September 2013

Submission by Highlands and Islands Airports Group to the European Commission
EU Guidelines on State aid to airports and airlines

Background
Highlands and Islands Airports Ltd (HIAL) is a publicly owned airport operator. First established in 1986, it is wholly owned by Scottish Ministers and sponsored by Transport Scotland, the national transport agency.

HIAL operates 11 regional airports across Scotland at Barra, Benbecula, Campbeltown, Dundee, Inverness, Islay, Kirkwall, Stornoway, Sumburgh, Tiree and Wick John O’Groats. HIAL is the largest publicly owned airport group in Scotland, in a market dominated by private operators.

The HIAL network stretches across a vast swathe of regional Scotland, from Shetland in the Northern Isles to Campbeltown in the south west of Scotland, and is perhaps the most diverse of Scotland’s airport operators with its mix of remote island and coastal locations, as well as city airports in Inverness and Dundee.

Working with its stakeholders and airline partners, HIAL is committed to supporting the essential socio-economic role of aviation in Scotland through the maintenance and development of our airports.

Our core activities are:
- Providing airports which meet regulatory standards and support essential transport connectivity
- Maintaining and developing airport infrastructure and services
- Working with airlines and stakeholders to maintain and develop scheduled, charter and freight air services
Our mission:
To provide and operate safe, secure and efficient airports which support the communities we serve.

Our goal is to:
- Provide airports that enable air transport to fulfill its essential role in Scotland’s diverse regions
- Work with stakeholders to develop sustainable air connectivity that supports socio-economic development in Scotland
- Advise Scottish Ministers on future developments and resource allocation through robust strategic planning and effective collaboration with airport users and stakeholders

Connecting regional Scotland
The HIAL group connects regional Scotland to a network of around 30 UK and international destinations, including Aberdeen, Edinburgh, Manchester, Birmingham, Belfast, London, Jersey, Amsterdam, Bergen, Geneva and Zurich. Popular holiday destinations in Portugal, France and Italy are also served from Inverness, the busiest airport in the HIAL network.

The HIAL network is served by a relatively small number of scheduled airlines: easyJet, flybe, Loganair, Eastern Airways, Hebridean and Helvetic. Low cost airlines easyJet and flybe provide the majority of flights, the latter in conjunction with its franchise partner Loganair.

The largest aircraft in use on the HIAL network is the A319, operated by easyJet on its Inverness-Gatwick route.

Table 1 shows the scheduled services available from each HIAL airport.

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<th>Table 1. Scheduled destinations served from HIAL airports</th>
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In 2012, HIAL’s airports handled 1.28 million passengers. Table 2 shows the passenger breakdown by airport.

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The HIAL group accounts for almost 6% of Scottish air passengers. Table 3 shows the number of passengers using Scotland’s major airports.

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Supporting the regional economy
HIAL airports serve the economic and commercial interests of regional Scotland, supporting oil and gas helicopter operations, lighthouse maintenance and Royal Mail services. By maintaining a strong network of UK and European destinations, HIAL airports also provide vital domestic and international connections for business and inbound tourism.

The company employs more than 500 people across its 11 airports, and at its group headquarters in Inverness.

While the majority of Scotland’s airports are privately owned, HIAL is a publicly owned airport operator and receives no private sector investment. Instead, in recognition of the lifeline nature of many of its airports, the company receives a subsidy from the Scottish Government (currently £22.9 million). For the year ended 31 March 2012, the company recorded an operating loss of £969,000.

Peripherality and transport alternatives
HIAL’s airports are amongst the most remote of any in Europe. Sumburgh, which serves Shetland, is the most northerly scheduled passenger airport in the UK and is some 350 miles from Edinburgh and 760 miles from London.
More than half of HIAL’s passengers are served by airports in what would typically be regarded as remote locations (excluding Inverness and Dundee).

Many of the communities HIAL serves lack the choice of surface access options that passengers in larger towns and cities take for granted. Even Inverness, the capital of the Highlands, is relatively poorly connected. The rail network is inconsistent, expensive and slow. There are no motorways and only limited stretches of the main artery into Inverness – the A9 – has dual carriageway. A road journey to Glasgow or Edinburgh typically takes in excess of three hours, and up to nine hours to London. Dundee is the most centrally located of HIAL’s airports, in that it is relatively close to Scotland’s largest population centres, but even a journey to London would take around 7 hours by road or rail.

