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Slots trading under Open Skies: the implications for allocating capacity

The signing of the Open Skies agreement between the EU and the USA has been hailed as a triumph for the consumer, with the prospect of more intensive competition in the transatlantic market. To facilitate this, new operators will want access to the UK's premier hub, Heathrow Airport. Yet Heathrow has for many years operated at capacity, with 'slots'—the right to land, use terminal facilities and take off—changing hands for high prices. How might the slots market in the UK affect the ability of new operators to develop transatlantic markets?

After several years of negotiations, the first-stage Air Transport Agreement was signed between the 27 EU Member States and the USA in April this year. As a result of the 'Open Skies' agreement (referred to as such due to its liberalisation of the previous restrictions on transatlantic flights), any US or EU airline will be able to fly between any airport in the EU and USA from March 2008.[1]

In theory, the potential increase in services between the EU and USA arising from this liberalisation will generate competitive pressures, such that consumers not only benefit from new services, but also from lower fares on existing routes.

A crucial element of the agreement is the removal of restrictions at Heathrow Airport, which has a greater volume of international passengers than any other airport in the world. The agreement removes restrictions on both the number of airlines that can operate flights to the USA from Heathrow, and on the routes that these airlines can operate. Crucially for UK consumers, this means that the four airlines that are currently exclusively permitted to fly from Heathrow to the USA—British Airways (BA), Virgin Atlantic, United Airlines and American Airlines—could now face significantly more competition, and routes now operating from Gatwick Airport may be served from Heathrow.

However, even if the skies are fully liberalised, there may still be restrictions to competition due to the limited physical capacity that airports can provide. Take-off and landing slots are essential for an airline to be able to operate, and these are limited in number. Indeed, the demand for slots at Heathrow exceeds capacity at almost all times of the day, and during peak periods by up to 30%.[2]

Given the limited number of slots, ensuring that they are allocated efficiently according to market demand is crucial. The EU slots Directive governs the manner in which slots are initially allocated.[3] Slots at Heathrow are currently largely inherited from season to season, although some trading does take place, unlike at many other European airports. After the Open Skies agreement, the value of slots increased substantially and there was much industry speculation about slot trades—at Heathrow in particular. However, given the lack of transparency resulting from the informal nature of the secondary market for slots in the EU, there were few formal announcements.

In 2006 the Commission published a study on the likely impact of a formal secondary market for slots.[4] The report concluded that that there would be substantial consumer benefits from secondary slot trading at European airports. The Commission is still developing its thinking in response to the study, but the upcoming implementation of Open Skies is likely to be a force for change.

This article examines the nature of the Open Skies agreement, the degree to which its impact will be limited by factors such as a shortage of appropriate slots, and the implications for the trading of slots in the EU.

Air Transport Agreement

Previous restrictions

The agreement in place between the UK and USA until March 2008, 'Bermuda II' (Air Services Agreement, July 1977), is complex; its main features are a limit on the number of entry points to the USA that can be accessed by flights from London, and restrictions on which airlines can operate between Heathrow and the USA, and the

Countdown to Open Skies

- **June 5th 2003: Commission agrees authorisation to open negotiations**
- **March 2nd 2007: draft agreement initialled in Brussels**
- **March 22nd 2007: agreement approved unanimously by the 27 EU transport ministers**
- **April 30th 2007: agreement signed at EU–US summit in Washington D.C.**
- **March 30th 2008: agreement comes into force**
- **2008: second-stage negotiations to begin within 60 days of implementation of the first stage (Article 21)**
- **2009: parties review progress of second-stage negotiations within 18 months of their commencement (Article 21)**
- **2010: the EU can re-implement some restrictions if an 'open aviation area' has not been achieved**

cities that they can each serve. The agreement has undergone a number of amendments, with perhaps the most notable change coming in the 1990s when Virgin Atlantic became the second British carrier to operate transatlantic flights from Heathrow.

The USA has held ‘open skies’ agreements with several smaller countries since the 1970s, and with some EU countries since the 1990s—eg, in 1992 it signed an agreement with the Netherlands for unrestricted landing rights in each other’s territory. However, the new Air Transport Agreement will supersede all of the existing bilateral agreements between the USA and Member States.

The agreement[5]

Both the internal negotiations in the EU and EU–US negotiations have been protracted. The agreement itself is detailed, but some of its salient points can be set out under the following categories.

