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Agenda

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Turbulence ahead? The new state aid guidelines for aviation

The European Commission has recently introduced new guidelines, due to become enforceable by the end of March 2014, on how member states can support airports and airlines in line with EU state aid rules. These guidelines have far-reaching implications for the financing of airport infrastructure, as well as how airports reach agreements with airlines. What does all this mean for the aviation sector?

According to the European Commission, the new state aid guidelines 'are a key ingredient for a successful and competitive European aviation industry'.[1] They set out the conditions under which member states and local authorities can grant state aid to airports and airlines in the EU, and are part of the Commission's state aid modernisation strategy. This strategy aims to foster growth in the EU by encouraging more effective aid, focusing the Commission's scrutiny on cases that have the largest impact on competition.

This article discusses the implications of the guidelines, focusing on the financing of airport infrastructure as well as the negotiation of agreements between airports and airlines.

What are the main changes in the guidelines?

Since the Commission's previous guidelines were introduced in 2005, the aviation sector has changed considerably.[2] Low-cost airlines have expanded significantly, while some more traditional 'flag carrier' airlines have experienced difficulties. Many hub airports currently have significant capacity constraints, with forecasts that, by 2035, around 2m flights will not be able to be accommodated.[3]

The new guidelines have a critical role to play in light of the expected bottleneck in the European aviation sector. Indeed, the Commission has recognised that:[4]

> Airport capacity needs to be optimised and, where necessary, increased to face growing demand for travel to [...] areas of Europe otherwise poorly connected, which could result in a more than doubling of EU air transport activities by 2050.

Given these developments in the aviation sector, the guidelines introduce a number of changes. The new rules on start-up aid and investment aid are applicable only to aid from now on (i.e. which is subject to the new guidelines). The new rules on operating aid are applicable to aid granted before now (i.e. the guidelines will apply retrospectively). The box below highlights the main changes.

What are the main changes in the new guidelines?

- **In contrast to the previous guidelines, the new guidelines allow smaller airports (with fewer than 3m passengers)to receive aid for operating purposes for a transitional period ('operating aid').** However, the maximum amount of aid that airports can receive to support their operating costs is restricted, and all such aid needs to be phased out by 2024.[1] Under the new guidelines, the Commission requires that airports in receipt of operating aid must be able to demonstrate, through a business plan, that they can fully cover their operating costs at the end of the ten-year transitional period.
- **The 2014 guidelines impose greater restrictions onaid received by airports for funding infrastructure ('investment aid').** Under the new guidelines, unless thereare 'exceptional circumstances', aid to finance infrastructure investments is allowed only for airports with fewer than 5m passengers per year, subject to certain restrictions. London Heathrow, Charles de Gaulle and Frankfurt airports, for example, all have far more than 10m passengers per year.[2]
- **The 2014 guidelines introduce the market economy operator (MEO) test for assessing the existence of aid in agreements between airports and airlines.** This approach differs from the earlier guidelines, which did not stipulate any principles for assessing whether an agreement contained state aid.[3]

- **The new guidelines introduce some changes to the conditions under which airlines can receive aid for launching new routes ('start-up aid').** Start-up aid willbe restricted to airlines connecting smaller airports (specifically, airports with fewer than 3m passengers per year). However, a slightly higher proportion of aid relativeto eligible costs is allowed than in the previous guidelines. Under the new guidelines, the conditions under which airlines can receive start-up aid are generally more flexible for those airlines connecting airports located in remote regions.

Note: [1] The maximum permissible amount of operating aid is restricted to 50% of the funding gap. Higher maximum amounts of operating aid are allowed for the smallest airports—those with fewer than 700,000 passengers per year. [2] For example, in 2012/13, London Heathrow had approximately 72.4m passengers; Charles de Gaulle had approximately 62.1m passengers; and Frankfurt had approximately 58.0m passengers, based on Airports Council International (2014), 'Airport Traffic Data, Worldwide Airport Traffic Report', 14 March. [3] The MEO test assesses whether the agreements would have been undertaken by a private investor; for further explanation, see the box entitled 'What is the MEO test?' below.

What is the MEO test?

Under the Commission's MEO test, a measure constitutesstate aid if the agreement would not have been undertaken under 'normal' conditions by a market economy operator.The MEO test considers whether a private investor would have undertaken the deal on terms similar to the state-owned entity.

If the MEO test is not passed, it will need to be demonstrated that any aid is compatible and in line with the EU's state aid laws. If the aid is not compatible, it is deemed illegal. Illegal state aid must be repaid by the beneficiary of the aid.

Note: The MEO test is an umbrella concept that captures the various assessments that could be undertaken to examine whether economic transactions carried out by public bodies grant an advantage that would not have occurred in normal market conditions. The MEO test is comparable to the more widely recognised concept of the market economy investor principle (MEIP).Source: European Commission (2014), 'Communication from the Commission: Draft Commission Notice on the notion of state aid pursuantto Article 107(1) TFEU', section 4.2.

What do the guidelines imply for the financing of airport infrastructure?