In our more remote island locations, the challenges are even more acute. In communities such as Lewis, Barra, Benbecula, Orkney and Shetland, the only viable alternative to air travel is a ferry journey to the mainland; often cheaper than flying, but involving long and inconvenient journeys, sometimes overnight.

The ability to connect quickly and seamlessly from one destination to another is one which is largely taken for granted in Europe. But for many parts of the remote Highlands and Islands, air travel provides a vital social and economic lifeline, and an essential means of connecting people and businesses.

**Supporting connectivity**

The cost of flying from the Highlands and Islands is considerably more expensive than in urban areas of the UK. In part, this reflects the region’s lower population base and relative distance from the main centres of population. This places additional, and disproportionate, financial burdens on local businesses and visitors to the region. The Scottish Government operates an Air Discount Scheme (ADS) which aims to tackle the problem of high air fares by providing a 40% discount on core air fares for residents in some of the most remote locations of the Highlands and Islands. The discount does not apply to inbound visitors, however.

The Scottish Government also subsidises certain lifeline services by means of a Public Service Obligation (PSO). This subsidy supports links to Scotland’s remote Highland and Island locations which would not otherwise be commercially viable including, for example, services from Glasgow to Campbeltown and Barra.

In addition, the UK Government has exempted departing flights from the Highlands and Islands from Air Passenger Duty (APD). Passengers flying to the region are, however, subject to APD and the tax is also levied on passengers connecting via other domestic hubs, such as Manchester and Gatwick. This affects a large proportion of passengers flying from Inverness, in particular.

In addition, the APD exemption on departing flights does not apply at Dundee Airport which has faced strong competition from privately owned Edinburgh Airport, Scotland’s busiest airport.

HIAL, in common with other Scottish airports, has voiced concern about the
impact of APD on tourism and business connectivity, and on the commercial viability of domestic and short haul air services. APD severely inhibits Scotland’s ability to attract new airlines. Scotland is expected to lose two million passengers and £210 million in tourism spend by 2016, according to a recent report by York Aviation. ¹

In June 2013, the UK Government announced a £20 million Regional Air Connectivity Fund to support regions not likely to benefit from the proposed High Speed Rail 2 network in England. While this funding is welcome, it does not address the fundamental problem of constrained capacity in the south east of England. As such, there is no guarantee, even with such a fund in place, that slots would be available at the busiest – and strategically most important – London airports.

At the same time, the fund is tiny in terms of the income generated for the UK Treasury by APD (currently £2.8 billion and projected to rise to £3.8 billion by 2017/18) and is dwarfed by state funding on rail.

A report by the Office of Rail Regulation shows that in 2011-12, the rail industry received some £698 million in Government funding - £268 million in support of franchised train operators, and a further £407 million in support of the Network Rail, which owns rail track and station infrastructure. ² In Scotland, Government subsidies amount to £7.67 per passenger journey, compared to a UK average of £2.74. ³ However, in the context of air travel, with APD increasing almost year on year, the principle appears to be that the passenger should pay.

Regional airports as economic drivers
Businesses and communities thrive on connectivity. The availability of fast, convenient transport options is key to attracting inward investment to a region.

Historically remote communities such as the Highlands and Islands have suffered from high unemployment and low levels of inward investment. However, the Highlands and Islands now enjoy a lower level of unemployment than the Scottish or UK average and the region has been successful in securing inward investment, particularly in Inverness. Leading companies such as Atos, Life Scan, Capita and Fujitsu have chosen to locate and expand their operations in the region.

The Scotch Whisky industry directly employs over 10,000 people with 85% of single malt whisky produced in the Highlands & Islands. It is Scotland’s largest food and drink export, operating in 200 markets around the globe, and as such international air connectivity is key.

Scotland is also the second largest producer of Atlantic Salmon in the world with almost all of that production taking place within the Highlands & Islands.