Market access

- All EU airlines will be permitted to operate flights to the USA from any point in the EU and vice versa (third and fourth freedom rights).
- The right to operate onwards to a third country after a flight to the EU/USA will be granted (fifth freedom right).
- All restrictions on fares and capacity on routes between the EU and USA will be removed, with the exception of US carriers being prohibited to price-lead on intra-EU routes.
- Unlimited code-sharing between EU, US and third-party airlines will be permitted.

Ownership

- Restrictions on EU investment in US airlines will be relaxed (although not completely, see below). EU nationals will not be permitted to have ‘control’ of US airlines. US nationals will not be allowed ownership of EU airlines; however, they must remain majority-owned by Member States or nationals of Member States.[6]

Second-stage agreement

- Negotiations on the second stage of the agreement are required to commence within 60 days of the implementation of the first stage. A second-stage agreement would aim to create an open aviation area, with the removal of the remaining restrictions (see below).

The agreement marks a significant change to the current arrangements and has scope for a large impact. Indeed, Jacques Barrot, Vice-President of the EU and European Commissioner for Transport, has stated that the economic benefits could amount to €12 billion and 80,000 jobs.[7]

Remaining restrictions

While the Open Skies agreement goes some way to a fully liberalised aviation market, it still leaves some restrictions and barriers, most of which will form part of the second-stage negotiations. These restrictions include the following.

- **Cabotage**—the right of an airline to operate within a foreign country’s domestic market, often in the form of a hub-and-spoke network. US airlines will have the right to do this between EU countries (but not within a country), while EU airlines will not have cabotage rights in the USA under the first stage of the agreement.
- **Ownership restrictions**—ownership of US airlines by foreign investors is limited to 25% of voting equity. Furthermore, ownership of up to 49.9% of total equity is permitted and will not be deemed to constitute control, while more than 50% of total equity shall not be presumed to constitute control of that airline, but will be considered on a case-by-case basis.

Removal of these and the other remaining restrictions would move the EU and USA towards an open aviation area, with unrestricted investment flows, access to domestic markets, and completely unrestricted provision of air services. This is the objective of the EU, with mid-2010 the target date for its achievement.

Allocation of slots

Although the skies may have been opened, there is still the physical restriction of limited capacity on the ground. Airport charging practices can be employed to alleviate demand constraints, but at the most congested airports demand still exceeds capacity at all periods.[8] With a limited number of slots available, their allocation has important implications for the level of competition. The majority of slots are often owned by the incumbent airlines (eg, BA at Heathrow), and they may be difficult to obtain by new entrants wishing to offer fresh competition.

Current schemes

EC Regulation 793/2004 governs the allocations of slots in the EU. An independent slot coordinator is responsible for these allocations (in the UK this coordinator is Airport Coordination Limited). Under this regulation airlines can retain their slots provided that they used them for at least 80% of the previous season. This is known as ‘grandfathering rights’, as slots are obtained purely because of their historical use. Incumbent carriers have grandfathering rights to 97% of slots at Heathrow.[9] New slots (or slots that are handed back) are given with some priority to new entrants or to airlines that have been on a waiting list. However, without an increase in the physical capacity of the airport, new slots are rare, and those that are handed back tend to be for less desirable times. It is important to note that slot trading does currently occur, which allows some flexibility for airlines. Such trading usually takes the form of a transferral of slots between airlines, possibly with a payment being made by one party. However, this tends to occur in a ‘grey’ market, where there are no formal property rights granted to the buyers. This type of trading occurs much more often in the UK than in the rest of the EU as a result of the high levels of congestion at many of the UK’s airports.

The presence of grandfathering rights in the current system can raise concerns about its effectiveness compared with a more market-based system. A system where customers’ willingness to pay for flights is reflected in airlines’ decisions about slots could be a more efficient method of allocating scarce capacity. The UK Department for Transport (DfT) has expressed its preference for a system based on these principles.[10] A formal secondary market has been estimated to have a positive impact on consumer welfare of €31 billion per annum by 2025.[11] At the same time, the DfT recognises the importance for peripheral regions of air access to key cities. It is therefore prepared to intervene via public service obligations (PSOs) to protect slots that are for routes considered vital for the development of peripheral regions.

