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Competition *policy brief*

Occasional discussion papers by the Competition Directorate–General of the European Commission

New State aid rules for a competitive aviation industry

1. State aid control 2.0

The Commission is modernising all the rules it uses for its State aid control. The Commission's guidelines are being revised to align them with the priorities of the EU's growth strategy, Europe 2020. The new rules will encourage Member States to put in place well-designed aid measures which further economic growth and objectives of common EU interest, while preserving competition in the Single Market. At the same time, the Commission will focus its attention on the cases with the strongest impact on the Single market, and will simplify the rules so as to make their implementation by the Member States easier. The new guidelines on State aid to airports and airlines contribute to that effort.

In a nutshell

These are smarter, tailored and simpler rules that:

- permit investment aid if there is a genuine transport need

- establish transition periods for small airports

- provide simple rules for start-up of new routes

- are flexible towards isolated regions

- ensure aid is not wasted and ends up where it is most needed

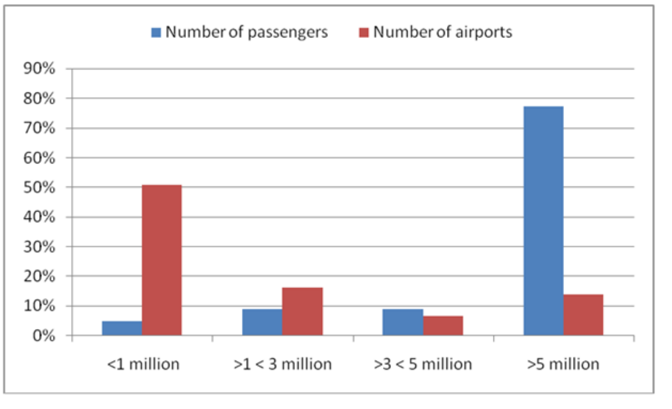
2. Introduction

European aviation industry

Aviation plays a fundamental role in the European economy for both EU citizens and industry, with more than 15 million annual commercial movements, 150 scheduled airlines, a network of over 440 airports, and 60 air navigation service providers. Airlines carry about 40 per cent of value of Europe's exports and imports, and transport 822 million passengers per year to and from Europe.

The majority of airports in the EU are small regional airports, with 60 per cent of the total serving fewer than 1 million passengers per year.

EU Airports per size category



Over the past 20 years, the EU airport industry has undergone fundamental changes. Previously airports were mostly managed as public infrastructures to ensure accessibility and territorial development; in recent years they have specific commercial objectives and are competing with each other to attract air traffic. Over the last decade, many former military or general aviation airports have been converted into civil aviation airports. This development has been supported by the emergence of low-cost carriers.

Low-cost carriers have brought important benefits to passengers, enabling millions of European citizens to travel more cheaply. In 1992, over 65 per cent of passenger seats were sold by incumbent air carriers and only 1.5 per cent by low-cost carriers. Low-cost carriers (42.4%) exceeded the market share of incumbent air carriers (42.2%) for the first time in 2011. This trend continued in 2012.

Now there is effective and growing competition among European airports, brought about by route liberalisation and airport privatisation. The major European airports compete with each other for point-to-point and transfer traffic in order to expand

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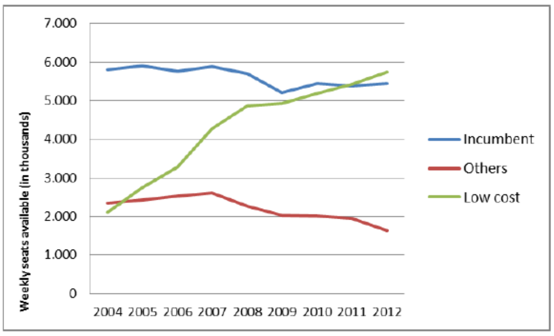
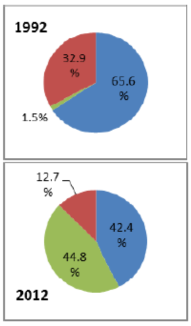
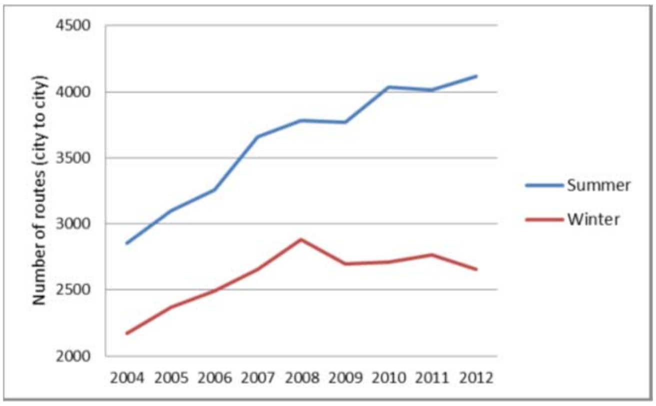
both their route/airline portfolio and reduce their dependence on the established hub carriers.





