Revision of the 2005 EC Guidelines on financing of airports and Start-up aids to airlines departing from regional airports

Comments by ACI EUROPE

The present note is intended to provide the European Commission with additional comments on the airport industry, so as to inform its reasoning and decision making in relation to the revision of the 2005 EC Guidelines on State aid for the aviation sector.

These comments take into account the position of DG COMP, as illustrated at the Public Hearing organized by the European Economic and Social Committee on 12 April 2012. In particular, they are focused on DG COMP's assessment of the present situation and stated 'key objectives', as well as its proposal to follow an 'integrated approach' to assess the financing of airports and their interaction with airlines.

1. Present situation & Key objectives

DG COMP has identified a number of key objectives based on its assessment of the present situation:

i) Increased competition between airlines and between airports / Need to ensure no distortion of competition.
ii) Airports enabling regional and local development / Need to ensure that airports continue to contribute full to that role.
iii) Airport overcapacity / Need to avoid duplication of unprofitable airports as well as avoid the maintenance and creation of overcapacity
iv) Vast majority of airports subsidized / Need to avoid waste of public money and reduce the need for public funding.
v) Airports not able to cover their costs / Need for airports to cover their costs and more private investments into airports.

While ACI EUROPE fully concurs with i) and ii), it considers that iii), iv) and v) raise significant issues in that some of the objectives identified are not necessarily compatible with current and future market developments as well as with the reality of airport operations and economics.

1.1. Competition & Regional development – i) and ii)

Increased competition in the airport sector as well as increased contribution to regional development are both closely correlated to the process of business transformation that Europe's airports have striven to follow over the past 20 years – evolving from mere infrastructure providers to fully fledged and diversified businesses.

Business transformation at Europe's airports is the direct result of the creation of a liberalized European aviation market. With airlines free to establish themselves at any airport within the EU/Switzerland/EEA and/or provide services to/from any of these airports, airport operators have faced increased competitive pressure – in particular as regards the level of user charges levied on airlines and passengers.

As a result, airports have looked at complementing their aeronautical revenues with commercial revenues[1], thereby ideally creating a virtuous circle. Competitive charges are a necessity to attract more air services (either from incumbents or new entrants) and increase passenger volumes, which in turn allow growing commercial revenues from passengers and visitors. These commercial revenues now account for 48% of airport revenues and are playing an increasing role in the financing of airport infrastructure.

While the lack of critical mass / traffic volume has tended to limit the ability of regional airports to fully follow this business transformation process (in particular as regards activity and revenue diversification), the permanence of public financing has allowed these airports (especially smaller ones) to continue to finance their infrastructure and operate.

Consequently, both business transformation (wherever possible) and public financing have been instrumental in the development of Europe's airports and at the same time, in the economic development of the communities they serve. This means that against a background of increased European integration and globalization, airports have now become strategic assets for regional development – driving not just tourism, but also wider inward investment, export capabilities and economic regeneration. As a result, airports in Europe provide more than 1 million onsite jobs and more than 4 million direct, indirect and induced jobs.

Today, the role played by airports as enablers of regional/local economic development is more important than ever at a time when Europe is looking for a growth compact. Moreover, this strategic relevance is set to further increase in the context of the global economic shift to newly emerged economies in Asia and South America. Indeed, Europe will become increasingly dependent on trade with these new economic powerhouses with airports providing the un-substitutable transport infrastructure enabling such trade.

Therefore, it is essential that EU policy not only preserves the role of airports as drivers of economic development and job creation, but also actively promotes it. While this needs to be the case for Transport policy, it also needs to be the case concerning State aid policy.

1.2. Current airport market context & future developments – iii)

1.2.1. Airport capacity

DG COMP considers that there is "airport overcapacity" in Europe and has indicated that one of its key objective with the revision of the Guidelines is to address this situation in order to "avoid the creation and maintenance of overcapacity".

[1] Retail, food & beverage, car parking, car rental concessions, real estate, advertising, etc.

The reality is that the European aviation network is characterized by a significant imbalance when it comes to airport capacity.