The 2014 guidelines impose new restrictions on the amount of aid that is allowed for financing airport infrastructure, particularly for larger airports (as shown in the box below).[5] However, the rules in the new guidelines in relation to the financing of airport infrastructure are more flexible for those airports located in geographically remote regions.

Maximum permitted investment aid intensities

Under the new guidelines, the total amount of aid is restricted relative to an airport's total eligible costs that can be received for funding infrastructure. The maximum proportion allowed declines with the size of the airport.

Size of airport based on average passenger traffic (passengers per year)	Maximum investment aid intensity
>5m	Normally 0%
3m–5m	Up to 25%
1m–3m	Up to 50%
<1m	Up to 75%

Note: The size of the airport is defined as the actual average passenger traffic during the two financial years preceding that in which the aid was notified, actually granted, or paid (in the case of non-notified aid).The maximum permitted aid intensity is defined as the maximum amount of state aid allowed relative to the eligible costs.
The maximum aid intensities may increase by up to 20% if the airport is located in a remote region.
Source: European Commission (2014), 'Communication from the Commission: Guidelines on State aid to airports and airlines', 20 February, para. 101.

As shown in the box above, the new guidelines impose fewer restrictions on aid for infrastructure received by smaller airports. The Commission has recognised that smaller airports are likely to face difficulties in attracting private financing at the appropriate price to be able to undertake the necessary infrastructure projects. This is in line with a large body of academic literature that has found that investors in smaller companies require higher returns than investors in larger companies that are otherwise similar.[6]

However, under the Commission's new guidelines, larger airports—defined as those with more than 5m passengers per year—are allowed aid to finance airport infrastructure only 'under very exceptional circumstances'.[7] The Commission does not provide an example of these 'exceptional circumstances', although it explains that they occur when there is a clear market failure, when it has not been possible to finance investments on capital markets, and where a very high level of positive externalities is associated with the investment. These are discussed further below.

What are the implications for airports planning infrastructure investments?

As a result of the new guidelines, larger airports in particular may face greater challenges in demonstrating that state funding for infrastructure investments is compatible with state aid law. However, as highlighted in Oxera's 2013 report for the UK Parliament's Transport Select Committee, certain large investments in infrastructure are unlikely to be viable without state funding.[8] Oxera's analysis showed that the construction of a new hub airport in the South East of England would not be commercially viable without state funding in the region of £10bn to £30bn, depending on passenger numbers. This is due to the significant time for investment in infrastructure to generate sufficient returns, combined with the complexities and risks associated with large projects.

What do the guidelines imply for the negotiation of airport–airline agreements?

The Commission's guidelines also have significant implications for agreements negotiated between many airports (particularly smaller regional airports) and airlines. In contrast to the previous guidelines, which did not stipulate any explicit rules on how to ensure compliance with the MEO test, the new guidelines introduce some high-level principles that will be relevant to any new airport–airline agreements.

What methodology does the Commission recommend for assessing the compatibility of airport–airline agreements?

The Commission's guidelines emphasise the role of financial analysis in assessing whether agreements between airports and airlines are in line with the MEO test. In particular, they stipulate that the existence of aid can be assessed through incremental profitability analysis, from the perspective of the airport at the time it signs a deal with an airline. According to the Commission:[9]

> arrangements concluded between airlines and an airport can be deemed to comply with the MEO test when they **incrementally contribute**, from an ex ante standpoint, **to the profitability of the airport**. [emphasis added]

This is in line with the approach that would be adopted by a rational private investor, which would be likely to assess the revenues gained (both aeronautical and non-aeronautical), and the additional costs incurred, as a result of the agreements between the airport and airline.

As an airline is not in a position to be able to assess the extent to which the revenue it generates covers the airport's incremental costs, the burden of proof is on the airport. Indeed, the Commission has stated that:[10]

> The airport should demonstrate that over the duration of the arrangement it is **capable of covering all costs stemming from the arrangement** (for example, an individual contract or an overall scheme of airport charges) **with a reasonable profit margin** on the basis of **sound medium-term prospects** when setting up the arrangement. [emphasis added]

In the MEO assessment, costs that the airport would have to incur anyway independently of the arrangement with the airline should not be taken into account.

In the new guidelines the Commission has acknowledged that airports differentiating prices charged to airlines represents a standard business practice and, provided that it is commercially justified, is in line with the MEO test:[11]

> the Commission considers that **price differentiation is a standard business practice**, as long as it complies with all other relevant competition and sectoral legislation. Nevertheless, such **differentiated pricing policies should be commercially justified** to comply with the MEO test. [emphasis added]

Is there a role for market price benchmarks?

In its guidelines, the Commission expresses strong doubts that it is currently possible to use market price benchmarks to establish aid-free arrangements. This appears to be on the basis that there are only a relatively small number of fully privately owned airports in Europe, and prices charged by privately owned airports may not provide a useful benchmark, as these airports often compete for the custom of airlines against airports that may have benefited from state support.

The concerns raised by the Commission in the new guidelines implicitly presuppose that private airports compete with airports that have received state aid. Although it is possible that competition may drive airports' prices towards incremental costs, privately owned airports are unlikely to set loss-making prices.