Regional airports have fostered the growth of point-to-point carriers, mainly low-cost carriers, in offering their capacity to airlines. As a consequence, the number of city pairs offered within the EU has risen, and competition among all airlines has increased, both among flag carriers and low-cost carriers. The results are lower fares, increased frequencies and more destinations for air travellers and air freight.

Number of intra-EU27 and domestic routes per season (summer vs. winter), 2004-2012



Smaller regional airports have also become accustomed to market pressures, as they compete for no-frills and regional services. In addition, privatisation has become an increasingly important trend in the airport industry, introducing even greater efficiency across the sector.

Why impose State aid control for airports and airlines?

Airports improve access to regions, which facilitates market access for regional businesses. They can also have significant economic impact in terms of employment and contribution to a country's GDP. For many remote communities and small islands, access to the rest of the country and beyond is often only possible by air.

Despite their positive effects on regional development and accessibility, regional airports present a dilemma. First, public funding to airport infrastructure has often resulted in duplication of (unprofitable) airports in the same catchment area, creating ghost airports and overcapacity at regional airports, while leaving the congestion problem of main airports unsolved.

Today 63 per cent of EU citizens live within a two-hour drive from at least two airports.

Second, the vast majority of regional airports do not generate sufficient revenue to even cover their costs. Regional airports sharing the same catchment area may suffer from a cannibalisation effect, i.e. a split of traffic among several underutilized airports, which prevents all of them from growing to become more attractive, and results in higher costs as density/scale economies are not realised. Ultimately the capacity of regional airports is and remains underutilised. Subsidies are then used to pay for investments, to cover operating losses and to attract price-sensitive airlines. Mainly low-cost carriers receive a mixture of discounts, success fees and marketing payments to stimulate traffic. When airports and airlines receive aid, their more efficient and more innovative competitors see the rewards for their efforts disappear. All this leads to distortion of competition.

The context in which the new guidelines have been discussed makes the issues at stake all the more pressing. While the European economy is showing signs of improvement and significant efforts have been made by airports to increase their profitability, 42 per cent of European airports remain loss-making. Expanding aid to airports and airlines is not the answer, even if regions have adequate resources. Instead the rules need to be tailored to ensure that the current level of public resources can be used more efficiently and in a less distortive fashion. Also, in public consultations, stakeholders have asked us for greater clarity and better rules. For these reasons we have created a new set of rules that are smarter, simpler and more flexible.

The new rules replace current guidelines dating from 2005. These guidelines formed the basis for nearly 100 decisions over the eight years they were in force.

Four reforms in particular are critical: (1) a transition period for operating aid, to allow unprofitable airports to adjust gradually to changing markets, (2) better targeted investment aid, to ensure that public support targets cases where it is truly needed, (3) simplified rules for start-up aid, to attract airlines to fly to new destinations and start using new and untested airports, and (4) clear rules for the assessment of airport-airline agreements, to ensure that they are aid-free and contribute to the profitability of the airports concerned.

New EU guidelines say goodbye to ghost airports

3. Improvements introduced by the new guidelines

Transitional periods for operating aid

One of the innovations in the new guidelines is the provision of a transition period, during which 50 to 80 per cent of the initial funding gap (the amount of operating costs not covered by revenues during 2009 to 2013) of small airports may be covered by aid.