The energy sector in the North of Scotland is booming with the possibility of another 24 billion barrels of oil still to be extracted and another 40 years of activity. With almost 25% of Europe’s tidal resource around our shores and 25% of its wind resource, the region has a massive renewable potential. A number of HIAL’s airports, including Wick John O’Groats and Sumburgh, play a vital role in supporting the energy sector in Scotland.

Dundee also has great potential as a centre of excellence for wind, marine and hydro energy.

For regional Scotland to maintain its economic vibrancy, it must retain a strong network of air links. However, in order to secure new services, state aid is often required. For example, Highlands and Islands Enterprise and its partners contributed £420,000 to support the first year of the Inverness – Amsterdam service, launched by flybe in September 2011. This relatively small investment has helped improve connectivity from the Highlands and delivered a wider economic return. A report commissioned by HIAL shows that the route has generated some £2.1 million in additional visitor spend, creating 61 FTE jobs and generating around £1.7 million GVA for the local economy. However, a new route of this nature takes time to embed and support is required to raise route awareness and build up passenger numbers to make a route viable.

**The tourism dividend**

There are additional economic benefits in terms of tourism. Access to regional Scotland from destinations across the UK and – increasingly – Europe supports the growth of inbound tourism, and sustains the many local businesses that rely on tourism, one of Scotland’s most important industries.

With iconic attractions such as Loch Ness, Ben Nevis and Dunrobin Castle, and the success of Holywood movies such as Braveheart and Brave, the Highlands and Islands of Scotland have been particularly successful in attracting international visitors.

In 2011, VisitScotland estimates that UK residents took 1.86 million trips to the Highlands, spending £485 million. Overseas visitors made 0.39 million trips, spending £129 million in the local economy. The tourism dividend is considerably higher in the Highlands than in nearby Aberdeen and Grampian, which attracted 1.62 million UK and overseas visitors, spending a combined £359 million in the local economy.

HIAL’s airports serve as a gateway to many of Scotland’s most popular and iconic tourism destinations and are therefore of strategic importance to the tourism industry, a sector which employs more than 13,000 people in the Highlands alone.  

Dundee too is intent on attracting a growing share of the visitor market, with plans

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for a new Victoria and Albert Museum in 2014, set to become a world class landmark for the city, which is part of a £1 billion transformation of the city’s waterfront.

Dundee Airport is regarded by local business groups as critical to the regeneration of the city, and its ability to tap into the inbound leisure market.
**Response to the proposed guidelines**

HIAL welcomes, in principle, the European Commission’s proposals for state aid to airports and airlines. The air industry has changed markedly in recent years, with many airports suffering a significant decline in passenger numbers, and several European airlines suffering collapse as a result of the global economic crisis. In particular, we welcome the EC’s commitment to support smaller, regional airports which may carry relatively smaller numbers of passengers, and/or require public subsidy, but which nevertheless provide a valuable social and economic lifeline for the communities they serve, particularly in areas that lack surface access alternatives and therefore rely more heavily on air travel.

However, we have a number of comments and concerns regarding some of the proposals outlined in the consultation paper.

In respect of **investment aid to airports**, we acknowledge that investment costs relating to non-aeronautical activities such as parking, hotels, restaurants and offices are ineligible. However, we would welcome clarity regarding the eligibility of surface access infrastructure eg. road and rail improvements. For example, the Scottish Government has proposed a rail stop at Inverness Airport as part of a wider investment in the rail network in the north of Scotland. Airports can only grow if they are well connected to the regions they serve, and we would be concerned if such important infrastructure investments were regarded in the same manner as retail developments.

We would welcome clarity too on whether groups like HIAL would be treated as a single entity or as individual airports, given that the number of passengers has a bearing on the extent of aid available. As a group, HIAL handles almost 1.3 million passengers; however, no individual airport has more than 620,000 passengers, and indeed the smallest has less than 10,000 passengers.

In the context of **operating aid to airports**, although the proposed guidelines are not applicable to HIAL because of the particular way in which we are funded, looking at the bigger picture, we would nevertheless challenge the assumption that small, remote airports can necessarily become profitable after a 10 year transition period. Airports have significant fixed operating costs, including security, air traffic control and fire service costs; while much larger airports can offset or absorb these costs relatively easily through their larger passenger base, smaller airports are less able to do so, and some may continue to require public subsidy on an ongoing basis. In the case of HIAL airports, many of the passengers at our smaller airports are National Health Patients and their spend is negligible compared to airports which have year round leisure passengers.

