



COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 20.05.1999  
COM(1999)182 final

COMMUNICATION FROM THE COMMISSION

TO THE COUNCIL, THE EUROPEAN PARLIAMENT,  
THE ECONOMIC AND SOCIAL COMMITTEE  
AND THE COMMITTEE OF THE REGIONS

**THE EUROPEAN AIRLINE INDUSTRY: FROM  
SINGLE MARKET TO WORLD-WIDE  
CHALLENGES**

EXECUTIVE SUMMARY ..... 3

1. THE STATE OF THE EUROPEAN AIRLINE INDUSTRY ..... 5

Air transport is a high growth industry, but cyclical and with uncertain profitability

The performance of the European air transport industry from a world-wide perspective

Structure of the industry

Productivity

2. THE NEED FOR PERMANENT RESTRUCTURING ..... 12

Improving the external environment

Continuing restructuring at company level

Restructuring at industry level

Competition law

Lack of an external dimension

3. TEN YEARS OF LIBERALISATION ..... 18

General experience up to date

ANNEXES ..... 21

Annex 1. Developments since full liberalisation ..... 22

Annex 2 Social impact of current trends ..... 26

Annex 3 Overview of Government-funded restructuring operations ..... 29

## EXECUTIVE SUMMARY

The airline industry has been challenged, during the last years, by the opening of the European market, the adjustments required to deal with the new competitive environment and the pressure of the US open skies strategy. The aim of the present communication is first to assess the progress which has been made and second to identify the initiatives which can contribute to the competitiveness of the industry.

- European airlines have developed innovative strategies in order to adapt themselves to market growth and competition challenges. During the last decade they have achieved considerable productivity improvements which now permits the sector to create new jobs. However they still suffer from relative structural fragmentation and financial fragility when compared to their main competitors, notably North-American carriers.
- Liberalisation and globalisation make the market increasingly competitive and require airlines to undertake large restructuring efforts. The Commission authorised state aid as a one-off measure to help national carriers to restructure during the transition to the liberalised single market. This transition is now over.
- The airline industry suffers from the same handicap as other industries in Europe, justifying general initiatives enhancing the efficiency of the economic environment<sup>1</sup>. The present communication identifies those deficiencies of the regulatory framework of air transport activities, which stand in the way of adjustment by European companies. To help the industry towards this strategy, the European Commission identifies the following policy orientation:
  - The Commission uses all the tools at its disposal to ensure integration of the European market. This includes the application of EC competition law to prevent attempts to re-fragment the market through public intervention or anti-competitive alliances or mergers. The monitoring of public and private behaviour, the transparency of Community legislation and the definition and dissemination of best practices on a number of issues such as Public Service Obligations, are important elements in this regard.
  - The elimination of technical obstacles to trade, in particular by faster and more efficient harmonisation of safety rules through the creation of a European Aviation Safety Authority and by giving impetus to ICAO activities in the environment field will help the industry

---

<sup>1</sup> The Competitiveness of European Industry - 1998 Report (Office for Official Publications of the European Communities CO-17-98-556-EN-C)

— The fragmentation of the internal market results also from the lack of an external dimension. Ownership rules and the bilateral agreements system create obstacles to industry restructuring at European level and to fair competition with the open skies countries. These economic consequences add to legal justifications for a genuine external dimension permitting to insert the alliances within a fair European framework.

- The present inefficiencies of the market and the sensitivity of the sector to economic cycles and external shocks lead the Commission to develop its function as an observatory of the European air transport industry. For this purpose it is carrying out a long term project for the creation of a comprehensive database of the European airline industry. This will increase the quality and availability of data and analyses on capacity, traffic, financial performance, productivity, industry and route structure, airports, and employment that are necessary to support a policy aiming at safeguarding the competitiveness of the industry. Information and analyses on industry trends will be available to the general public on the Commission's internet site. This tool will enable the Commission to monitor the evolution of the industry in general and of air fares in particular, focusing on routes and airports that give rise to prima facie excessive operating ratios.
- This communication will be the subject of discussions that the Commission intends to hold with the industry, national regulators and users.

## 1. THE STATE OF THE EUROPEAN AIRLINE INDUSTRY

### **Air transport is a high growth industry, but cyclical and with uncertain profitability**

1. Over the past half century civil aviation has developed into a global industry generating high added value. It has become the primary mode for international and intercontinental mass transport of passengers and high-value cargo. Today, it is a growth industry characterised by direct and indirect job creation. Air transport is a highly cyclical industry, because of its strong correlation to the economic cycle. A wide set of factors determines the demand for air transport. This includes income, price, many country/region specific features such as population size and growth rate, availability of alternative transport modes, migration flows and cultural and historical attitudes.