To give small airports enough time to adjust to new market developments, the new rules allow granting of operating aid to small unprofitable airports during a 10-year transitional period, after which the airport must be able to cover its own costs.

The key element for assessing operating aid to airports is an *ex ante* business plan that proves the airport will be able to cover all operating costs by the end of the 10-year transitional period.

For airports handling fewer than 3 million passengers, the maximum permissible amount of aid will be limited to 50% of the initial operating funding gap of the airport (the amount of operating costs not covered by revenues during 2009 to 2013) for each year of the transitional period.

For example: if the initial funding gap of a given airport is equal to EUR 1 million, the maximum amount of operating aid that the airport could receive would be EUR 5 million over ten years (50% x 1 million x 10).

For airports handling up to 700 thousand passengers, the maximum amount of aid will be 80% of the initial operating funding gap, for a period of five years. After that, the Commission will reassess the case and see whether special rules should be devised.

At the end of the transitional period, airports must be able to finance their operations from their own resources and may no longer receive operating aid. In the intervening time, those airports should improve their finances by gradual increasing airport charges to airlines, introducing rationalization measures by differentiation of business models, and attracting new airlines and customers to fill idle capacity.

Certain European airports have already started to diversify their activities to increase profitability. For example, Tampere-Pirkkala airport in Finland (a regional airport handling around 600,000 passengers per year) converted its vacant cargo hangar into a low-cost terminal to offer cheaper services at a more efficient cost base than at its full service terminal.

Connectivity remains ensured where necessary

Although airports in general may no longer receive aid after the transitional period, it will still be possible to receive compensation for uncovered operating costs of services of general economic interest (SGEI). This applies to airports with an important role in improving regional connectivity of isolated, remote or peripheral regions of the EU. For example, compensation could be permitted if the disappearance of an airport would hamper the social and economic development of an area by isolating it from the rest of the EU. The assessment will depend on the particular characteristics of each airport and of the region that it serves.

If the State aid to discharge a SGEI is granted to airports where the average annual traffic does not exceed 200,000 passengers over the duration of the SGEI entrustment, it is exempt from the notification requirement, but needs to comply with the compatibility criteria set out in the 2012 SGEI Decision[1]. State aid not covered by the 2012 SGEI Decision (notably to airports exceeding the traffic threshold of 200,000 passengers) can be declared compatible under Article 106(2) of the Treaty, if the conditions of the 2012 SGEI Framework[2] are met. However, the State aid granted to discharge a SGEI at airports with annual traffic above 200,000 passengers needs to be notified to the Commission.

[1] Official Journal L7, 11.01.2012, p. 3-10

[2] Official Journal C8, 11.01.2012, p. 15-22

For further information see the 2012 SGEI Package IP/11/1571

Better targeted investment aid

Besides making operating aid smarter, the guidelines improve the rules for investment aid.

In the first place these rules are clearer. The Commission's case experience has shown that many regional airports operate far below their full capacity. The 2005 guidelines do not provide clear rules on overcapacity and duplication of infrastructure. They do not make a distinction for financing needs according to airport size, and leave open the issue of maximum permissible aid intensity.

The new guidelines will allow investment aid only if there is a genuine transport need and only when the positive effects are clear, such as improved accessibility, regional development and less traffic congestion at major airports.

Aid should only be used to create additional transport capacity where there is a demand for it. Public money should not be wasted on aiding investments that lack satisfactory prospects or undermine existing airports in the same catchment area. Funds should not be spent on aiding areas that are already well connected by other modes of transport – such as high-speed trains.

As a general rule, only projects that would not have been undertaken, or would not have been undertaken to the same extent without State aid, will be supported.

The new rules for investment aid are not only more clearly outlined, but also better tailored to airport size.

Aid will not be allowed to exceed certain ceilings. Depending on the size of the airport, these range from 25 per cent to 75 per cent of maximum permissible aid.

Airport size	Aid intensity
3 - 5 million	Up to 25%
1 - 3 million	Up to 50%
Below 1 million	Up to 75%

The percentage of maximum permissible aid will be higher for smaller airports than for larger airports.

