

**INTRODUCING COMMERCIAL ALLOCATION MECHANISMS:  
THE UK CIVIL AVIATION AUTHORITY'S RESPONSE TO THE EUROPEAN  
COMMISSION'S STAFF WORKING PAPER ON SLOT REFORM**

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## The CAA's Approach

1. This document sets out the UK Civil Aviation Authority's (CAA) response to the Commission Staff Working Document on commercial slot reform<sup>1</sup>. It is intended to complement the response being separately submitted by the UK Government on this issue.
2. The UK, including the CAA, has stressed the importance of reform in this area, especially for Heathrow and Gatwick, which have some of the most intensively used capacity in Europe. These airports offer a scarce resource, the value of which is not properly reflected when either allocating new slots or when transferring slots between airlines. This reduces pressure to use slots optimally and is neither in the interest of aviation customers, whose demands are not fully reflected in the use of slots, nor of airlines, which are unable to access the slots needed to operate higher-yielding services.
3. Shortly after the publication of the Commission's White Paper publication setting out the two-phase process of reform in which we are now involved, the CAA published its paper, *Implementation of Secondary Slot Trading*<sup>2</sup>. This set out the Authority's reasoning for supporting the introduction of commercial mechanisms to the secondary slots allocation process and explored a number of the key issues in detail. The findings of this work, together with NERA's substantial review of the options, make it clear that secondary trading would represent a substantial improvement over the current administrative system. But they also reveal that what may appear to be the minor details of any reforms are likely to have a profound impact on how well the system functions.
4. Since publication of the Commission's staff working paper, the CAA has stepped up its work on this issue, engaging particularly with the UK Government and the Office of Fair Trading (OFT). The CAA has advised the UK Government on its reply, and this response is intended to complement that. Separately, the CAA has worked with the OFT on a paper on the competition implications of further reform, which the OFT plans to present to the European Competition Authorities and DG Transport in the first half of 2005.
5. The CAA's long-held view is that efficiency should be the primary driver of reform of the regulations. A key determinant of efficiency is competition; the health of the industry and its users depends heavily on the ability of competitors to enter the market or to innovate. We understand that it is for this reason that the Commission has identified slot mobility as a central objective of the reforms. However, we would argue that this places an undue emphasis on slot mobility for its own sake whereas the key concern should be the ability to deal effectively with anti-competitive behaviour if it occurs. For this, we believe that standard competition law should in the main be sufficient and should be preferable to blunter *ex-ante* remedies. The lack of success of the new-entrant rule in promoting rivalry is one example of the difficulties of attempting to legislate in this way. The CAA's position reflects the prioritisation of efficiency over mobility and its belief in the general adequacy of existing competition law.

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<sup>1</sup> European Commission (September 2004) *Commercial slot allocation mechanisms in the context of a further revision of Council Regulation (EEC) 95/93 on Common rules for the allocation of slots at Community airports*.

<sup>2</sup> Civil Aviation Authority (November 2001) *The Implementation of Secondary Slot Trading*.

6. Lastly, our aim is a light-touch regulatory approach wherever possible whilst meeting the objectives of the reforms. Regulation should only be introduced where justified by the overall benefits to the industry and its users.

## **Secondary Trading**

7. The UK already has some experience of slot exchanges through the existing "grey" market. Although the number of slots changing hands is not enormous, the numbers of slots and players are significant enough to suggest that the grey market has become relatively well known to those airlines interested in buying or selling slots. Although the legality of such informal market trades is a matter of contention, it is undeniable that the operation of the present market has provided invaluable experience, which has been helpful in trying to extrapolate the likely effects of a formalised market. This trading has also had the effect of making more efficient use of a scarce resource.
8. The CAA continues to argue that secondary trading should be formalised as soon as possible to facilitate a greater volume of trading. This would make explicit the principle that where a resource is scarce it should be put to the highest value use. By enabling slots to be easily transferred from those with low valuations to those with higher valuations, this should become more of a reality.
9. There is considerable discussion in the Commission's working paper on the degree to which trades of slots should be regulated, both in terms of the degree of transparency required and the type of trading that should be permitted under the reforms. As stated earlier, the CAA believes that the starting point should be one of minimal intervention, with restrictions or requirements placed on the market only where the net benefit to users is shown to be positive. It is unfortunate that no impact assessment has been carried out to gauge the balance of benefits for the different options proposed in the paper; without this, it is difficult accurately to determine the optimum level of regulation.
10. The CAA's view, shared with the UK Government, is that there is little to be gained from restricting the types of transaction that can be carried out in the market. Exchanges and bilateral trades play an important role in facilitating the many day-to-day adjustments in schedules that take place at all airports<sup>3</sup>. To insist, for example, that all trades have to go through a formal "slot exchange" could actually result in a reduction in the number of trades as holders become less eager to trade without knowing the identity of the buyer. This could have the counter-productive effect of ossifying schedules. We therefore believe that, in common with other sectors, it should be left to the market to determine the best way of trading. This may - but not necessarily - include the establishment of an informal "slot exchange" trading platform.
11. Similarly, we believe that there are strong arguments for a light-touch approach to regulating transparency: firstly, because the method and composition of a trade should, in our view, be left to the market, the types of exchange may not always be straightforward. Many slot transactions are likely to involve non-monetary considerations, which make up-front disclosure of a summary of the deal difficult and subject to concerns of commercial confidentiality. Proposals such as pre-sale publication of an offer price would be misleading in these circumstances. Nevertheless, we do acknowledge that