Major hubs and several secondary hub airports serving large conurbations and/or capital cities face increasing congestion problems due to a lack of physical capacity. This situation is not going to improve, given the difficulties faced by these airports in obtaining their license to grow.

Indeed, EUROCONTROL estimates that by 2030, that 19 of the top 20 major European airports will experience congestion levels equivalent to London-Heathrow airport today. Given the role of these airports as nodes of the aviation/ATM (Air Traffic Management) network, this situation will result in "*unprecedented levels of congestion, with delays snowballing throughout the whole European network*".

Regional airports[2] have historically offered spare capacity. However, the creation of the Single Aviation market has led to significant traffic growth at these airports, resulting in a reduction of their spare capacity.

Between 2001 and 2010, passenger traffic at regional airports grew by 59%. Regional airports have therefore been the most dynamic segment of the airport industry[3]. It is worth noting that over the same period, passenger traffic growth at small regional airports (below 1 million passengers/year) was even more impressive at 81%. Moreover, in 2008, there were 81 more airports with commercial jet services than in 1996[4]. These figures clearly point to a more intensive use of available capacity at these airports.

Seeking a perfect or near-perfect match between airport capacity and demand for air traffic is neither possible nor desirable – both from an economic and operational point of view:

- Spare capacity (and related sunk costs), is an inherent feature of airport economics.

  The capital intensive nature and long lead-time associated with airport infrastructure development mean that runways and terminals need to be built not only to accommodate short-term demand, but also prospective demand over the medium/long term. A short-term approach is not economically neither operationally viable as it would result in repeated and prolonged lack of adequate capacity.

- Spare capacity at regional airports is essential for a smooth, flexible and safe operation of the aviation/ATM (Air Traffic Management) network.

  This allows regional airports to play a part as a 'safety valve' for congested airports, offering alternative/fall back re-routings. This role is likely to remain in the coming years given the above-mentioned increasing congestion of larger airports.

[2] Below 5 million passengers/year

[3] By contrast: +32%, + 25% and +18% growth in passenger traffic for airports between 5-10 million passengers, 10-15 million passengers and +25 million passengers.

[4] A. Reynolds-Freighan (2010), "Characteristics of airline networks: A North American and European Comparison, Journal of Air Transport Management, Vol. 16, pp. 121-126.

- Looking forward, the European aviation network will require more airport capacity – including at regional airports.

  Notwithstanding the present economic downturn in Europe, demand for air traffic has shown a significant degree of resilience[5]. While air traffic is expected to post weak growth in 2012, the medium/long term prospects remain extremely good, with passenger traffic nearly doubling by 2030[6].

  However, the lack of airport capacity will be one of the major challenges faced by the European aviation system and beyond, the European economy. This situation is referred to as the *airport capacity crunch*. EUROCONTROL estimates that by 2030, 11% of passenger demand will not be accommodated due to insufficient airport capacity. This will result in roughly 260 million passengers unable to fly and will directly hamper the competitive position of Europe on the global market place.

  The airport capacity crunch is being addressed as part of the EU's Single European Sky (SES) project. While SES is looking at tripling capacity in the air (ATM), it is also looking at aligning capacity on the ground (airports) with this objective. This means that more airport capacity is essential to secure the economic and operational performance of the European aviation system. This has also been recognized by the *Airport Package* adopted by the EC in December 2011, of which capacity is one of the key pillars[7].

  In that context, the spare capacity presently available at regional airports will become increasingly relevant – contributing to the mitigation of the airport capacity crunch. Should the State aid guidelines effectively aim at addressing what is perceived by DG COMP as a problem of airport overcapacity, this would be at odds with the established direction of the Single European Sky and the *Airport Package*.

- Spare airport capacity is also a prerequisite to effective competition in the aviation sector, as it is necessary for both airport and airline market entry.

1.2.2 Regional airports: a look into the future

In the next 20 years, demand for air transport to/from regional airports is set to increase significantly, due to:

- More aviation liberalization

  The EU is developing an integrated aviation market with all neighboring countries to the East and across the Mediterranean. Significant steps have already been made, including the successful conclusion of an Open Aviation Area with Morocco, Jordan and Georgia as well as negotiations under way with other countries such as Israel and Tunisia.

