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Transport & Logistics Compass

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The 2014 EU State aid guidelines Can airports keep up?

We give you an insight into the challenges of the new EU regulations and identify potential need for action to successfully prepare you for a more competitive future.

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A changing aviation landscape

Adopting to new market conditions

The European Commission's new EU "Guidelines on State aid to airports and airlines" confront European airports with new challenges at a period when both airlines and airports are fighting hard to adapt their business models to fast and consistently changing market conditions.

Liberalisation and deregulation of air traffic has broken up the old concept of national carriers. Protected markets and airports are increasingly experiencing how the market pressure that has been driving competition in the airline business over the last years is now being passed on to them.

The European airline industry is changing

In this environment, airports are required to work hard to win and retain their airline customers.

With low-cost carriers (LCCs) having won the battle for intra-European air travel, their market share is expected to further increase over the next years from the 45% they currently hold to substantially over 50%. But LCC buyer power at airports has traditionally been very high and LCCs are driving a hard bargain with business models focused on multiple hubs across Europe giving them full flexibility to move around their fleet in search for high-yield routes. This includes new routes to primary airports, creating new revenue opportunities but also yield threats for those airports trying to please both LCCs and network carriers.

Whilst it is expected that network carriers will try to maintain a certain level of intra-European routes to feed their hubs and international networks, medium-sized network carriers will be struggling hard in the fight against LCCs and better funded network carriers. Because pressure from Gulf and resurgent US-carriers will stay very high, European network carriers will be forced to continue working actively on their costs base which frequently includes (re-)negotiation of airport charges.

A more sophisticated and competitive market for passengers

Competition is also high from the other airport customer group: the passengers. With the number of airports having increased significantly over the last 20 years, passengers now often have multiple choices where to fly from. What is more, leisure travellers are becoming more flexible in terms of where they actually fly to, making price the single most important factor when making their choice.

Can airports keep up?

As airlines have been demonstrating for some time now, airports also need to overhaul their business models to adapt to increased competition and high cost pressure. High costs for safety and security, the negative effects of fiscal measures such as air traffic taxes and ongoing uncertainties about the development of the European economy will continue to impact confidence in the aviation sector.

These are the market conditions in which airports now need to respond to regulatory pressure through the new EU guidelines on state aid and in which they are required to demonstrate that their business model is ready for a competitive future.

The new situation for airports

- New EU guidelines require airports to prove they are ready for the future
- Competitive pressure and cost awareness is passed on from airlines to airports
- Airports are required to work hard to win and retain their airline customers
- Competition for passengers remains high

At a glance: the new guidelines

For which airports do the new guidelines apply?
The new guidelines apply to all EU-airports providing airport services to airlines, whereas different rules apply according to annual passenger volumes and to specialised airports providing predominantly freight services.

What are potential consequences?
In the worst case, airports can be ordered by the European Commission to repay public funding (eg, case number SA.35388 Gdynia airport).

From which date do the new guidelines apply?
The new guidelines replace the 1994 and 2005 aviation guidelines with the publication in the Office Journal of the EU and came into force on 4 April 2014.

Do the older guidelines still apply in some cases?
For **operating aid**, the new guidelines apply in all cases, even if (unlawful, non-notified) operating aid was granted before the publication of the new guidelines.

The new guidelines apply to all **investment aid** notified prior and all investment aid (notified or unlawful) granted after the publication of the new guidelines. The new guidelines do not apply for all unlawful non-notified investment granted prior to the publication of the new guidelines. For these cases, in accordance with OJ C119, 22.05.2002, p.22, the rules in force at the time when the investment aid was granted apply.

What are the requirements for state aid to be granted?
The following conditions must all be met inclusively:

1. Contribution to a well-defined objective of common interest
2. Need for state intervention
3. Appropriateness of the aid measure
4. Incentive effect
5. Proportionality of the aid
6. Avoidance of undue negative effects on competition and trade between member states

Which type of state aid is possible?
Investment aid can be granted to airports with the following intensities depending on passenger figures:

Proportionality of the aid	
<1 million PAX	up to 75%
1–3 million PAX	up to 50%
3–5 million PAX	up to 25%
>5 million PAX	only in very exceptional circumstances

Note that an additional rule applies, limiting the aid intensity to the maximum of the capital cost funding gap, meaning the shortfall in net present value between revenues and costs associated with the investment.