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<sup>3</sup> For example, 30% of Heathrow's more than 9000 slots are modified in some way every year for operational reasons.

there is some benefit to a degree of post-trade transparency that we believe would likely outweigh the regulatory costs imposed on holders. Such an approach may include some kind of disclosure requirement such as those commonly used for stock exchanges. This would still be complex in cases, but because the requirement would only apply after the deal, the impact on willingness to trade would be reduced. Requiring sellers to notify the market of the key terms and conditions of the trade once completed would give other players a helpful indication of the likely market value of slots and therefore the opportunity costs of holding onto such assets. This should itself incentivise slot mobility as shareholders focus on management to act in their best interests. All this would appear to be achievable through the effective working of the market, with only minor regulatory intervention.

12. It may also be necessary to restrict the ability of slot holders to condition sales in a way that would stop its onward sale to other purchasers. The outlawing of such restrictive covenants for slots might impact on liquidity in the short run whilst preserving it in the future.
13. Allowing non-airline interests to buy and own slots would be one way of enabling the wider value of slots to be properly reflected. For example, much has been made of the likely impact of commercialisation on regional services; the argument is that higher value, long-haul services will displace short-haul, lower value services from congested airports. Of course, such displacement of services has its source in the congested nature of the airport, rather than commercialisation *per se*. However, giving regional interests the opportunity to buy slots would enable them to act on the high value they place on safeguarding services.
14. There are further advantages to allowing other non-airline interests to own slots. For example, it would allow slots to form part of a security package for financing that fully reflects the value of an airline's access to congested airports. We therefore fully support open-ownership of slots, although to insure against the unlikely situation where slots are purchased purely for speculative purposes, some form of use-it-or-lose it rule should be retained.

## **Primary Trading**

15. Although full acceptance of secondary trading remains our first priority, we also believe that there are considerable benefits to be gained from reform of the current system of primary allocation, particularly to deal with large new tranches of additional capacity, such as may be delivered by the opening of a new runway, or major operational changes. A liquid secondary trading market should be able, over a period, to remove inefficiencies in the system introduced by administrative allocation. However, this would take time and create potential windfall gains for recipients of slots from administrative allocation. For these reasons, we support the UK Government's view that any reform of the regulations should also permit the introduction of primary auctions for slots allocated from the pool or from any future increase in capacity.
16. There can surely be no argument about the theoretical basis for encouraging allocation via auctions; by enabling competing players to demonstrate the value they place on a slot through their willingness to pay, an auction provides an objective method of allocation, removing the need for an administrator to second-guess the value to the industry and its users of competing demands. Nevertheless, doubts remain as to the practicality of an

auction involving so many potential players and items, as well as the well-documented problem of interdependency – the need to be successful in a series of primary bids in order to obtain a workable “suite” of slots. However, auction theory and practice is well developed and we do not believe that these issues should be insurmountable. We therefore intend to continue working on this issue but believe it would be helpful if the Commission could prioritise gaining a better understanding of how to overcome these difficulties at a European level.