We share the concerns echoed by ACI Europe that the withdrawal of operating aid after a 10 year transitional period could result in higher airport charges which, in turn, could drive cost conscious airlines customers away and/or lead to the withdrawal of key routes.

Finally, we welcome the proposal to provide **start up aid to airlines**, but believe the EC is not realistic in some of its assumptions.
As discussed above, the aviation industry was badly affected by the global downturn, which resulted in a significant drop in passengers and income at airlines and airports across the UK and Europe, from which the industry is only now recovering.

As the table below shows, HIAL was severely hit by the downturn, losing more than 200,000 passengers between 2007 and 2009, and passenger numbers only began to recover in 2011:

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Source: CAA & HIAL

The Scottish Government’s route development fund, introduced in 2002, supported more than 30 routes, including a number from Inverness, and brought about around £100 million of economic benefit to the Scottish economy. We welcome the prospect of state aid for airlines resuming after such a turbulent period for the industry. For a relatively small operator such as HIAL, state aid could make a significant contribution to our route development efforts and, in turn, help support regional economic growth across Scotland.

However, we would welcome greater clarity on the qualifying criteria for new and expanded routes – for example, whether they must operate a minimum number of flights per week, or whether they must operate year round.

A number of routes operated from HIAL’s airports are seasonal, including Inverness to Zurich and Geneva, and Sumburgh to Bergen. Smaller regional airports lack the population base, business demand and inbound appeal to sustain year round traffic. Nevertheless, seasonal services provide a valuable economic return for airports, airlines and local businesses that rely on tourism and inward investment. If such services were exempt from support this would limit regional economic growth.

On a more substantive point, we have serious concerns about the proposal to limit support to 2 years. From experience we know that this is an insufficient period to allow a new route to become profitable, particularly in the current economic climate, and especially in the context of small regional airports.
Regional airports, particularly those in more peripheral areas, face particular challenges in securing and sustaining direct, point to point routes, including:

- **Relative distance from key business and leisure markets** - our Highlands & Islands airports are amongst the most remote of any in the UK and cover an area larger than Belgium. This relative isolation results in additional fuel costs for airlines and means they can operate fewer rotations than they could from more centrally located airports. This makes smaller, regional airports a more costly, and therefore less attractive, proposition for airlines.

- **Size of local population** – the Highlands and Islands occupy a vast swathe of Scotland but have a population of just 448,671, according to the 2011 UK Census. This represents a population density of 11 persons per sq km, compared to 67 for Scotland as a whole, and 260 for the UK. Unlike the Highlands and Islands, the city of Dundee – Scotland’s fourth largest city – cannot be described as peripheral, given its close proximity to Scotland’s two largest cities. However, it does suffer from a declining population and strong competition from nearby Edinburgh Airport.

- **Ability to sustain year round services** – as we have discussed, this is a particular challenge for smaller city airports such as Inverness and Dundee.

- **Capacity constraints / charges at larger airports** – Capacity constraints at London Heathrow and London Gatwick airports have resulted in a dilution of regional air services into London, as airlines increasingly abandon the domestic market in favour of more lucrative medium and long haul destinations. Additionally, the decision by one of two operators at Inverness, Flybe, to withdraw from London Gatwick in response to rising airport charges illustrates the challenge for smaller regional airports which are effectively being forced to compete with more commercially attractive destinations in Europe and beyond.

- **Profitability/ ability to incentivise airlines** – HIAL is a loss making organisation. None of its airports would be commercially viable in the private sector, even Inverness. Although HIAL has been successful in securing new business and sourcing new streams of revenue, we nevertheless rely heavily on public subsides in order to operate our airports. As a result, HIAL is constrained in terms of the discounts that it can offer to airlines. Although we strive to be competitive, we do not have the commercial power of larger airports such as Edinburgh or Manchester which have significantly larger marketing budgets at their disposal. Unlike private airports, we cannot borrow money in order to invest in new infrastructure or marketing support, and must operate within budgets set by the Scottish Government. This limits our ability to incentivise new and expanding airlines by underwriting routes.