[5] 2011 Passenger traffic growth at EU airports outperformed EU GDP growth by a factor of 4 (6,3% v. 1,5%)
[6] Traffic at European airports will grow from 1,408 billion passengers in 2009 to 2,668 billion passengers in 2030 (ACI). Similarly, EUROCONTROL expects the number of flight movements to grow from 9,413 million in 2009 to 16,887 million in 2030 (EUROCONTROL *Long-Term Forecast 2010-2030*)
[7] The Airport Package provides for the EC to ask Member States to devise national strategies on how to address Europe's airport capacity crunch.

Ultimately, the EU is looking at a considerably enlarged European aviation market of 58 countries bringing together more than 1 billion potential fliers.

These new markets are extremely relevant for Low cost carriers as they can be served with their existing single type/medium haul fleet. Their entry will spur a new market dynamic which will be especially beneficial to regional airports - with similar effects to those witnessed upon the creation of the Single aviation market in 1993 and its extension to new EU Member States in 2004.

- New aircraft technology

  Aircraft technology keeps evolving with a strong focus on fuel and other operating efficiencies. The A320 NEO and Boeing 737 MAX soon to become available will allow a substantial reduction in operating costs, thus increasing the economic viability of many air routes. This will reduce the risk of network seasonality for regional airports and open up new point-to-point routes to/from regional airports, which until now were not economically viable.

  Beyond these new short/medium-haul aircraft, the recently launched Boeing 787 and the forthcoming new A350 are for the first time providing long haul aircraft combining increased fuel efficiency with medium seating capacity. These aircraft will open up the prospect of long haul connectivity at larger regional airports.

Aviation liberalization and new aircraft technology will therefore create new demand for air services to/from regional airports, resulting in an increase in their use and a further reduction of their spare capacity – pursuing an already established trend.

1.3. Airport economics: from myth to reality – iii) and iv)

1.3.1. Cost recovery

DG COMP recognizes that airports are not able to cover their cost. This applies in relation to aeronautical revenues (charges paid by airlines and passengers) at industry level. Indeed, based on all such revenues, in 2010 European airports had an under-recovery of €4 billion on their operating expenses[8].

If this is a reality for all airports, (smaller) regional airports are clearly handicapped in achieving activity and revenue diversification due to their lack of critical mass / traffic volume. While larger airports are able through such commercial revenues to finance their operating expenses and capital costs, (smaller) regional airports rely more heavily on grants and public financing.

[8] ACI EUROPE 2011 Economics Report.

In that context, DG COMP's objective for airports to be able to cover all their costs is unrealistic. A strict cost-recovery principle would simply price many regional airports out of the market and deprive them of existing air services and opportunities to develop new air services. This in turn would lower demand for existing infrastructure and create even more surplus capacity – reducing connectivity for the regions with a damaging impact on their economy and employment.

1.3.2. Public funding

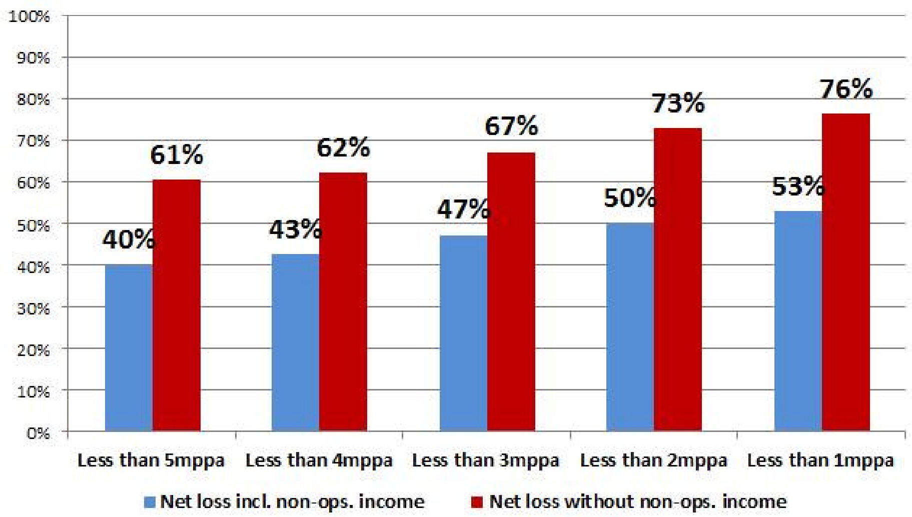
Based on the above, public funding continues to play an important role in airport financing. This role derives primarily for the high capital intensity of the airport business and very long lead time of airport investment – which typically makes it more difficult to attract private investors compared to other sectors[9].