17. It is important that the reform does not attempt to be overly prescriptive about auction design, but simply enshrines the key principles governing their operation: transparency, consistency and non-discrimination. Beyond that, we believe that the design of auctions should be left to the individual member states to tailor to the circumstances of the individual airport. However, we recognise that this wish may need to be balanced with a desire to avoid a profusion of different auction designs across Europe.
18. One area where the CAA view differs from that of the UK Government is on how to deal with the proceeds from any slot auctions. The CAA believes that any revenue from slot auctions should be available to fund the costs of providing additional capacity – whether in terms of spending on physical infrastructure or the mitigation of environmental impacts. In the case of new capacity, it is generally the airport operator who would have incurred the investment risk. Similarly, where capacity improvements require environmental mitigation measures (e.g. possible “mixed-mode” at London Heathrow), or the involvement of other bodies (e.g. the air navigation service provider), the CAA considers the airport is best placed to play the mediating role.
19. The UK would need to give consideration to the way that receipts from the sale of slots would be regulated at the designated airports<sup>4</sup>. There should be no question of windfall gains. Where the airport operator has incurred costs in funding capacity, auction proceeds would assist in meeting these and go some way to mitigating the risks involved in lumpy investment. More generally, the interaction with the regulation of airport charges would need to be fully considered.
20. Ensuring that airports receive the receipts from slot sales would also ensure that the additional costs imposed on airlines under auctions would remain within the aviation industry – crucial when considering the competitiveness of national and European aviation in global terms.

### **Grandfather Rights**

21. The costs associated with formalised trading will bring with it a greater desire for clarity on the property rights acquired with a slot. Much is made in the Commission’s staff working paper of the importance of tenure and the grandfather rights that are incorporated in the current regulations. Whilst we understand the Commission’s rationale for wanting to “shake-up” the system of historic precedent to aid slot mobility, we think that the principal aim should be assurance that anti-competitive practices can be dealt with effectively and we believe that extant competition law should be sufficient in this regard. Furthermore, we do not believe that sufficient work has been done to assess the impacts that any proposals for churn or the limitation of property rights

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<sup>4</sup> The UK CAA regulates the airport charges of the designated airports, Heathrow, Gatwick, Stansted and Manchester.

would have on the stability of the system and its users. The expiry of a few slots may undermine the viability of an entire service as the knock-on effects ripple through a carrier's slot portfolio at that airport. This would potentially have a discriminatory impact on smaller and foreign airlines, which would be less able to re-jig their services. Some of the proposals from the Commission would seem to impose excessive and unjustified uncertainty, such as the 3% minimum churn. The CAA feels that these should be ruled out at this stage on the basis of impracticality and the negative effects on slot holders and consumers, particularly at a time when European airlines are still recovering from the impact of a number of exogenous shocks.

22. Other ideas such as a rolling churn of leaseholded slots could be more practicable as long as sufficient notice is given to holders of the expiration dates of the slots involved. However, even this change would have significant impacts on slot holders over time, would add another layer of complexity, and should not be considered until a proper analysis of the impacts has been carried out. Applying leasehold tenure to new slots would introduce the problem of a secondary market involving slots with differing tenure. Even more difficult would be a reform of existing slot tenure given the lack of proof of any anti-competitive effect of a system based on grandfather-rights and the increased likelihood of legal challenge from owners of existing slots. We agree with the UK Government that any proposals for a radical reform of grandfather rights should therefore be subject to a full assessment of the costs and benefits, including the impact on competition. Until then, we do not believe that a considered view can be reached on the options. The best approach is to formalise secondary trading as quickly as possible. If necessary, property rights for these slots could be defined so that revision of tenure is not precluded should a review after a suitable period show that the system is not working well and that more radical options need to be considered.

## **Summary and Recommendations**

23. The CAA strongly supports the Commission's emphasis on the importance of introducing commercial mechanisms to achieve a more efficient use of slots. Our recommendations are that:
- securing a sounder regulatory foundation for secondary trading should be the number one priority for reform but that the primary slot allocation process should also be reformed;
  - the system should be regulated with a "light-touch". Although there are strong temptations to regulate for both the mechanism of trades and their transparency, excessive intervention could be counter-productive, leading to fewer trades being carried out, with knock-on costs to users. Ex-post transparency of trades should be sufficient to provide information to the market;
  - the current ability to carry out slot exchanges or swaps should be retained, as they play a key role in providing market liquidity;
  - there are advantages in allowing ownership of slots by non-airline entities, but the use-it-or-lose it rule should be retained to guard against abuse;
  - existing competition law is sufficient to deal with any anti-competitive behaviour in the system. Removal or attenuation of grandfather rights would therefore require significant evidence of detriment before it could be justified;

- primary auctioning of slots should be permitted, although we stress that further work is needed to bottom out the practicalities; and
  - proceeds from auctions should be directed to offsetting the costs (both infrastructure and environmental) of slot creation and should therefore flow in the first instance to the airport operator rather than to Government;
24. We believe that these reforms would bring considerable and immediate benefits to the European aviation industry and its users, particularly those using congested airports and recommend their introduction as a matter of priority.