between Heathrow and US destinations. As a result, some anticipate that Open Skies will liberalise the lucrative transatlantic passenger market, reducing UK-to-US ticket prices by approximately 10 per cent and increasing overall transatlantic air travel by as much as 50 per cent by 2013.

SLOT ALLOCATION AND ILLIQUIDITY

Despite the optimism, the benefits of unrestricted transatlantic competition are unlikely to be fully realised given existing congestion, access and infrastructure issues at Europe's busiest airports. Limited slot access and slot illiquidity at Heathrow and other airports will continue to constitute significant barriers to entry for the provision of transatlantic services on the most profitable routes. This is the result of both the historical manner in which slots have been allocated and the privileges of use (and reuse) that have been bestowed upon incumbent carriers under the existing allocation rules.

Currently, the allocation of slots in the EU is an administrative procedure governed by EC Council Regulation 95/93 (as amended). The regulation defines slot capacity available for allocation (a definition that, since the coming into force of Regulation 793/2004, also includes the use of airport infrastructure), the process of such allocation, and the supervision and monitoring of how allocated slots are then used.

The rights to use airport infrastructure to operate services out of congested airports are allocated by 'slot coordinators', who have a duty to act in a transparent, neutral and non-discriminatory manner. The coordinator allocates slots to applicants as permissions to use the airport infrastructure for landing and taking off during the requested period. Once this period of use has elapsed, the carrier has a right of first refusal to continue using the slots subject to a 'use-it-or-lose-it' rule requiring the carrier to demonstrate that it has used the slots for at least 80 per cent of this period.

Only when the carrier cannot demonstrate such required intensity of use (or elects voluntarily to give up the slots) are slots returned to the pool. Otherwise, the incumbent may continue to retain already held and employed slots. These rights are known as 'grandfather rights' and they potentially enable incumbent carriers to hold allocated slots in perpetuity.

It is also important to note that the use-it-or-lose-it requirement is purely a quantitative concept and has no qualitative aspect in terms of evaluating how the allocated slots have been employed. Given the value of slots and the access they will provide in the future at congested airports, there is arguably a strong incentive to use allocated slots

at less than optimal efficiency (eg, by operating half-empty flights) rather than risking reallocation from the pool to a competitor. This raises the question of whether other carriers might make more effective use of the slots and, if so, how to construct a system that deters inefficient use and ensures allocation or transfer to those carriers likely to employ the slots most efficiently.

Incumbent carriers have historically benefited from more-or-less free use of slots: valuable rights to which their competitors have had only limited access. This position is a legacy of the days of state-run, flagship carriers that has not been addressed by privatisation or deregulation of the European airline industry. As it stands, the principle of grandfather rights insulates and reinforces incumbent positions at hub airports and means that there is very little slot liquidity. Thus, at Heathrow 97 per cent of the slot capacity is allocated (and unlikely to become available), while the remaining unallocated slots are largely unsuitable or unattractive for transatlantic operations. Although new entrants do receive priority when slots become available, they are very limited in number: the loss rate for grandfathered slots is less than 0.5 per cent annually, whereas increases in runway capacity and the recovery and reallocation of slots during peak and prime periods have been very limited in the past decade.

Open Skies will not address the lack of slots or slot illiquidity that has resulted from capacity constraints and an allocation system that assigns slots primarily on the basis of historic use. Therefore, for new entrants, the process of building a meaningful number of slots at congested airports will be difficult. Furthermore, those European airlines which currently have Heathrow slots (but were unable to serve the transatlantic routes out of Heathrow) will have to sacrifice other services into Heathrow if they decide to employ (or transfer to alliance members) any of their current slots for transatlantic services.

SLOTS AS A TRADABLE COMMODITY

Both the European Commission and expert commentators have concluded that slots could be better allocated through market mechanisms, including alternative primary trading (eg, auctions) and secondary trading mechanisms rather than through purely administrative criteria.

Primary trading mechanisms would be used to determine an initial allocation of slots with governments, airport coordinators or authorities in charge of selling (or granting) the rights (or 'permissions' to use). The objective of primary trading would be to improve the efficiency of allocation by ensuring that slots (whether they be new ones or those already subject to grandfather provisions) were allocated to airlines that valued them most highly. Secondary trading, in turn, would be used once an initial allocation of slots had been made, allowing airlines to sell (or possibly lease) slots that they had been allocated. Such secondary trading would, therefore, further increase efficiency by allowing changes or corrections to be made via the market once the primary allocation had been established.