Furthermore, as acknowledged by the Commission, airports across the EU are currently witnessing 'growing involvement of private undertakings'.[12] There are thus a number of airports in Europe whose prices are not set on the basis of social or regional considerations.

Although the Commission is currently expressing doubts, it is possible to establish a robust benchmark that can be used to derive a market price. The analysis of airports' business plans can provide valuable evidence, given their inherent subjectivity, but comparator analysis should also be considered. The advantage of this latter approach is that it is based on actual market evidence, rather than the hypothetical scenarios outlined in the business plan.

The likely impact of the guidelines on the European aviation landscape

The Commission has so far published only a few decisions on state aid cases in the aviation sector, although it is currently undertaking at least 28 in-depth investigations of airports and airlines, and expects to reach a final view on these cases by September 2014.[13] The decisions that are published over the next six months will provide valuable insights into how the Commission is applying the new guidelines.

The Commission expects that loss-making airports should be able to transform themselves during the ten-year transitional period, and that only the most inefficient airports will close as a result of the new guidelines.[14] According to the Commission's impact assessment, no airports handling over 500,000 passengers are likely to close as a result of the new guidelines, although smaller airports may close if they fail to improve efficiency and increase revenues. This is in contrast to the concerns raised by the European Regions Airline Association that around 80 regional airports may be forced to close, as well as general speculation in the press that 'dozens of smaller airports may face cutbacks or even closure'.[15]

However, according to the Commission, based on the example from the UK where many small airports are commercially viable, the Commission has 'reason to be optimistic and to believe that the number of closures will be low'.[16]

Any significant closure of airports could have costs from the perspective of socioeconomic development and integration within the EU. Accordingly, the Commission has not ruled out further changes to the guidelines in the future.[17] It would be helpful, however, if the Commission could clarify how it intends to assess the socioeconomic and integration impacts of any airport closures. At this stage, it is too early to predict how the landscape of the European aviation industry will be altered as a result of the new guidelines. This will only be known with time as the outcome of the tension between the requirement for state funding to support loss-making airports and the fact that, in general, demand for air travel outstrips capacity in Europe becomes clearer.

Oxera is advising on more than 20 state aid cases in this sector.

[1] For further details, see European Commission (2014), 'State aid: Commission adopts new guidelines for state aid to airports and airlines', 20 February, accessed 8 March 2014.

[2] European Commission (2005), 'Communication from the Commission: Community Guidelines on financing of airports and start-up aid to airlines departing from regional airports', *Official Journal of the European Union*, 9 December.

[3] Eurocontrol (2013), 'Challenges of Growth 2013, Task 4: European Air Traffic in 2035', p. 3.

[4] European Commission (2011), 'White Paper: Roadmap to a Single European Transport Area – Towards a competitive and resource efficient transport system', 28 March, para. 28.

[5] The Leipzig-Halle (2011) decision established that the construction of airport infrastructure cannot be dissociated from an airport's operations and should therefore be classified as an economic activity, and hence within the remit of the state aid rules. For further details, see Case T-455/08 *Flughafen Leipzig-Halle GmbH and Mitteldeutsche Flughafen AG v Commission*, [2011] ECR I-00000.

[6] See, for example, Van Dijk, M.A. (2006), 'Is Size Dead? A Review of the Size Effect in Equity Returns', RSM Erasmus University, May; and Fama, E. and French, K. (1992), 'Common Risk Factors in the Returns on Stocks and Bonds', *Journal of Financial Economics*, 1, pp. 43–66.

[7] European Commission (2014), 'Communication from the Commission: Guidelines on State aid to airports and airlines', 20 February, para. 105.

[8] Oxera (2013), 'Would a new hub airport be commercially viable?', prepared for the Transport Committee, January.

[9] European Commission (2014), 'Communication from the Commission: Guidelines on State aid to airports and airlines', 20 February, para. 63.

[10] European Commission (2014), 'Communication from the Commission: Guidelines on State aid to airports and airlines', 20 February, para. 63.

[11] European Commission (2014), 'Communication from the Commission: Guidelines on State aid to airports and airlines', 20 February, para. 62.

[12] European Commission (2014), 'Communication from the Commission: Guidelines on State aid to airports and airlines', 20 February, para. 4.

[13] European Commission (2014), 'State aid: Commission adopts new guidelines on state aid to airports and airlines (Aviation Guidelines)—Frequently asked questions', 20 February.

[14] European Commission (2014), 'New State aid rules for a competitive aviation industry', Competition Policy Brief, 2, February.

[15] For further details, see Massetti, L. (undated), 'New EU Guidelines on State Aid to airports and airlines, ERA Perspective', European Regions Airline Association, last accessed 21 March 2014; and Reuters (2014), 'Europe's regional airports struggle as traffic shifts to hubs', 10 March, last accessed 11 March 2014.

[16] European Commission (2014), 'New State aid rules for a competitive aviation industry', *Competition Policy Brief*, 2, February.

[17] The Commission plans to undertake an evaluation of the new guidelines at any time within the next six years, and has not ruled out potential changes to the guidelines on the basis of 'important competition policy or transport policy considerations'.