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5 The Highlands and Islands in Numbers, HIE, January 2013
- **Impact of APD** – Regional airline flybe, which serves the majority of HIAL’s airports, is required to pay in excess of £70 million in Air Passenger Duty and recently cited the tax as one of factors behind its decision to sell its entire portfolio of slots at London Gatwick. As a regional airline serving relatively thin domestic routes, often in remote, sparsely populated areas, flybe is disproportionately affected by APD. Given that they are one of our biggest customers and play a vital role in connecting the Highlands and Islands, we share their concern about the impact of APD on regional connectivity.

- **Diversity of airlines** – HIAL’s airports lack the diversity of airlines, and aircraft types, of other larger airports. In the past, airlines such as BMI and BA have operated from HIAL’s airports, the latter in its own right and through a franchise agreement with Scottish airline Loganair. Historically, legacy carriers such as BA operated routes between the Highlands and London in order to serve their hubs, Gatwick and Heathrow. However, capacity constraints at the London airports have resulted in a significant reduction in the number of regional airports with links to London’s main airports. At the same time, the emergence of low cost airlines has changed the market dynamic quite considerably. BA no longer operates from any of HIAL’s airports (and BMI no longer exists). Today, HIAL’s largest operators are easyJet and Flybe, both low cost carriers. While they have helped transform connectivity to and from the Highlands, they are intensely competitive on price based on passenger loads and sector lengths. This makes our airports a less attractive proposition for low cost airlines and limits our ability to grow our network because we are - in Inverness and Dundee, at least - in competition with much larger airports that can offer better incentives, higher yields, and more passengers. At the same time, operators at HIAL airports typically use smaller aircraft than they would at larger airports, primarily due to the extra costs associated with flying to remote regions, and the smaller population base. Again, this makes our airports less attractive from a commercial perspective.

Collectively, these issues make it significantly more difficult for an airport operator such as HIAL to secure new routes. Indeed, often the challenge for HIAL is to **retain** existing services, rather than secure new routes.

Given these many challenges, a two year funding package will simply not incentivise airlines to operate from smaller regional airports. New routes are unlikely to be commercially viable in their early years, and the notion that funding could be withdrawn after just two years is wholly unrealistic.

Evidence from working with our airline partners suggests that a period of 3 years is required, as a minimum, to allow a new route to mature sufficiently. Limiting support to 2 years would not incentivise airlines to consider operating from remote/sparsely populated regions, such as the Highlands and Islands. Indeed, it may act as a barrier to route development in the region, according to Fraser Grieve, Highlands and Islands Manager for the Scottish Council for Development and Industry, representing a cross section of local, national and international
businesses:

“Two years is not long enough to establish and develop a commercial operation particularly where there are growing pressures on major airports to squeeze out the size of aircraft that are able to make a commercially viable service given the low population density of the H&I region. Measures proposed in these guidelines may go some way to helping airports such as those operated by HIAL but they will not give sufficient time to grow services where they can be self-sustaining. HIAL airports do not just need help to level the playing field but to enable it put forward propositions that could be attractive when viewed against other more easily profitable routes.”

Additionally, the prospect of route development funding being withdrawn within two years may undermine efforts to attract inward investment to a region. Businesses are unlikely to invest in a particular location if there is uncertainty surrounding the future of strategically important air links.

HIAL believes that in the face of such challenges, the EC should reconsider its proposal to allow state aid for a maximum of 2 years and should instead consider a minimum of 3 years as a more appropriate and realistic timescale. However, in the context of smaller regional airports (under 1 million), we would propose a 5 year timescale may sometimes be required.

We would also urge the EC to ensure that support is not aimed solely at point to point international flights, but that support is also offered to encourage access via domestic and other hubs.

Access to a hub is absolutely key to small regional airports, which typically lack the population base to support year round international destinations. Only two of HIAL’s airports, Inverness and Sumburgh, serve international destinations. Only Inverness has access to a major international hub, Amsterdam.

While it is our ambition to increase the number of point to point international destinations available from our airports – Inverness has recently secured a new seasonal Geneva service, for example – we are realistic about the opportunities.

