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“Start-Up Aid” for Low Cost Carriers– A Policy Perspective

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Abstract

On 7 February 2005, the European Commission published draft “Community guidelines on the financing of airports and start-up aid to airlines departing from regional airports” for consultation. This article focuses on the Draft Guidelines’ statements on “start-up aid,” which seek to integrate the Commission’s statements in last year’s Charleroi decision into a consistent state aid policy framework. It is submitted here that such an attempt is highly problematic, given the absence of a coherent and objective justification for start-up aid in its proposed form. The Commission should not depart from its long-standing hostility to operating aid for reasons of perceived political expediency. At the very least, the Commission should limit the distortive effects of such aid to the greatest possible extent, in particular by limiting it to routes to and from truly regional airports.

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State aid

“Start-up aid” for low cost carriers – a policy perspective

By *Sven B Völcker, Wilmer Cutler Pickering Hale and Dorr LLP**

On 7 February 2005, the European Commission published draft “Community guidelines on the financing of airports and start-up aid to airlines departing from regional airports” for consultation. This article focuses on the Draft Guidelines’ statements on “start-up aid,” which seek to integrate the Commission’s statements in last year’s *Charleroi* decision into a consistent state aid policy framework.

It is submitted here that such an attempt is highly problematic, given the absence of a coherent and objective justification for start-up aid in its proposed form. The Commission should not depart from its long-standing hostility to operating aid for reasons of perceived political expediency. At the very least, the Commission should limit the distortive effects of such aid to the greatest possible extent, in particular by limiting it to routes to and from truly regional airports.

Invention of the “start-up aid” concept in the Charleroi decision and the Draft Guidelines

Partially as a result of the *fracas* caused by Ryanair, the Commission’s *Charleroi* decision is mainly known for the Commission’s demand that Ryanair repay part of the aid that it had received from the Walloon Region and the Charleroi Airport Authority.

The Draft Guidelines also seek to create the impression that they are primarily an attempt to keep in check the “negotiating methods used by low-cost airlines to obtain aid from public authorities” (*para 7*).

Less well recognised is the fact that, in the *Charleroi* decision, the Commission for the first time accepted that “start-up aid” for airlines such as Ryanair departing from smaller or “regional” airports could be compatible with the Treaty at all. In doing so it not only departed from its 1994 Guidelines on state aid in the aviation sector (the “1994 Guidelines”), but also from its consistent policy position that operating aid (aid subsidising ongoing operations rather than one-off investments) can only be accepted in the most exceptional circumstances.

Indeed, the *Charleroi* decision and the Draft Guidelines allow public authorities – usually regions or the publicly-owned airport authorities themselves – to subsidise for a period of up to five years as much as 50% of the “start-up” costs of airlines that open up new routes departing from regional airports.

This type of aid is clearly operating aid to the benefit of individual carriers. The 1994 Guidelines allow operating aid only in two very narrowly defined circumstances:

- (i) the aid represents compensation for public service obligations imposed under Regulation 2408/92, or

- (ii) the aid is of a “social character,” *i.e.* it is granted to individual consumers with special needs.

Plainly, neither category applies to services such as those that were offered by Ryanair and were the subject of the *Charleroi* decision. While both the decision and the Draft Guidelines seek to introduce a number of conditions for start-up aid to be compatible with the Treaty, the fact remains that the concept does not fit well with the Commission’s state aid policy to date.

Justification offered for the “start-up aid” concept

The Draft Guidelines say that start-up aid may “form part of a coherent airport policy characterised by a demonstrated willingness to develop the profitability of [regional airport] infrastructures that are not always profitable.” Start-up aid to airlines departing from such airports is viewed as helping those airports to develop the “critical mass” needed to become commercially viable, and thus ultimately reduce their reliance on public funds.

The Draft Guidelines then offer two principal reasons why helping the development of regional airports is a worthwhile undertaking. First, a coherent airport development policy – of which start-up aid is apparently deemed to be an important element – will result in the “promotion of regional development, tourism, the local economy or a region’s image” (*para 77*). Second, regional airports “could also provide a solution to one problem of transport policy: that of saturation of the capacities of the major airports” (*para 79*).

Two additional justifications are mentioned in the *Charleroi* decision but are absent from the Draft Guidelines: the environmental benefits of encouraging the use of regional airports, and their role in the “development of competition” between airlines.

For the reasons set out below, these considerations do not justify the authorisation of operating aid in disregard of the Commission’s consistent state aid policy.

Aid to carriers for the benefit of regional airports?

