

# Agenda

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## Overruled: the state aid case against Ryanair and Charleroi Airport

**In a judgment issued in December 2008, the Court of First Instance overturned the European Commission's decision that the low-cost airline Ryanair received state aid through its contract with Charleroi Airport. What role did the market economy investor principle play in the decision and judgment?**

The ruling of the Court of First Instance (CFI) was the culmination of a case lasting since early 2002, when the European Commission received a complaint alleging that Ryanair had received state aid at Brussels South Charleroi Airport (BSCA).<sup>1</sup> The *Charleroi* case was the first in a series of regulatory and judicial proceedings concerning the contractual arrangements between low-cost airlines and state-owned regional airports across Europe. It has set important precedents for the manner in which such cases will be considered in the future, both in aviation and in other sectors of the economy.<sup>2</sup>

### The arrangements between Ryanair and BSCA

The agreement at issue was signed in November 2001 by Ryanair, BSCA and the Walloon government (which owns the airport), and concerned Ryanair basing aircraft at BSCA. A base is where aircraft remain overnight; it is important for an airport to have aircraft based there because they can operate early outgoing flights and late incoming flights, maximising the amount of time the airport is used and the number of air traffic movements it will receive. Prior to this agreement, Ryanair had already operated flights to and from BSCA under an earlier (1997) agreement, using aircraft based at other European airports.

The precise terms of the 2001 deal were crucial to the Commission's consideration of whether it represented state aid to Ryanair. Among the key terms were the following.

- The landing charges payable by Ryanair were approximately 50% lower than the general charges for using the airport, which were previously fixed by the Walloon Region (via a decree of the Regional Parliament). The basis of charging was also different for Ryanair. While the standard tariffs were set on the

basis of the weight of the aircraft, Ryanair paid charges according to the number of embarking passengers.

- Payments were to be made to Ryanair by BSCA at the start of the contract. A maximum of just under €3m could be paid, most of which was on the basis of €160,000 for each new route opened from BSCA to another airport.
- Ryanair was to pay a discounted fee for ground handling of €1 per passenger (compared with a standard fee of €10 per passenger).
- A promotional arrangement ('Promocoy') was set up, whereby Ryanair and BSCA each contributed €4 per passenger to a fund for advertising and promotion of flights to and from BSCA.
- Ryanair was to base between two and four aircraft at BSCA, and operate at least three rotations per day with each aircraft, for a 15-year period.

The arrangement at its core was therefore discounting standard airport rates in return for long-term commitments to provide a minimum level of service at the airport.

### The Commission's investigation and decision

For a given arrangement to constitute state aid, four conditions must cumulatively be met, as derived from Article 87(1) EC Treaty:

- there should be aid granted from state resources;
- that aid should distort or threaten to distort competition;
- the aid must favour certain undertakings or the production of certain goods; and

- the aid must distort trade between Member States.

In this case, the Commission and the various interested parties (including Ryanair) focused on whether there had been aid granted from state resources. This issue effectively turned on whether the market economy investor principle (MEIP) was satisfied. The MEIP states that if an arrangement would have been entered into by a private investor, it cannot represent state aid (as the state is then behaving in the same way any other agent in the economy would, so there is no transfer from state resources). Whether or not the MEIP was satisfied was a key area of contention between Ryanair and the Commission.

The first issue of importance when considering the MEIP is whether it could be applied at all to the specific deal signed by Ryanair. This proceeds from the Commission's characterisation of the fees paid by Ryanair to use the airport as 'taxes' (given that they are set by decree of the Walloon Parliament) rather than charges (which could be set by the airport independently of political authorisation). The Commission stated in its decision that:

the Walloon Region has placed itself in a situation of confusion of powers. Instead of acting within the framework of its public powers, it deviated from the rules that it laid down itself by making the agreement ... with Ryanair. The 'commercial need' to attract Ryanair to Charleroi thus made it move outside the applicable framework in relation to fixing charges in Wallonia ... The principle of private investor in a market economy cannot be used as a basis for justifying this confusion of powers or the advantages granted to Ryanair. (para 153)

Due to this alleged confusion of roles between BSCA and the Walloon Region, the Commission concluded that the MEIP approach was not applicable to the relationship between those two parties and Ryanair. The corollary of this is that any price lower than that set by parliamentary decree would have represented state aid to Ryanair. This approach will identify genuine state aid to an airline only when the original decree set prices at the same level as would have been set by a private investor. The Commission did not undertake an analysis of whether this was the case.