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There appears to be strong support for secondary trading of slots as it would formalise a practice that has been in existence for several years now, at least in the UK. Heathrow slots have been traded and exchanged along with (often) undisclosed sums of money. This practice was scrutinised in the 1999 English High Court's judgment in *R v Airport Coordination*, in which the court held that airlines have the authority under Regulation 95/93 to exchange slots and for such exchanges to be accompanied by financial compensation. Although different EU member states may take alternative views (ie, as to whether Regulation 95/93 actually permits trading in exchange for compensation), to see slots as tradable commodities is neither a novel idea nor a radical leap forward. Existing rights and obligations attached to the airport slot would simply transfer to the purchasing carrier, including grandfather rights and use-it-or-lose-it obligations.

Less clear is how primary allocation would (or should) work. As noted above, slots are currently allocated by reference to administrative criteria. This applies only to 'new' slots (ie, the small number of unallocated slots and those returned to the pool under the use-it-or-lose-it principle); there is no process of allocation (or reallocation) for slots currently held by incumbents.

Many critics of the system argue that the introduction of a primary market mechanism that deals only with available or new slots is unlikely to change the current dynamic and provide credible possibilities for new entrants. In particular, the retention of the grandfather rights principle will continue to favour incumbents that have entrenched positions at hub airports and that would have very little reason or incentive to return slots to the pool for reallocation. In addition, any benefits from secondary slot trading would be reduced by a system that retains the grandfather rights approach and restricts overall liquidity since only a small number of slots (and often those of lesser commercial value) would likely be subject to secondary trading.

In short, many argue that any form of primary allocation that does not address the potential distortion produced by the historical allocation (and continued possession) of slots will make very little meaningful difference (and might make matters worse). They suggest that only the reclamation of grandfathered slots and primary allocation of time-limited rights through, for example, an auction, would result in the most efficient use of slots, increased competition and, in turn, the greatest overall benefit to consumers.

Against this, others argue that slot mobility should not be a goal in itself and that a formalised secondary market might be beneficial, even without the introduction of a primary market mechanism. There would still be benefits in establishing a secondary market as long as there are rules in place to deal with instances of market power (as discussed below). However, whatever new primary allocation mechanism might be chosen, it would need to be fair and defensible. This includes avoiding an arbitrary reallocation of slots: one that creates liquidity simply for liquidity's sake without considering who in fact is best positioned to make the most efficient use of these valuable rights.

SLOT OWNERSHIP

It has not been definitively established who owns slots but commentators seem to agree that the airlines do not have ownership rights. Airlines might claim that slots belong to them because slots are an integral part of the infrastructure enabling them to offer downstream services to customers. But this argument is not recognised in law. Slots are allocated to airlines with a 'permission' to make use of them (potentially for an indefinite period) but such rights are not synonymous with ownership.

The better view is that airlines have rights to use defined infrastructure that is owned or operated under licence by airport operators whose own rights might derive from national property case law and legisla-

tion. The position appears to be the same in the US where the aviation regulator (Federal Aviation Administration) notes that "slots represent an operating privilege subject to absolute FAA control". Finally, it should be noted that incumbent airlines have not, until relatively recently, listed slots as assets in their annual accounts (and, where they have, only in relation to purchased slots and not the vast majority, which were allocated to them free of charge in the past).

Nevertheless, even without a supportable claim to legal ownership, incumbents clearly have certain property rights, which, in addition to the right to use for the purpose of operating commercial flights, includes certain rights of transfer and exchange (subject to limitations laid down in Regulation 95/93 and in the absence of any applicable jurisprudence). Those rights can be extended (or limited) either by further European Community legislation or national case law and the interpretation of community law by the European courts. Such extension (or limitation) of an airline's right to use would not interfere with the underlying property rights, which derive from, for example, the ownership under national property law of, or statutorily granted rights to operate, a runway or terminal building. As airlines have certain property rights in slots, they may attribute value to those rights and, subject to limitations and conditions laid down by EU and national law, transfer their rights for value. The proposals that envisage various forms of primary and secondary trading reflect this legal position: the transfer of property rights for valuable consideration does not depend on the transferor being the owner of the underlying property right.