The very premise of operating aid to carriers – *i.e.* that they help regional airport infrastructures become profitable – is dubious. As the *Charleroi* example shows, it is typically the regional airport authority itself that grants the financial advantages to the relevant airline.

If it were true that up-front financial incentives for carriers such as Ryanair help to create a “critical mass” of passenger traffic and therefore move the break-even point forward in time for regional airports, such up-front promotional benefits should not be considered “aid” in the first place under the market-economy investor test.

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State aid – airports

By definition, such financial incentives would not be state aid and there would be no need to develop the kind of extensive rules for finding them compatible with the common market that the Draft Guidelines seek to lay down.

Quite apart from this basic logical flaw, the “critical mass” argument provides a very weak link between the obvious and immediate benefit to the airline and the anticipated long-term gains to the airport. The Commission’s discussion in the *Charleroi* decision of the business plan of the airport authority, BSCA, illustrates how tempted regional airports can be to overestimate the long-term financial benefits of a long-term agreement designed to attract low-cost carriers to the airport.

Indeed, the *Charleroi* example itself illustrates that toleration of “start-up aid” may not make “unprofitable infrastructures profitable,” but may actually have the opposite effect of encouraging the build-out of unprofitable infrastructure. As the *Charleroi* decision reveals, BSCA actually achieved positive net results before concluding the agreement with Ryanair.

However, that may change in future: BSCA is currently building a second terminal at Charleroi, even though the first terminal’s current utilisation is at most 50%. Thus, instead of trying to achieve a return on its past investment, BSCA is increasing its investment in new infrastructure, which can only be viable if additional airlines are attracted to the airport.

This illustrates the moral hazards of allowing start-up aid to airlines: if it is successful in terms of attracting additional traffic, it may prompt further pressure to build additional infrastructure, which itself is typically financed by public funds. This in turn may lead to calls for yet more start-up aid to make use of that additional infrastructure.

Start-up aid as assisting regional development?

The suggestion that start-up aid can conceptually be justified by regional development is also misplaced. As both the *Charleroi* decision and the Draft Guidelines point out, start-up aid is *ad hoc* operating aid granted to individual airlines, and thus cannot be justified by regional development considerations *stricto sensu*, unless perhaps if the airport in question is in one of the outermost or sparsely populated regions that are eligible for special assistance under article 87(3)(a). It is arguably inconsistent for the Commission to “recycle” regional aid considerations in the context of article 87(3)(c)’s “certain economic activities.”

Indeed, the *Charleroi* decision and the Draft Guidelines seem to pay no more than lip service to regional development considerations. None of the criteria they set out for the compatibility of start-up aid with the Treaty is clearly linked to any regional development aim, with the single exception that start-up aid may be granted for up to five years, rather than three, in the case of article 87(3)(a) regions.

The Draft Guidelines’ definition of airports at which start-up aid would be available makes no reference to the location of the airport in question, but only to the number of passengers using that airport. But passenger numbers are clearly an inadequate proxy for airport location because they do not allow for a distinction between airports that are truly regional, and “secondary” airports. The latter are merely smaller airports located in well-developed and populated areas – for example, Venice-Treviso or Paris-Beauvais.

Moreover, the only airports for which the Commission clearly excludes start-up aid are those with more than 10 million passengers per year. This still leaves airports such as Brussels eligible for assistance as “regional airports” – a clear indication that “start-up aid” as proposed in the Draft Guidelines has little to do with regional aid considerations.

Start-up aid as relieving congestion in the air and on the ground?

Equally questionable is the notion that start-up aid for activities at smaller airports, regional or secondary, could reduce congestion in the air and on the ground.

First, as with the regional aid justification, there is no clear link between perceived congestion and the eligibility for start-up aid. Brussels Zaventem is not a congested airport, yet this was not a factor in the Commission’s willingness to authorise start-up aid for Ryanair at Charleroi airport, referred to by Ryanair as “Brussels South.”

Second, to the extent that congestion is a real problem, the question is whether start-up aid will do anything to remedy it. The essence of “start-up” aid is that it incentivises an airline to start up a wholly new route, rather than simply moving its traffic from a congested hub airport. Indeed, at paragraph 92(d), the Draft Guidelines explicitly state that start-up aid should not be available for a route replacing another route that the airline had previously served from another airport “located in the same economic attraction zone or population centre.”