Operating aid can be granted to airports with passenger volumes below three million. The maximum average annual aid is limited to 50% (80% for airports with less than 700,000 passengers) of the so-called initial operational funding gap which equates to the five-year (2009–2013) average annual operational funding gap. Note that state intensity is limited to the operational funding gap for the transitional period (the ten-year period for which aid can be granted) which needs to be set ex-ante. A further increase in aid during the transitional period is not possible.

For how long can operating aid be paid?
Operating aid can be granted for a maximum of ten years after which no further aid is possible. Special rules will apply to airports with passenger figures smaller than 700,000 for which the further treatment will be evaluated four years after the publication of the new guidelines.

Is state aid the only option?
State aid is not the only option. As it is linked to strict rules under the guidelines, we strongly advise airports to carefully consider all feasible options. In many cases, more recommendable options include an analysis of certain non-economic activities that can be reimbursed through public funds, a Market Economy Operator test and, for some airports, an analysis of whether the criteria for public funding of services of general economic interest can be met.

Preparation for the transitional phase is therefore key for many airports affected by the new guidelines.

Old and new challenges

The need for profitability
According to the European Commission, 42% of European airports are loss-making. For some major European markets this number is even higher, as for example for Germany, where only 6 of the 22 international airports are expected to have achieved a net profit in 2013.

But the Commission has now set a tight horizon over which European airports must reach profitability. Airports are given a ten year transitional period after which they must have reached full coverage of their operating costs.

No long-term certainty for airports under 700,000 passengers
Although airports with less than 700,000 passengers are granted certain more favourable conditions under the guidelines (average maximum aid intensity is 80% of the initial funding gap compared to 50%), those airports are faced with the challenge that the time horizon of this aid intensity is limited to the next five years. Four years after the publication of the guidelines, the Commission will reassess the market conditions for those airports.

The Commission requires European airports to change their business models, but it is not yet clear what the future holds for smaller airports.

The issue of average funding gaps
The maximum aid intensity is linked to the initial funding gap which is defined as the average of the annual operating funding gap for the five years preceding the new guidelines (2009–2013). This requirement will particularly put those airports under constraints that have only recently experienced a sharp decline in revenues. Their calculated average funding gap will be significantly lower than the current funding gap, as it is based on past revenue levels that are no longer realistic to achieve. This is not unusual for regional airports that are depending on a limited number of carriers and are therefore hit hard when those carriers abandon routes or are driven out of business entirely. Regaining those routes is not an easy task in the current environment and often comes with a sharp yield discount. For affected airports the new guidelines can mean that the level of allowed operational aid might not be enough to cover current losses.

Refinancing sunk investment costs
Permissible investment aid under the new guidelines is limited to new undertakings. This limitation neglects the fact that smaller airports have already invested heavily in capacity with the beginning of the aviation market liberalisation. Impacted by the current market environment, many airports are now sitting on liabilities too large to be refinanced. However, state aid for past investments is not foreseen under the new guidelines, putting those airports under particular liquidity constraints.

The role of national programmes
Member states are encouraged to develop national schemes under the guidelines, adding another element of uncertainty until those schemes have been fully implemented.

The importance of identifying non-economic activities
Activities normally falling under the responsibility of public bodies (eg, air traffic control, police, customs, firefighting) are non-economic activities that can be publicly funded without constituting state aid. However, public funding of those activities must not put an individual airport in a favourable competitive position compared to other airports not receiving public compensation if it is normal under the applicable legislation that airports are bearing those costs.