The Air Transport Agreement does not cover any special allocation priority. However, airlines that are currently restricted from operating from Heathrow would qualify as new entrants if they were to seek slots. This would give them priority in the allocation of 50% of the slots pool, although there are limited slots that could be used for transatlantic services, so this priority may have little impact.[12]

The most likely method of slots being obtained is via direct transfer. Incumbents could switch some of the slots from their other existing services to transatlantic flights, while new entrants may be able to obtain slots from their alliance partners or from trading on the secondary market.

The US system of slot allocation differs from the EU regime (and most of the world). The difference stems from antitrust legislation preventing airlines from discussing schedules, routes, fares, etc. As such, meetings between airlines to rearrange schedules and exchange slots, as in the EU, do not tend to take place. Instead, airlines simply schedule their flights with expected timings and then join the queueing system at each airport for planes taking off and landing. The exceptions to this system are at the busiest airports such as New York–JFK, and Chicago–National.[13] Here the Federal Aviation Administration specifies the hourly number of slots, and these are then traded in a formal secondary market.

Possible amendments to the EU slots Directive

The current EC regulation was an amendment of EEC Regulation 95/93; however, the changes were small and technical. The UK Civil Aviation Authority (CAA) is a leading proponent of slot reform because the issue is perceived to be of great importance to UK airports, with their high levels of congestion.

There are two main options for slots reform:

– formalise secondary trading (as seen at the busiest US airports and as favoured by the CAA);
– reform primary allocation of slots (eg, through auctions).

A movement to secondary trading could clarify the rules governing slots trading to confirm its legality. The reforms could also enforce a minimum level of transparency and clarify whether third parties could engage in slots trading.[14] In other words, it could be one way of systematising the current processes and trades that occur anyway.

While secondary trading should enhance efficiency, it may create competition concerns if it allows an airline to abuse a dominant position. The CAA and Office of Fair Trading have noted this and suggested that a market investigation by national competition authorities could be the solution to these concerns.[15] This would allow each case to be treated individually.

The primary allocation approach would be a method of changing the way slots are initially allocated at airports. This could be in terms of changing the current administrative rules, attaching a price to each slot, or the auctioning of slots.[16] This basic approach to introducing a price for the slots attempts to ensure that they are allocated more effectively.

In theory, these reforms could benefit both airlines and passengers. Passengers should find that airlines offer services and routes which are closer to their preferences and willingness to pay, while airlines may benefit in negotiations with airports since obtaining slots would be a strong signal of their intention to operate a specific route or service.

Intentions of carriers and potential issues

Since the signing of the Air Transport Agreement, there have been few formal announcements from airlines regarding slots trades. It is therefore unclear whether, or how, potential new entrants will obtain slots at Heathrow, or what course of action incumbents might take. Increasing transparency about the trades is something that a reformed slots Directive might address.

Incumbents may choose to switch more services to the transatlantic market. This may be to protect their current position from competition, or it may be that they wish to make use of the lifting of some of the restrictions. For example, BA and American Airlines are currently prevented from flying from Heathrow to Dallas and Atlanta—BA has already announced that it will move its Dallas and Houston flights to Heathrow from Gatwick once restrictions are lifted, and American Airlines has announced that it will move some of its flights from Dallas to Heathrow.[17] While BA can achieve this by redeploying some of its own short-haul slots, it is not clear how, or indeed if, American Airlines can acquire sufficient slots at the right times to offer effective competition.

While there has also been speculation about bmi selling its 12% share of slots at Heathrow, or indeed possibly being taken over, there has been no formal statement on this.[18] In fact bmi's press releases suggest that it is considering expanding its transatlantic operations.[19] Furthermore, it has upgraded its long-haul fleet of aircraft, lending further support to the view that it may well be considering operating transatlantic flights from Heathrow.[20]

Access to Heathrow for carriers that currently have no slots at the airport may come through their group alliance partners. For example, Delta Air Lines is part of the Skyteam Alliance, the members of which also include Air France/KLM, both of which have slots at Heathrow.

All of these potential slot reallocations can only be implemented at the cost of reduced flights on other routes, and it is not clear what impact this will have on competition.

A further aspect of the Open Skies agreement that has attracted little attention is the ability of non-national carriers to operate from airports in the EU to the USA. This may well see a substantial increase in competition. For example, BA has already filed an application with the US Department of Transport for permission to operate services between any point in the EU and USA.[21] As most EU airports are less slot-constrained than Heathrow, it is likely that competition on these routes may be intense given that some routes may become completely unrestricted.