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Third, it is questionable whether start-up aid could ever achieve the aim of relieving congestion at major hub airports – if this were really what such aid was designed to achieve. Hub airports are congested because carriers are drawn to them for the very connectivity benefits that cause those airports to be congested. Secondary or regional airports – to the extent that they do not form spokes connected to a hub – are attractive only to carriers unconcerned about connectivity because they seek to attract only local traffic. In any event, those carriers will typically seek out regional or secondary airports, rather than congested hubs, due to their much lower costs, for example because of lower landing and airport charges. Conversely, it would take enormous financial incentives for a network carrier to open up routes unconnected to its hub, because its very business model is premised on attracting a high number of connecting passengers.

Fourth, as regards congestion on the ground, it is difficult to see what benefits would result from authorising start-up aid. To the extent that airlines operating from regional or secondary airports actually reduce surface traffic, this will most likely be at the expense of train travel. However, it is precisely such a diversion of traffic away from rail transport that is anathema to the Draft Guidelines, which consider that no start-up aid should be granted if there is already a competitive high-speed rail link (*para 87*).

Environmental benefits?

The *Charleroi* decision also mentions the environmental benefit – avoidance of pollution – of encouraging use of regional airports through start-up aid. The Draft Guidelines do well not to take up this line of argument.

There is no case that start-up aid reduces pollution. To the extent that low-cost airlines, which are the primary if not exclusive beneficiaries of start-up aid, create opportunities for discretionary (often weekend) travel, this will increase rather than reduce pollution. The same applies to the extent that carriers use secondary airports such as Charleroi to attract urban populations who would otherwise have used the main airport. As most secondary airports are at a greater distance from the city centre, those passengers need additional surface transport, usually by car or bus, so creating additional pollution.

Development of competition between airlines?

The final justification for start-up aid mentioned in the *Charleroi* decision – again one that is absent from the Draft Guidelines – is the notion that such aid could facilitate the “development of competition” between airlines. This is plainly not a ground on which any kind of state aid should be authorised under recognised principles of state aid law.

Authorising aid in order to encourage competition would be tantamount to authorising aid because of, rather than despite, its distortive effects on competition. This is excluded by article 87(3)(c) of the EC Treaty, which allows the Commission to authorise aid only “where such aid does not adversely affect trading conditions to an extent contrary to the common interest.”

Indeed, in the Draft Guidelines the Commission attempts to create certain safeguards to ensure that the recipient of “start-

up aid” does not enter into competition with carriers already operating from the same airport or from another one in the same population centre or economic attraction zone.

Conclusion on possible justifications for “start-up aid”

It follows from the preceding discussion that the justifications offered for start-up aid in its currently proposed form lack a sound policy rationale linked to the development of regional airports, are inconsistent with the criteria developed for permissible start-up aid, are to an extent self-contradictory, and are arguably even incompatible with the state aid rules of the Treaty.

Conditions for start-up aid

While allowing operating aid for low-cost carriers at regional airports is thus conceptually problematic, the parameters for permissible operating aid in the *Charleroi* decision and the Draft Guidelines appear to aggravate rather than minimise the resulting distortions of competition in at least three respects:

- permitting an unprecedented duration and intensity of operating aid
- stipulating that aid should be calculated on a per-passenger basis
- providing no apparent limits on the use of aid to subsidise promotional tariffs.

Duration and intensity of start-up aid

As noted above, under the EC Treaty it is the rare exception that operating aid is allowed at all. In the case of start-up aid, the maximum permissible duration of five years and intensity of 50% of eligible start-up costs are unprecedented for aid measures.

In justifying a five-year period in the *Charleroi* decision, the Commission relied on a “similarity to public service obligation schemes” (*para 312*). However, such an analogy is weak. Low-cost carriers such as Ryanair are heavily geared towards discretionary travel rather than travel meeting basic business and social needs in remote or sparsely populated regions. Moreover, Regulation 2408/92 allows only for a three-year duration of compensation for public service obligations, and requires member states to use an open and non-discriminatory tendering process that normally averts a finding of state aid in the first place.

Similarly, a 50% ceiling for permissible aid intensity is extraordinary, as the Commission readily acknowledges in the *Charleroi* decision (*para 319*), even apart from the particularly detrimental category of operating aid. By way of example, under the guidelines on national regional aid, the highest aid intensity permissible under article 87(3)(c) of the EC Treaty is generally 20%, except in the sparsely populated or outermost regions, where it may be as high as 30%.

In addition, the *Charleroi* decision and the Draft Guidelines appear to say that only the average aid intensity over five years has to be limited to 50% of the total additional start-up cost, so that even higher percentages would be permitted during the initial part of the relevant period.

Per-passenger calculation

Another potential source of competitive distortion is the requirement that the total aid be calculated “per embarking

passenger” (*para 92(j) of the Draft Guidelines*). This means that the carrier in question will receive more aid the more successful it is on the route in question. For example, the higher its load factors are and the more the carrier increases its frequencies, the more start-up aid it could expect.