Planning ahead

2009–2013	Ten year transitional period (2014–2023)
Annual average funding gap	Ex-ante analysis
• **Average of the annual funding gap** sets maximum aid amount • Maximum aid amount is limited to 50% of the initial funding gap (80% for airports with less than 700,000 passenger)	• Amount is to be determined on the limits of an **ex-ante business plan** and the **initial funding gap** • Aid amount is to be fixed covering the expected funding gap over the ten-year transitional period. • **No increase of the amount ex-post during the course of the ten-year transition period**

The need for preparation and decision making

Key decisions now required

With the new guidelines giving airports not only a definite time horizon for operational profitability but also a set of different angles on how to tackle financial issues, key decisions now need to be made by airport shareholders and management.

Knowing the limits of the new guidelines

The new guidelines set specific limits under which circumstances and to which extend state aid can be granted. It should be clear that for many airports those requirements will not only result in an insufficient level of possible aid but most likely also in business model affecting constraints during the ten-year transitional period. Every aviation manager is well aware of the inherent volatility of the sector. However, the EU-guidelines require airports to determine the required aid amount ex-ante with no headroom available during the transitional period if market conditions change.

Identifying the right choice

Airports should therefore be strongly encouraged to carefully consider all available financial options that might give them and their shareholders more flexibility.

An analysis if certain non-economic activities can be funded through public bodies under the existing legislation and competitive landscape could for instance reduce the need to receive state aid.

A recognised and powerful tool in demonstrating that public funding does actually not constitute state aid is the Market Economy Operator test. The Market Economy Operator test is a statement proving a public company shareholder has acted like a market-oriented private provider of capital, often taking into account that positive returns in infrastructure investments are delivered only after many years.

Occasions on which the Market Economy Operator test can be applied are wide and include amongst others aircraft charges incentive schemes, agreements with low cost airlines, shareholder loans, capital increases and loss compensations.

The advantage of a successful Market Economy Operator test is that certain limitations and (notification) requirements attached to state aid under the new guidelines do not apply as public funding can be proven to be state aid free.

In certain, very specific, circumstances, the operation of an airport can be defined as a Service of General Economic Interest. However, rules are very strict and are likely to only apply to a clear minority of European airports.

Identifying the right choice for public funding

Non-economic activities	Market Economy Operator test	Investment aid	Operating aid	Services of general economic interest
• Activities that normally fall under the responsibility of the state do not fall under the rules on state aid • Funding of those activities allowed but no over-compensation and local legislation to be considered • Separated cost-accounting required to avoid state aid situation	• Proof that a private investor would grant the same funding • Positive return must be shown • Test to be performed ex-ante • Only information as available ex-ante to be considered • All social, regional-policy and sectorial considerations are disregarded	• Investment aid under new guidelines in general possible • Certain requirements are to be met cumulatively • Assessment of possible aid amount to be performed ex-ante	• Operating aid possible during ten-year transitional period • Certain requirements are to be met cumulatively • Assessment of aid amount to be performed ex-ante • Special rules for airports < 700,000 passengers annually	• Overall management of airport may be defined as service of general economic interest • Article 106(2) of the Treaty and Altmark case law apply • Only feasible if catchment area of airport would be isolated from rest of EU without airport services

Our expertise

We know the airport market in depth. Our team of dedicated airport specialists at PwC has extensive knowledge and experience in advising airports in a wide range of services with a key focus on state aid issues, airport charges, airport finance and corporate restructurings. Our clients also benefit from our close relationships to industry leaders and representatives from airports, airlines, aviation authorities and air transport associations.

It is a key strength of PwC – and a sign of the quality, depth and breadth of our services – that our client relationships span airports ranging from leading international hubs to many small and medium-sized regional airports. With the airport market having been at the centre of focus for EU state aid investigations over the past years, we have proven our highly valued expertise in numerous state aid assessments.

Our goal is always to provide airport managers and shareholders with tailor-made and sustainable solutions that meet the challenges of a fast changing aviation landscape.

About us

Our clients face diverse challenges, strive to put new ideas into practice and seek expert advice. They turn to us for comprehensive support and practical solutions that deliver maximum value. Whether for a global player, a family business or a public institution, we leverage all of our assets: experience, industry knowledge, high standards of quality, commitment to innovation and the resources of our expert network in 157 countries. Building a trusting and cooperative relationship with our clients is particularly important to us – the better we know and understand our clients' needs, the more effectively we can support them.

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