Conclusions

The Open Skies agreement is likely to have different impacts for different market agents. US airlines have gained access to Heathrow, the busiest international airport; EU airlines have gained access to the USA, although those that have seen their protected routes opened up, such as BA from Heathrow, are likely to benefit less from the agreement. The biggest beneficiary is intended to be the consumer, through increased competition and lower fares. However, the actual impact that the agreement will have on competition and fares depends on how competitive the current situation is (a matter of debate), and also on whether other restrictions on physical capacity will become the new limiting factor to competition. In order to help overcome these restrictions, the European Commission may consider reforming its current slots regulation. It could adopt the primary allocation approach, which could lead to some efficiency improvements. However, this would be a radical change as it would override the principle of grandfathering rights. Alternatively, formalising secondary trading would capture a significant proportion (if not all) of the efficiency benefits associated with reallocation of slots to users that value them most, but with fewer challenges regarding implementation, given that secondary trading would be voluntary.

[1] The UK has negotiated a delay in implementation of the agreement, from October 2007 until March 2008, in order to give Heathrow more time to complete the building of Terminal 5 and thereby increase its capacity.
[2] Airport Coordination Limited (2007), 'Heathrow Summer 2007: Start of Season Report', p. 8.
[3] Regulation (EC) No 793/2004 of the European Parliament and of the Council of 21 April 2004 amending Council Regulation (EEC) No 95/93 on common rules for the allocation of slots at Community airports.
[4] Mott MacDonald, Oxera, Hugh O'Donovan Associates and Keith Boyfield Associates (2006), 'Study on the Impact of the Introduction of Secondary Trading at Community Airports', February. Available at www.oxera.com.
[5] European Commission (2007), 'Information Note: Air Transport Agreement between EU and US', Directorate-General for Energy and Transport, March 6th.
[6] USA/CE 'Air Transport Agreement', 2007.
[7] European Commission (2007), 'Open Sky: Jacques Barrot Welcomes the Draft Aviation Agreement Reached by the EU–US Negotiators', press release IP/07/277, March 2nd.
[8] For a discussion of demand-related charging, see *Agenda* (2005), 'Pricing Signals at Airports: Implications for Airlines and the Environment', July. Available at www.oxera.com.
[9] Airport Coordination Limited (2007), 'Briefing Note: EU–US Open Skies and Access to Heathrow Airport'.
[10] DfT (2003), 'The Future of Air Transport', White Paper , para 4.40.
[11] Mott MacDonald, Oxera, Hugh O'Donovan Associates and Keith Boyfield Associates (2006), op. cit.
[12] Airport Coordination Limited (2007), 'Briefing Note: EU–US Open Skies and Access to Heathrow Airport'.
[13] Starkie, D. (2003), 'The Economics of Secondary Markets for Airport Slots', published in IEA (2003), 'A Market in Airport Slots'.
[14] CAA (2006), 'Reforming Airport Slot Allocation in Europe: Making the Most of a Valuable Resource', April.
[15] Office of Fair Trading and CAA (2005), 'Competition Issues Associated with the Trading of Airport Slots', prepared for Directorate-General for Energy and Transport.
[16] CAA (2006), 'Reforming Airport Slot Allocation in Europe: Making the Most of a Valuable Resource', April.
[17] BA (2007), 'Texas Flights Move to Heathrow', press release, June 27th; and American Airlines (2007), 'American Airlines to Significantly Increase and Upgrade its London Service', press release, July 5th.
[18] See, for example, *The Times* (2007), 'BA Ready to Pounce if bmi Chief puts Stake up for Sale', March 28th, http://business.timesonline.co.uk/tol/business/industry_sectors/transport/article1577590.ece; and *The Times* (2007), 'BA Strikes Secret Heathrow Slots Deal with BMI', March 30th, http://business.timesonline.co.uk/tol/business/industry_sectors/transport/article1591309.ece.
[19] bmi (2007), 'bmi Praises UK Government's Support of EU–US Open Skies Deal', press release. March 22nd.
[20] bmi (2007), 'bmi Unveils $750 Million Fleet Acquisition Plan: Five Airbus A330s and Five A321s to Join Fleet', press release, July 10th.
[21] BA (2007), 'Traffic and Capacity Statistics May 2007', press release, June 5th.