Some flexibility may also apply to larger airports (over 5 million passengers). Public funding may, for instance, be justified when an existing site is being relocated. Otherwise, state funding may only be allowed under very exceptional circumstances. There must be a clear market failure. The Commission will also take the size of investments into account as well as the impossibility of financing investments on the capital markets. At the same time, the aid must have very clear positive effects and competition distortions must be limited.

More flexibility for airports located in remote and peripheral regions

The ceilings for investment aid to finance airport infrastructure at airports located in remote regions (such as outermost regions, sparsely populated areas, islands) may be increased by up to 20 per cent irrespective of the airport size.

In addition, small airports located in peripheral regions of the EU may be eligible for higher maximum levels of aid.

Simpler start-up aid for new airlines

In order to improve connectivity between regions, the 2005 guidelines allowed airlines to receive start–up aid for operating new destinations from regional airports or operating new schedules with increased flight frequencies. All parties involved, i.e. airlines, airports and public authorities, considered these rules complex and cumbersome.

Under the old rules, only airlines at 18 airports in eight Member States received start-up aid for launching new routes and new schedules from those airports. Under the new rules, more airlines should be able to receive aid they are legitimately entitled to.

The new guidelines simplify the conditions for start-up aid. In the future airlines will be able to receive aid covering 50 per cent of airport charges for new destinations during a three-year period.

More flexible arrangements in terms of airport size and eligible destinations could be justified for airports located in remote regions, for example on an island or in a sparsely populated area.

Airline-airport arrangements

The new guidelines also provide guidance on how State aid rules apply to agreements between airports and airlines, including rebates and other advantages granted by airports and public authorities to airlines. Since airports are still predominately publicly owned and often rely on public support to finance their operations, State aid rules can also apply to agreements between airports and airlines. Public authorities are often directly or indirectly involved in attracting airlines through marketing support, rebates or incentive schemes with the objective of increasing the connectivity of a region. State aid rules apply to all agreements between airlines and airports irrespective of their business model.

Agreements concluded between airlines and airports will be considered free of aid if a private investor, operating under normal market conditions, would have accepted the same terms. The best way of assessing this is to require that the airport be capable of covering all costs stemming from the agreement with an airline. In other words, airport revenue (airport charges and the non-aeronautical revenue, such as shops and parking) must at least pay for the incremental costs induced by the presence of the airline, and contribute to the airport's profitability.

If the arrangement is not profitable, the airport/airline deal will be considered as public support to the airline.

Unless it meets the conditions for start-up aid, the benefiting airline would need to pay back any incompatible aid.

Example: Following several complaints, the Commission investigated alleged aid to air carriers at Berlin Schönefeld Airport. The agreements with the carriers were considered free of aid because each of these agreements could reasonably be expected to improve the financial situation of the airport when they were entered into.

4. Impact

Stricter rules coupled with a ten-year transitional period for receiving State aid will encourage airport managers to cut costs and operate more efficiently. The Commission has conducted an impact assessment to estimate the effects of the new rules.[3]

Benefits for tax payers

The first beneficiary of the new rule is the European tax payer. According to the assessment, operating aid per passenger could be halved from €6.19 to as little as €3.09 per passenger. This could save public authorities across Europe as much as €2.35 billion over a ten-year period (see table below for estimates per airport category).

Estimated amount of operating aid in EU airports, in million EUR, for a period of 10 years

Airport size	Current situation	New rules
<200 000	**1 949**	**974-1 949**
200-500 000	**2 497**	**1 248**
500 000 – 1 million	**183**	**92**
1 – 3 million	**71**	**36**
3 -5 million	**0**	**0**
Total	**4 700**	**2350- 3 325**
Average per passenger (in EUR)	**6.19**	**3.09-4.29**

Ticket prices

Under the new rules – as is only fair – it is the passenger, not the tax payer, who funds the cost of air travel. While reducing State aid could in theory lead to an increase in ticket prices, this change is estimated to be minor.

According to our calculations, if airports passed on the loss of subsidies entirely to their passengers, this would lead to at most a €3 increase in airfare per journey. However, these calculations do not take airports' savings into account.

First, to cover gaps created by decreasing State aid, airports will increase the efficiency of their operations. Estimates of the total amount of savings per passenger during the transition period run between €6.7 and €12.6 per passenger.