In practice, the main challenge with respect to future efficient allocation – and, in turn, the ultimate efficacy of any follow-on trading – consists in finding the right balance between the legitimate interests and expectations of incumbent air carriers (which have invested significantly at hub airports) and ensuring the possibility of meaningful new entry and competition at congested airports. The costs involved in disrupting the current distribution of slots, even if it is rooted in a historically inefficient system of allocation, might outweigh the benefits (if any) that may be gained by enhancing the position of current competitors or facilitating new entry by reallocating all or some slots. Incumbents might be best placed to reap economies of scale, the benefits of which are passed on to consumers in a manner that could not be offered by alternative users of the slots.

As such, determining ownership of the underlying property rights for the purposes of the primary allocation of slots and providing compensation to the owners of those underlying rights (be they member states or airport operators) should not undermine the concept of a tradable right in slots or, therefore, a secondary market in which slots move to those carriers who value them most.

THE ROLE OF COMPETITION LAW

Recent European Commission policy has been to remove, or reduce sector-specific protection from competition law that has been enjoyed by a number of industries. This has been the case, for example, in the motor industry (ie, the revised motor vehicle block exemption) and in the maritime sector (ie, the repeal of the block exemption for liner conferences). Equally, in the air transport sector, the commission has repealed a number of sector-specific block exemptions including the one relating to IATA passenger tariff conferences for routes between the EU and non-EU countries, which it has decided not to renew. Overall, it indicates a general level of confidence on the Commission's part that substantive and procedural competition law is sufficient to address issues that might arise out of sector-specific behaviour and that any insulation from competition law's normal reach is unjustified. Save in exceptional cases, the application of competition law through public enforcement or private actions, as opposed to ex-ante regulation, appears capable of addressing competition problems as and when they may occur. However, some suggest that competition law cannot adequately address anti-competitive behaviour that would result from a pure market approach to primary slot allocation and secondary trading. For example, merger control is unlikely to apply to transactions involving the sale or leasing of slots, whereas article 81 EC (or its national equivalents) might be limited in its applicability (ie, transactions involving one or a relatively small number of slots are unlikely to be viewed as appreciable and would, therefore, be outside the scope of the prohibition).

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Overall, there is the concern that slot trading may well fall between the main planks of competition rules, in particular unilateral exclusionary behaviour that exploits or protects an airline's market power. Indeed, dealing with slots strictly as a tradable commodity raises concerns as to whether a primary trading process or secondary trading might enable airlines to reinforce dominant positions, for example, at hub airports or on specific sets of commercial routes to and from particular airports. Some believe that a market-based system might lead to a consolidation rather than a reduction of incumbents' slot holdings and that incumbents will, in turn, have the opportunity and incentive to abuse their market power.

Unilateral firm conduct

Article 82 EC – or its national equivalents – governs unilateral behaviour by companies (or groups of unrelated companies) occupying a dominant (or collectively dominant) market position. Its provisions do not prohibit dominance itself or the manner in which such dominance is achieved: it prohibits the abuse of dominance as manifested in certain exclusionary or exploitative behaviour. Thus, a dominant company might abuse its position when it conducts business in a manner that restricts or distorts competition that remains in the market, whether that be through exploitation of its commercial partners or customers (exploitative abuse) or by excluding actual or potential competitors from the market (exclusionary abuse).

However, the distinction between permissible and abusive competitive behaviour by a dominant company is not always clear. Dominant players are allowed (and indeed expected) to compete actively on a given market, albeit that such behaviour should reflect competition 'on the merits' (ie, competition reflecting the competitive advantages enjoyed by the dominant company rather than restrictive practices). In terms of dealing with slots as a tradable commodity, the incentive for an already strong or dominant carrier to increase slot holdings at a congested airport may reflect a strategy to restrict competition by limiting access to a scarce resource. Equally, however, it may reflect a pro-competitive strategy to increase efficiency through the extension of existing complementary services at a hub airport.

Such concentration of slots in the hands of one carrier naturally gives rise to concerns

that it will (or has the incentive to) engage in anti-competitive conduct amounting to abuse of a dominant position contrary to article 82. Abuse would, in this context, be characterised as exclusionary insofar as 'slot hoarding', refusal to supply, overbidding or what might be called 'predatory purchasing' denies other competitors (or potential competitors) access to an essential input that would otherwise allow them to compete and contest the incumbent's market position.

In terms of exploitative abuse, this occurs, for example, where the dominant company indulges in 'excessive' pricing. The possibility of exploitative abuse might materialise in a market for slots at a particular airport (where the conduct might also be regarded as exclusionary against a rival seeking to purchase slots) or into a downstream market for the provision of air transport services (where the victim would be the passenger, the consumer of such services). The first type of abuse might best be addressed through the rules applicable to a secondary trading system; the second type might be more appropriately addressed through an ex-post application of the rules under article 82.