The more obvious approach from an economic perspective when applying the MEIP would be to 'ring fence' the activities which are of a commercial nature, and split them from the regulatory and governmental activities.

### Analysis of BSCA's business plan

Despite considering the MEIP to be not applicable in the case of Ryanair's contract with BSCA, the Commission

analysed the expected contribution of the agreement to the airport. The basis for doing this was a business plan covering the period up to 2010, which had been created by the airport prior to the signing of the contract with Ryanair; analysis of this plan (by all parties to the proceedings) formed a large part of the case before the Commission. The plan covered all of the activities of BSCA, rather than just the costs and revenues that are associated with Ryanair, and that are consequently contingent on the completion of the agreement.

The Commission identified a number of shortcomings in this business plan.

- **Creation of passengers from full-fare airlines.** Prior to signing the agreement with Ryanair, BSCA received a very small number of passengers from full-fare airlines (fewer than 20,000 in 2001) and an even smaller number of passengers from charter airlines (fewer than 10,000). The business plan projected that the number of passengers from full-fare scheduled airlines would increase significantly over the course of the agreement (to 150,000 in 2007, and to 300,000 in 2010) (European Commission decision, Table 3). The Commission criticised the lack of a rationale behind these projections, and particularly the fact that other papers submitted by the airport had indicated that it could hope to obtain significant quantities of full-fare traffic only in the event of capacity constraints at Zaventem (the main airport serving Brussels).
- **Treatment of passengers from other low-fare airlines.** The business plan also included a significant uplift in passengers from other low-fare airlines, with numbers reaching 450,000 per annum by 2010. At the same time, Ryanair's passenger numbers were expected to plateau at 700,000 per annum from 2003 to 2010 (European Commission decision, Table 3). The Commission argued in its decision that both of these projections were likely to be inaccurate. It considered that the other low-fare passengers should be reassigned in the business plan as if they were Ryanair passengers. This had the effect of reducing the profitability of these customers, as the contribution of €4 per passenger to Promocyt applied only for Ryanair passengers.

This criticism by the Commission seems questionable. It removed all passengers from other low-fare airlines from the business plan on the basis of the minutes from a BSCA board meeting held at around the time that the Ryanair agreement was concluded, which stated that it would be 'illusory to hope that another airline would establish a base at Gosselies' (the location of BSCA). However, even if this were the case, it does not preclude passengers from other

low-fare airlines which are using BSCA as a destination rather than a base.

Furthermore, the Commission did not take into account the fact that even if it were inconceivable that another airline would wish to set up at BSCA before Ryanair did so (explaining the statement in the board papers), that does not mean that it would be inconceivable for another airline to wish to do so after Ryanair's commencement of operations. There are several economic reasons for this.

- **Demand proving.** Ryanair's presence at the airport demonstrates that there is demand at the airport, and that it is possible to operate profitably from it. This has the impact of reducing the perceived risk for other airlines considering setting up from BSCA, meaning that they would require a lower rate of return.
- **Network externalities.** A second, and possibly more important, feature is the presence of network externalities at airports.<sup>3</sup> In the case of non-hub airports, these network externalities are primarily two-sided.<sup>4</sup> Consumers will place a greater value on flying to airports which have good transport links for onward connections, and, to a lesser extent, shopping and refreshment amenities. However, both transport operators and retailers will set up at airports only where there is a certain minimum throughput of potential customers. Consequently, boosting passenger numbers should increase other facilities provided, which in turn will increase passenger willingness to pay to fly to the airport. The impact of Ryanair starting operations at BSCA would be expected to boost transport links and other amenities, and this would increase the expected profits of other airlines setting up at the airport.<sup>5</sup> Consequently, Ryanair setting up a base at BSCA could increase the willingness of other airlines to fly from the airport.
- **Advertising.** Finally, the presence of Ryanair at BSCA would raise the profile of the airport, potentially providing spillover benefits to other airlines considering operating there.

Ex post evidence would also tend to support the proposition that signing the agreement with Ryanair would encourage other airlines to come to the airport. In July 2004 Wizz Air set up at Charleroi; in 2008 it flew 270,155 passengers from the airport, a figure not dissimilar to the 300,000 other low-cost passengers expected in the BSCA business plan for that year.<sup>6</sup> Onair (an Italian low-cost carrier) began flights in 2005 from BSCA to Pescara, while Jetairfly opened a one-aircraft base at the airport in 2008. Overall passenger numbers (2.96m in 2008) were in fact

higher than projected in the original business plan (2.42m), despite there being no passengers from full-fare airlines. Ex post evidence is not strictly relevant for the MEIP, which is an ex ante assessment (ie, before the business decision is taken), but it can provide a useful sense-check on the assumptions originally made in the business plan.