Such a method of calculation is at odds with the stated purpose of start-up aid, *i.e.* to compensate for the risks of flying from an unknown regional airport. If start-up aid were about insuring low-cost carriers against the risk of commercial failure due to the relative obscurity of the airport in question, it should in fact provide for the opposite: the fewer passengers, the more aid.

No apparent limits on subsidising promotional tariffs

While the *Charleroi* decision notes with apparent disapproval the “in principle unlimited” use of public funds to subsidise Ryanair’s promotional fares (which can be as low as £1.00 – €1.46), neither the decision nor the Draft Guidelines contain any clear prohibition on using aid for this purpose. Indeed, given the pervasiveness of promotional fares as an advertising tool for low-cost carriers, they will be quick to claim that the “costs” of such fares are “marketing and advertising costs incurred at the outset for publicising the link” (*para 92(b) of the Draft Guidelines*).

Directly subsidising the selling price is surely the most distortive form of aid imaginable, so that the Draft Guidelines’ admonition that aid not be used to cover recurring operating costs such as aircraft leases may be of little practical relevance.

Conclusion

Both the concept of start-up aid and its implementation as proposed in the Draft Guidelines are flawed. Despite the Draft Guidelines’ attempt to portray start-up aid as part of a rational and consistent policy to promote the use of regional airports, it is readily apparent that start-up aid is designed to support a particular business model – that of low-cost carriers such as Ryanair.

Such a move may be politically expedient given the current popularity of the low cost business model and the low-cost carriers’ skills in using regulatory proceedings to further raise their public profile. But it is bad state aid policy.

At the very least, the Commission should revise the Draft Guidelines to limit start-up aid to cases in which airlines depart from truly regional airports located away from the major population centres and “economic attraction zones” already served by other carriers, including those served indirectly through the spokes of network carriers.

Furthermore, the Commission should change the Draft Guidelines’ methodology to ensure that carriers departing from such regional airports are only insured against the risks of flying from such airports, but do not receive additional financial rewards if they make the route a success by attracting a large number of passengers.

Only then can start-up aid begin to serve the Commission’s stated aim: to be part of a coherent state aid framework.

References

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europa.eu.int/comm/transport/air/rules/doc/stateaid_consultation/com_2005_en.pdf

See also Commission press release IP/05/149, 8 February 2005
europa.eu.int/rapid/pressReleasesAction.do?reference=IP/04/157&format=HTML&aged=1&language=EN&guiLanguage=fr

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 in Charleroi (*OJ 2004 L137/1*)

See also Commission press release IP/04/157, 3 February 2004
europa.eu.int/rapid/pressReleasesAction.do?reference=IP/04/157&format=HTML&aged=1&language=EN&guiLanguage=fr

Since this decision, the Commission has authorised several state aids for the development of regional airports, *e.g.* Commission press releases IP/05/58, 19 January 2005 (Germany)
europa.eu.int/rapid/pressReleasesAction.do?reference=IP/05/58&format=HTML&aged=0&language=EN&guiLanguage=fr
and press release IP/04/1266, 20 October 2004 (Spain)
europa.eu.int/rapid/pressReleasesAction.do?reference=IP/04/1266&format=HTML&aged=1&language=EN&guiLanguage=fr

Italian tax breaks for newly listed companies condemned as unlawful state aid

On 21 March, the Commission ruled that special tax rates and reliefs in Italy for companies listed for the first time during 2004 were unlawful. Any benefits already enjoyed will have to be repaid.

The ruling was unusual largely because the €56m allocated by the Italian Treasury for this purpose was itself highly unusual. No sector or region was favoured, and no special purpose was served – certainly not one that might have gained special state aid treatment, like environmental protection or job creation.

To qualify, an unlisted company had to make an initial public offer that resulted in a capital increase of at least 15% and in its listing on a regulated European exchange between 2 October 2003 and 31 December 2004. It was not limited to Italy’s stock exchanges, but naturally it could only benefit companies with taxable revenue in Italy.

A reduced rate of corporation tax – 20% instead of 33% – would apply for three years. Companies could also offset all their listing costs against their 2004 tax bill.

As the range of markets selected by this strange largesse was random, some difficulty in proving a distortion of competition might have been expected.

The Commission had none. The aid benefited a few companies – ten, in fact – that all had high growth potential. Because it was linked to income tax, it mainly availed Italian companies. For the same reason, payment was in proportion to earnings, so it was operational aid, which is forbidden. All such companies would compete on some European market.