Second, in line with current trends, airports will open up other sources of revenue, such as shops, restaurants, cafés and car-parking to cover costs. Possible revenues could increase from €3.5 to €8.2 per passenger.

So, on balance, gains in revenues through increased efficiency and running commercial operations add up to a total increase of between €10.2 and €20.8 per passenger, which clearly offsets the €3 increase in cost per passenger.

The new rules are not likely to affect the low-cost carrier model, providing these companies continue to operate efficiently.

Expected savings made by EU airports, in EUR per passenger[4]

Airport revenue

Airports with passenger traffic	Non-aeronautical revenue			Non-aeronautical revenue potential per passenger	
	Max	Average	Min	Min	Max
1-3 million	€ 7.72	€ 4.68	€ 1.61	€ 3.07	€ 6.11
1-500 000	€ 9.75	€ 5.26	€ 2.77	€ 2.48	€ 6.98
500 000 - 200 000	€ 14.11	€ 5.60	€ 0.70	€ 4.89	€ 13.41
Below 200 000	€ 9.56	€ 6.81	€ 3.27	€ 3.53	€ 6.28
Average				€ 3.50	€ 8.19

Airport costs

Airports with passenger traffic	Operating costs			Cost efficiency gains per passenger	
	Max	Average	Min	Min	Max
1-3 million	€ 13.50	€ 7.96	€ 4.74	€ 5.54	€ 8.76
1-500 000	€ 13.45	€ 10.97	€ 8.66	€ 2.49	€ 4.79
500 000 - 200 000	€ 24.16	€ 14.23	€ 4.51	€ 9.93	€ 19.64
Below 200 000	€ 28.32	€ 19.57	€ 11.26	€ 8.76	€ 17.06
Average				€ 6.68	€ 12.56

Total efficiency gains

Airports with passenger traffic	Total efficiency gains per passenger	
	Min	Max
1-3 million	€ 8.61	€ 14.86
1-500 000	€ 4.97	€ 11.77
500 000 - 200 000	€ 14.82	€ 33.05
Below 200 000	€ 12.29	€ 23.34
Average	€ 10.17	€ 20.76

Connectivity

The new rules guarantee that isolated regions, in particular remote regions, will remain connected to the rest of the EU. Key airports in such areas may still receive State aid to discharge such an SGEI even after the end of the transition period.

Moreover, airports (irrespective of their size) located in remote regions will be able to benefit from higher aid intensity ceilings to develop their infrastructure. In order to increase the mobility of EU citizens by establishing access points for intra-EU flights and to stimulate regional development in remote regions, the criteria for granting start-up aid for new routes from these regions are more flexible.

[3] SWD(2014) 42 and SWD(2014) 43.

[4] Calculated under the assumption that currently underperforming airports would be able to achieve at least the average level of non-aeronautical revenues or operating costs (i. e. minimum efficiency gain). The upper boundary is calculated under the assumption that currently underperforming airports will move to the present-day average by adjusting their revenue and cost structure.

Outlook

We expect that most airports will be able to transform themselves during the ten-year transition period, and that only the most inefficient airports will close down.

According to the impact assessment, no airports handling over 500,000 passengers will close. However, some smaller airports may close if they fail to improve efficiency and increase revenues.

Considering the example of the United Kingdom, where many small airports are commercially viable, there is reason to be optimistic and to believe the number of closures will be low.

Simpler rules on start-up aid make it likely that new connections will appear, which will increase connectivity.

The new rules will, however, put an end to subsidised airports that duplicate existing capacity. These are a waste of tax payers' money and undermine competition.

The conditions under which Member States may grant state aid to companies in financial difficulty are not set out in the present Guidelines, but in the Commission's Rescue & Restructuring Guidelines[5]. Such aid can only be granted under strict conditions, ensuring that the aided company will become viable without continued state support, that the company contributes to the costs of the restructuring and that the distortion of competition created by the aid is effectively off-set[6].

In conclusion - the new guidelines for State aid to the aviation industry provide rules that are smart, simpler and better tailored to the industry. They ensure that State aid - taxpayers' money- is not wasted, and is spent where it will benefit passengers and citizens the most.

[5] Official Journal C244 1.10.2004, p.2 ff

[6] MEMO/04/172