- **Cost of fire and maintenance services.** The Commission analysed at some length the funding of fire and maintenance costs at the airport. From 1990 to 2001 these costs had been met by the Walloon Region rather than the airport itself. However, at the time of signing the agreement with Ryanair, BSCA was in a 'legal vacuum' where the Region had not agreed to extend the agreement to cover fire and maintenance costs. The Commission considered that €1.6m of these costs were fixed, and so should not be considered when analysing the profitability of the agreement with Ryanair, but that further incremental fire and maintenance costs of around €1.5m per annum were due to the contract with Ryanair and should be taken into account.

As a result of these findings, the Commission's revised business plan sharply reduced the expected profitability of the agreement between Ryanair and BSCA. The expected profit of €108.6m over the period 2001–15 was subject to deductions of €141.3m as a result of the identified issues, the largest of which was a reduction of €78.4m arising from the removal of passengers from full-fare airlines. Overall, therefore, the Commission's expectation was that the agreement would be loss-making from the perspective of BSCA, and that therefore the MEIP was not satisfied by the agreement.

The framework adopted by the Commission when considering the agreement appears somewhat confused. It seems clear that the appropriate manner in which to assess an agreement of this type is on an incremental basis—that is, are the additional revenues earned as a result of the contract greater than the incremental costs which the contract incurs?<sup>7</sup> The Commission has gone some way in this direction by removing some of the fire and maintenance costs which would have to be borne by the airport (or Region) regardless of the level of traffic. However, it has left the remainder of its business plan on a non-incremental basis, simply taking all of the costs and revenues of the airport into account. While undertaking an incremental analysis would in this case have been considerably more complex than simply taking the overall business plan as it stands (or at least without the cost and revenue apportionment required to undertake an incremental analysis), from an economic perspective it is the best way to represent the decision-making process which a profit-maximising private sector agent would undertake.

## The appeal to the CFI

Ryanair appealed the Commission's decision to the CFI on a number of grounds, including the following.

- That the Commission had treated BSCA and the Walloon Region as separate entities, when in reality they should be taken as one and the same organisation, through the ownership of BSCA by the Walloon Region, and the close relationship between the airport and the Region. Ryanair characterised what the Commission saw as 'confusion' between airport and Region as them in fact being a single economic entity.
- That the Commission should have assessed the measures taken by the Walloon Region with reference to the MEIP. In particular, Ryanair criticised the assessment by the Commission that by setting airport charges, the Region was acting as a regulator rather than as an economic agent (in this case, the owner of the airport).
- That the Commission's approach amounted to discrimination between private and public airports, because private firms would have a freedom of pricing denied to publicly owned airports. In particular, Ryanair argued that, under the Commission's approach, if the Region set airport charges then this would be a regulatory act, whereas if the Region entrusted the setting of charges to its wholly owned subsidiary airport, this would be a commercial act. Ryanair argued that this distinction was artificial.
- That the Commission had not fulfilled its obligation to provide reasons for taking a decision.

All of these points were disputed by the Commission, which stated before the court that:

- taking the Region and BSCA together would have no impact on the findings, since the agreement with Ryanair did not confer any advantage on the Region;
- the application of the MEIP is incompatible with the Commission's guidelines on the application of state aid law to the aviation sector, according to which public investment in airport infrastructure constitutes a general measure of economic policy;
- the fixing of landing charges to obtain access to infrastructure falls within the exercise of public authority powers.

## The CFI judgment

When considering whether the Region and BSCA should be treated as a single entity or as separate, the CFI determined that 'the Walloon Region and BSCA ought to

have been regarded as one single entity for the purposes of application of the [MEIP]'. The main reason given by the CFI was that, when applying the MEIP, commercial transactions must be considered as a whole in order to consider whether the Region and BSCA behaved in a commercial manner. However, the CFI noted that the Commission did not provide sufficient evidence to rule out the prospect that, due to the financial ties between the Region and BSCA, the Region obtained financial benefits from entering into the agreement.

This ruling from the CFI would appear to be important in the context of any reconsideration of state aid by the Commission, as it goes to the heart of the approach adopted in the decision. In several instances (eg, the treatment of fire and maintenance, and regarding the capping of payments to the environment fund in the business plan) the Commission treated the two entities as separate. Consequently, a potential new decision would have to be adopted on a somewhat different basis to the original one.