Smaller regional airports like Inverness cannot realistically sustain the range of international services as larger airports such as Edinburgh, Manchester or Stansted. Therefore access to key domestic hubs – such as London City from Dundee and Manchester and London Gatwick from Inverness – is of critical importance, particularly for business connectivity.

According to the Highlands and Islands Federation of Small Businesses:

“Access to and through London by air is of the utmost importance to every sector of our economy – It is not just about getting people to and from Inverness, for Inverness acts as a hub for the whole region and many passengers from London will travel on from here.”
Only two airports in the HIAL network currently have access to London airports, Inverness (to Luton and Gatwick) and Dundee (to London City). Neither airport has access to Heathrow. Indeed, in recent years, as Heathrow has reached capacity, the number of regional airports with access to the airport has declined markedly, from 18 in 1990 to just eight today. Access to Gatwick is also increasingly under threat. In June 2013, UK regional airline Flybe announced the sale of its entire portfolio of slots at Gatwick, citing the impact of APD and “punitive charges” at the London airport. As a result, some of the most remote areas of the UK – including Newquay, Guernsey and Jersey – could potentially lose a valuable link to Gatwick.

A recent survey of more than 300 businesses across the Highlands found there was widespread concern about the risk of a further erosion of links between the region and London, with one energy business in the far north of Scotland warning:

“Our business is very isolated and already very difficult to get to - losing any more flights will severely limit ability to conduct business as well as attract/convince people to work with us.”

The study, by business organisation SCDI, also found that Inverness had lost 50,000 passengers to other Scottish airports – Aberdeen, Edinburgh and Glasgow – because of a lack of direct flights to Heathrow from the city. For an airport with just over 614,000 passengers, this represents a significant loss of business. It also has a direct bearing on the region’s ability to attract visitors and inward investors. The other Scottish airports do not have connecting flights with Inverness and are in the region of 2-3.5 hours away by road, which is not best use of business time, or attractive for new business investment.

HIAL therefore believes that start up aid should not be restricted solely to new international services – which would clearly give larger airports an advantage – and that support should be extended to new or expanded services from regional airports to larger domestic hub airports.

Regional Scotland – a special case
Many of the challenges we have identified above apply to other regional airports across the UK and, indeed, Europe. However, HIAL’s airport network is perhaps the most distinctive in Europe, serving a vast geographical area which is sparsely populated, lacks adequate surface access provision and is therefore hugely reliant on air transport as a means of transporting people and goods. These links are of vital importance to the economy of regional Scotland. The proposals advocated by the EC, although well intentioned, would leave areas of the Highlands and Islands even more isolated. Instead of promoting route development, they would undermine our efforts to secure new services as airlines looked elsewhere, to airports with more guarantee of success. The one size fits all approach advocated by the EC is simply unworkable and will disadvantage smaller regional airports. Limiting support to two years is short-termism at its worst and will not deliver a sustainable economic return. Regions such as the Highlands and Islands must have greater flexibility, and must be given more time
to nurture new routes. We are indeed a special case.

**Conclusion**

While we welcome the decision by the EC to refresh its guidelines for state aid to airlines and airports, following a hugely challenging period for the industry, we believe that the proposals, in their current form, represent a missed opportunity to support an industry which sustains tens of thousands of jobs across Scotland, encourages business investment and economic growth, and delivers lifeline services to some of the most remote areas of Europe. In particular, we do not believe the proposals reflect the distinct challenges facing small, regional airports in Scotland and would urge the EC to reconsider its proposal to limit start up aid to airlines to 2 years. The HIAL network of airports is amongst the most peripheral in Europe, serving a vast geographical area of regional Scotland and connecting sparsely populated remote and island communities that have limited transport options. We do not consider that a ‘one size fits all’ approach is fair or proportionate and we would urge the EC to consider the challenges we have outlined in more detail, particularly in respect of start up aid for airlines. There is a real danger that, while the market continues to recover and passenger numbers increase, smaller regional airports are squeezed out of the market and do not enjoy the fruits of this growth.

**Further information**

HIAL would welcome the opportunity to meet officials to discuss the particular challenges we face in terms of funding, peripherality and connectivity. Contact details are provided below.

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