Market definition

Article 82 would only regulate the use or misuse of slots where it is established that a carrier holds a dominant position. The mere holding of a high number of airport slots may not confer a position of dominance. The relevant market is likely to be defined by reference to certain air transport services rather than a market for slots.

Slots, it might be argued, are an upstream input into the downstream service market in which airlines compete. If so, it is dominance on this latter market that must be established to found a claim. Market definition has the potential to handicap any potential claim based on an airline's holding of slots at a particular airport since any relevant downstream transport market might be contested by carriers operating out of different airports or by operators of other forms of transport. That congested airports have stimulated competitors and, in particular, budget airlines to look elsewhere for slot capacity suggests that different airports (and therefore the slots available) may be regarded as falling within the same relevant geographic market. The finding that two or more airports fall within the same relevant market implies that operators at these different airports will exert competitive pressure on each other and that the right to use, for example, over 40 per cent of the slots at one airport does not necessarily confer a position of dominance on that carrier.

Abuse

Even if a carrier were dominant in a relevant market as a result of the right to use a high percentage of available slots, the acquisition of further slots does not imply abuse. Thus, where dominance exists in an upstream 'slots market' (something potentially difficult to prove), the claimant or competition authority still faces hurdles. Existing case law has established that exclusionary behaviour does not necessarily infringe article 82 when the dominant company can demonstrate an objective justification for its actions. Moreover, in line with the European Commission's initiative to introduce a more economics-based approach to the application of article 82, it would be necessary to demonstrate that the acquisition of more slots gives rise to a restriction of competition: this may depend on the number of slots acquired as well as the specific circumstances in which the carrier operates. If a restriction were established, the carrier would have the opportunity to demonstrate that the acquisition and use of the additional slots would produce efficiencies that would be passed on to consumers. As such, a dominant incumbent might justify its behaviour on the basis that its already established position makes it best-placed to make the most efficient use of the acquired slots and that it is simply extending the benefits of the system it has in place. Where an airline controls all or the vast majority of slots at an airport and refuses to sell slots to actual or potential competitors, one might construe this as an abuse of a dominant position. Aggrieved third parties might argue that the airline owns and controls a facility to which competitors require access to provide services. In short, slots at congested airports might be regarded as an 'essential facility' (ie, where reasonable access to a sufficient number of slots is indispensable, there are no suitable alternatives and it is not economically feasible – nor technically possible – for competitors to reproduce the facility).

It is unclear whether competition law can deal satisfactorily with all of these issues

It should be noted that the courts have never ruled on the issue of essential facilities in the air transport sector. However, based on other cases, a refusal to supply slots would not be viewed as an abuse where the slots in question were not indispensable to relevant downstream service (ie, other slots were available from other airlines at the airport or are available at other airports from which competing services might be offered) or where the refusal is objectively justified (ie, that the incumbent is better placed than others to use the slots most effectively by, for example, taking advantage of the hub network that it already has in place).

It should also be noted that, where an abuse has been proven in previous exclusionary cases, the time involved has been substantial, so much so that potential complainants may be deterred from bringing similar claims.

MARKET INVESTIGATIONS

Finally, there has been discussion of the potential use that might be made (ex-ante and ex-post) of market investigations or sector inquiries to examine the conditions in which slots may be allocated and subsequently traded. The Air Traffic Working Group of the European Competition Authorities acknowledges that, with the exception of the UK, the main difficulty for most authorities would be the lack of remedial powers. In its recommendations, the group notes the possibility of such investigations as both an ex-ante and an ex-post competition control, while highlighting both pros and cons. The question, however, is not so much whether such investigations could be used as procedural tools to review and address competition issues arising from a market-based approach. Rather, it is to determine whether the use made of slots and the circumstances in which they are traded (or not traded, eg, slot hoarding) constitutes a competition law infringement or evidences other market failures.

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It is unclear whether competition law, rather than tailored slot allocation or trading provisions, can deal satisfactorily with all of the competition issues peculiar to the sector and, in particular, those which arise out of the acute illiquidity detailed above. Indeed, in such circumstances, a system of allocation based purely on market mechanisms (and without any additional supply-side measures) may produce unintended outcomes. In this light, some commentators have noted that the American experience is instructive insofar as the introduction of a pure pricing mechanism appears to have strengthened the position of a small number of carriers.