The second core finding of the CFI was that the actions of the Walloon Region in fixing airport charges should be considered economic activities. It stated that:

the fixing of the amount of landing charges and the accompanying indemnity is an activity directly connected with the management of airport infrastructure, which is an economic activity ... The airport charges fixed by the Walloon Region must be regarded as remuneration for the provision of services within Charleroi Airport, notwithstanding ... that a clear and direct link between the level of charges and the service rendered to users is weak. (paras 88–89)

This is an important point since it helps clarify the extent of what will be considered an economic activity—even when prices are being set directly by an element of the government, they will be considered part of an economic activity so long as there is a payment for services rendered.

Following from this, the CFI found that the argument that airport charges may not be set by the airport itself is not sufficient to exclude the application of the MEIP to the agreement between BSCA and Ryanair. It went on to comment that the MEIP should be applied since the scheme reducing charges could have been introduced by a private operator, implying that the MEIP may have to be applied whenever a state agency undertakes an activity which could equally have been undertaken by a private investor. The CFI found that the refusal to apply the MEIP to the agreement between Ryanair and BSCA created an error in law.



The actual application of the MEIP to the agreement between Ryanair and BSCA was not considered in detail by the CFI. However, it did note that 'it cannot be excluded that the application of that principle [the MEIP] to the single body made up of the Walloon Region and BSCA might have led to a different conclusion [than that there had been state aid].<sup>1</sup> This statement seems well grounded given the difference in the treatment of fire and maintenance costs and environment fund payments, which seem likely to have been necessary under such an approach.

As a consequence, the CFI annulled the decision by the Commission.

## Conclusions

The *Ryanair Charleroi* decision is an important one in setting precedents for future state aid cases. Some features (eg, the intermingling of the airport and Region) are likely to be specific to this case; other areas ruled on by the CFI (eg, a government setting charges can still be

acting as an economic agent) are important clarifications. In particular, the judgment would appear to have the corollary that, in future, some elements of taxes may need to be treated as revenue when considering whether contracts between a state-owned company and a private sector company contain state aid. This finding may have implications beyond the aviation sector.

However, it is important to note that no consideration has yet been given by the CFI to the merits of whether the Commission actually carried out its MEIP assessment in an appropriate manner (or, indeed, whether the CFI considers itself able to rule on this matter). Hence, at present, many important economic questions are left open. What approach should be taken where ex ante and ex post evidence conflicts? Is an incremental approach appropriate for assessing the value of contracts? What should be the duration of contracts between state-owned bodies and private sector firms? Finally, how should complex issues such as the potential for network externalities be treated by the Commission?

<sup>1</sup> Judgment of the Court of First Instance in Case T-196/04 *Ryanair Ltd v Commission*, December 17th 2008; Commission Decision of 12 February 2004 concerning advantages granted by the Walloon Region and Brussels South Charleroi Airport to the airline Ryanair in connection with its establishment at Charleroi, 2004/393/EC. Oxera advised Ryanair throughout the proceedings.

<sup>2</sup> For a more detailed discussion of some of the economic issues raised by this case, see Pilsbury, S., Niels, G. and Jenkins, H. (2004), 'Making Sense of the Market Economy Investor Principle: An Economic Perspective', *Competition Law Journal*, 3, pp. 120–31.

<sup>3</sup> Network externalities occur when consumer demand is contingent on the number of other customers who have already bought the product. The classic example is a telephone system (which is useless if you are the only individual on it, but very useful if everyone else is already connected).

<sup>4</sup> At a hub airport, there will be one-sided network externalities, as airlines will value slots more highly when there is a wide range of other connecting flights for passengers. This seems unlikely to be an important consideration at a small regional airport such as BSCA.

<sup>5</sup> So long as they are not operating the same routes as Ryanair, where the head-to-head competition may be enough to more than outweigh the network effects.

<sup>6</sup> Source: <http://www.charleroi-airport.com/doc.php?nd=162&tid=62&docid=472&lg=2&page=3&site=1>.

<sup>7</sup> This is for an uncongested airport. The situation is somewhat different for airports which are near or at capacity, as it would be expected that such airports would need to cover their fixed, as well as variable, costs.

If you have any questions regarding the issues raised in this article, please contact the editor, Derek Holt: tel +44 (0) 1865 253 000 or email [d\\_holt@oxera.com](mailto:d_holt@oxera.com)

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