Historically, the importance of public financing has been a reality for airports of all size, including very large airports. All of Europe's major hubs were developed through public financing.

While the above mentioned business transformation process of Europe's airports has certainly contributed to a reduction in the need for public financing in the past 20 years (not least through the requirement for airports to abide by fiscal discipline), such financing remains a significant necessity. This is the case not only for (small) regional airports, but it can also be the case for very large airport projects such as in the development of green-field airports[10].

With regard to regional airports in particular, the graph below shows that the percentage of these airports posting a net loss in 2010 would have increased from 40% to more than 60% had they not received grants and other public financing (accounted as non-operating income). This means that an additional 80 airports would have become loss making (out of 390 airports with less than 5 million passengers/year) – adding to the close to 158 airports already loss making.

[9] In the case of the new Munich airport which was opened in 1991, the capital intensity of the project meant that a return on the initial investment could not be expected before 2017.
[10] See project for a new London airport in the Thames Estuary at a reported cost of €58 billion.



An approach whereby airports would be required to achieve full economic viability without public financing would therefore potentially result in the closure of nearly 250 European airports. This would have a devastating impact on hundreds of local/regional communities across the EU, with a significant spillover effect on the European economy and its competitiveness.

Moreover, it is important to note that outside Europe, public financing of airports continues to be a largely followed and unquestioned model. This is the case in the US where airports have unlimited access to public capital through Government bonds, a tax exemption status and $3 billion in annual grants. Similarly, most emerging nations are today capitalizing on airport's strategic role for economic development and global relevance by providing massive amounts of public funds for airport development[11].

With State budgets under severe constraints in most parts of the EU, public authorities are now focused on avoiding the waste of public money and ensuring that every cent spent generates a return for society. In this regard, State aid control should be focused on competition assessments - not on controlling how public money is being used by national authorities, as alluded to by DG COMP ("avoid waste of public money").

1.3.3. Private funding

In the current financial climate, European airports are also having problems accessing capital markets and private finance – a major issue for any capital intensive industry. While public funding could potentially have provided a cushion or a partial alternative in the past, this is much less the case at a time of ever tightening fiscal austerity.

In 2010, despite a -19% decrease in their capital expenditure resulting from the current crisis (€7.2 billion), Europe's airports faced a +29% increase in the cost of funding capital investment (€9 billion) as access to capital markets remained extremely difficult and costly[12].

[11] China alone is building 78 new airports by 2020.
[12] ACI EUROPE 2011 Economics Report.

In that context, ACI EUROPE fails to see how a more restrictive approach to public financing of airports might facilitate private investment – as implied by DG COMP. On the contrary, public funding is often useful to incentivise private investors to participate in infrastructure projects. It is likely to be seen as even more important in the present environment given the reluctance of private investors to cover a larger share of the required financing.

As investors attending the 2012 ACI Economics and Finance conference (London, 8-9 February 2012) have put it: "Many (airport) projects are not privately financeable" or "Funds are available, provided someone else takes the risk". There are airports that are at a risk of default on their refinancing obligations due to the difficulty of accessing equity.

This reflects the fact that, since 2008 private investors have reconsidered airports as an asset class, showing much less appetite for such long-term strategic assets. In this context, the persistence of high regulatory driven costs[13] combined with national aviation taxes is clearly hurting the attractiveness of European airports[14].

2. Assessing the financing of airports and its interaction with airlines

Based on the information given in the first part of these comments, it is clear that a number of issues/determinants are especially relevant when assessing investment aid and operating aid to airports. These are:

i) The increasing strategic relevance of airports not only for regional economies but also for the European economy as whole and its future global relevance.
ii) The airport capacity crunch that Europe is facing and the policies already in place or planned at European level (Single European Sky, *Airport Package*).
iii) The increasing relevance of regional airports and their future prospects based on further aviation liberalization and evolving technology.
iv) The inherent limitations of airport economics due to the lack of critical mass/size with regards to the 'user pays principle' and achieving profitability – in particular when it comes to regional airports.
v) The continuing importance of public financing, especially given the pace and modalities of airport developments outside Europe and the difficult environment for private financing in Europe.

Cumulatively, these issues/determinants merit a cautious and measured approach on State aid. A balance should be struck between them and the need to ensure that distortions of competition between airports are reduced to a minimum. As repeatedly stated by ACI EUROPE, there is indeed a need for a clearer level playing field at the level of the airport industry, especially given the above mentioned competitive pressures to which airports are now submitted. In this regard, it should be

[13] Security costs alone have inflated to more than €5 billion / year, accounting for 27% of operating costs (from 5% prior to 9/11).
[14] None of the European airports that are presently credit-rated has a positive outlook.

noted that ACI EUROPE has commissioned an ad hoc study on airport competition, due to be released shortly[15].

Accordingly and in line with its existing position[16], ACI EUROPE advocates:

- **A flexible approach to investment aid to airports, so as to preserve the ability of Europe to keep funding publicly the development of its airport infrastructure**.

  Apart from being mandated by the above mentioned issues/determinants, such an approach is also duly justified given:

  - The increasingly competitive situation between aviation and rail, and
  - The massive public financing presently afforded to rail infrastructure: €41.8 billion/year[17].

  From a competition point of view, it would indeed be unacceptable to consider limiting the ability of Member States to finance the development of airport infrastructure while almost unconstrained public funding is allowed for the rail sector. Such a discrepancy could not even be justified on environmental grounds: aviation is now included into the EU ETS (Emissions Trading Scheme) and Europe's airports are world leaders on carbon management[18].

- **A fair approach to operating aid to airports, recognizing the inherent limitations of small regional airports**.

  Public aid to these airports should be considered as a way to counteract the fact that their size prevents them from pursuing the activity/revenue diversification possible for larger airports as part of their business transformation as well as their lack of economies of scale as regards operating costs. This could be done through Public Service Obligations for airports with maximum traffic level of 1 million passengers/year.

Moreover, **ACI EUROPE considers that the above issues/determinants make it difficult to pursue an 'integrated approach' between aid to airports and aid to airlines**, whereby any aid to an airport would be considered as potentially involving an aid to its users. Indeed:

- An integrated approach would de facto be based on the assumption that airlines should pay for the full cost of the infrastructure they use – this does not correspond to the reality of airport economics as a result of significant competitive pressures exercised by airlines on airports and the need to attract air traffic.

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[15] The study is due to be released at the 22nd ACI EUROPE Annual Congress & General Assembly taking place in Madrid on 20-22 June 2012.

[16] 'A Level Playing Field for European Airports : the Need for Revised Guidelines on State Aid' (16.6.2010)

[17] Yearly average over 2007-2009. This amount represents 137% of total airport revenues (€30.4 billion in 2011).

[18] 59 European airports accounting for more than 52% of European air traffic are *Airport Carbon Accredited (www.airportcarbonaccreditation.com)*

- An integrated approach would make it more difficult to justify the public financing of airports, as this would require not only a competitive assessment as regards the airport itself but also as regards the airlines flying out of this airport. As such it would add significant legal constraints to airport development.

- An integrated approach would make it more difficult to justify a flexible approach to investment aid, thus limiting the ability of Europe to keep funding publicly its airport infrastructure.

- An integrated approach would create significant difficulties in reconciling assessments/exemptions for aid to the airport with assessments/exemptions for aid to the airlines. Ultimately, a more rigid framework would probably be systematically imposed on the airport due to higher sensitivity of the airline market from the competition point of view. This risks limiting airport development – and with it related connectivity and economic development opportunities for the local/regional communities.

Brussels, June 2012