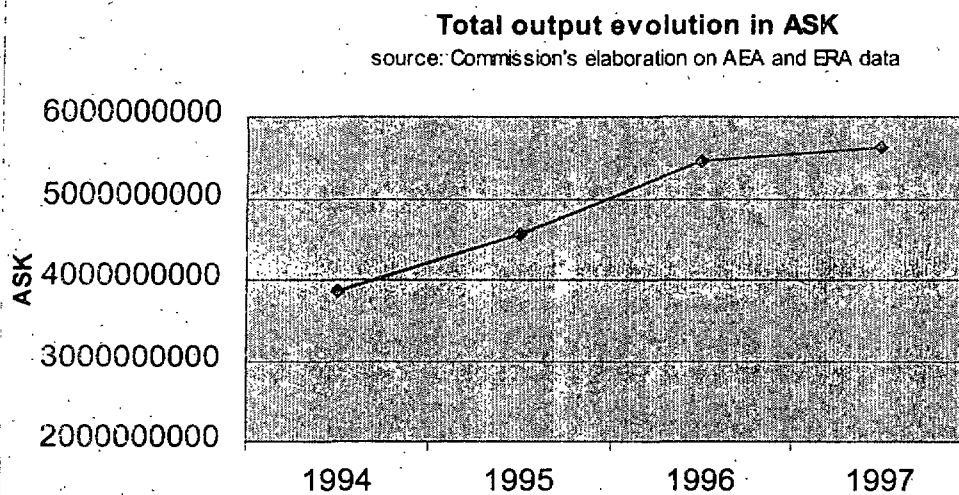
However, economic growth is the main driving force: an increase in GDP usually entails a more than proportional increase in traffic, and conversely demand is very sensitive to recessions. With income elasticity of demand for air transport being high<sup>2</sup>, fluctuations in the economy result in even wider fluctuations in the aviation industry.

2. In recent years air transport recorded a strong growth in the volume of output produced and sold. After the crisis at the beginning of the decade, when the joint impact of the world recession and the gulf war resulted in a tangible decline in demand, the air transport industry has been growing at a sustained pace, both at World and European level. According to ICAO data, passenger traffic in terms of passenger-kilometres performed rose by 7% in 1997 over 1996. The year 1997 was one of great expansion for the major European airlines as well: available statistics show that AEA member airlines traffic (revenue ton kilometres RTK) increased by 9.7%; capacity (available seat kilometres ASK) by 6.7%; and freight traffic by 5.3%. More recent data tell us that the trend is continuing in 1998. The evolution of the industry in the EU, summarised in figure 1, shows the evolution in the ASK performed by the European carriers on the intra-EU routes.

---

<sup>2</sup> Income elasticity of demand for air travel is the ratio between the percentage change in demand and the percentage change in income:  $\text{income elasticity} = \frac{\% \text{change in demand}}{\% \text{change in income}}$ . For instance, a 2% increase in income generating a 6% increase in air travel demand means that income elasticity is 3. The available empirical evidence shows that income elasticity usually varies between 1.5 and 2.5 depending on the type of passenger (lower for business passengers, higher for leisure passengers).

Figure 1<sup>3</sup>



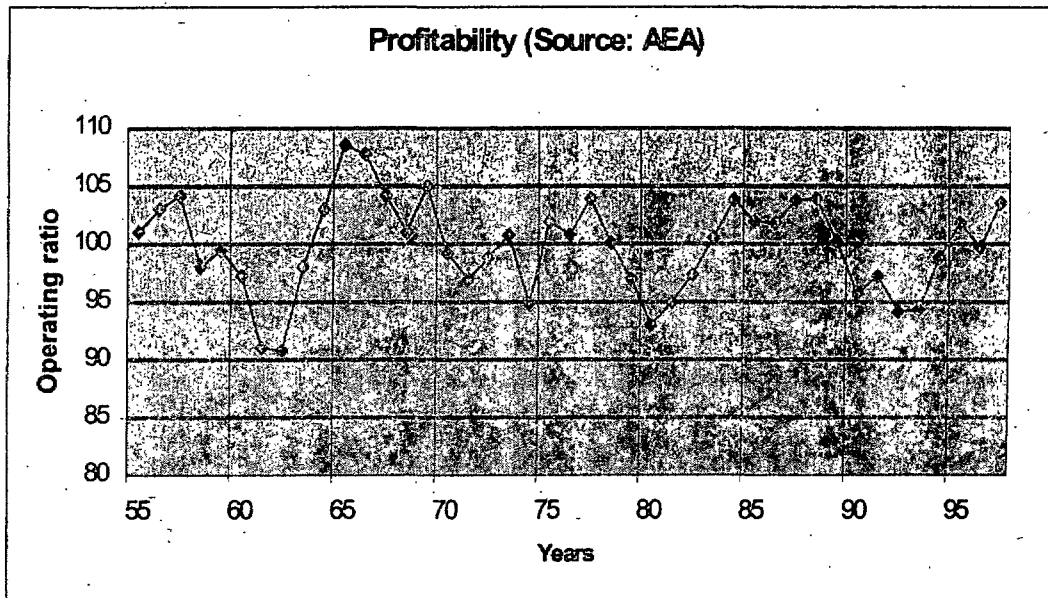
3. The outlook for aviation is difficult to predict. According to the latest market studies carried out by the major aircraft manufacturers, world-wide demand for air travel will continue to grow strongly in the next two decades, at a rate of about 5% per year. However, this forecast should be adjusted to take into account major events that cannot be anticipated. The recent financial and economic crisis in south-east Asia is a typical example of unforeseen factors negatively affecting the industry. Indeed the slump immediately resulted in some increased air transport overcapacity on routes to and from Asia, which might spread, to some extent, to other markets.
4. Air travel will not grow homogeneously across the world but vary from a geographical area to another. In some areas air transport is already a mature industry and growth will be therefore moderate: this is the case of the US domestic market and more generally North America, for which a yearly growth rate of 2% to 3% in the period 1996-2006 is forecast. Until recently growth was expected to be very large in Asian markets (7% to 9% yearly increase) but the financial and economic crisis currently hitting the region suggests that more cautious figures should be contemplated. Even in their most recent market studies, aircraft manufacturers still retain an optimistic forecast in the medium-long term for Asia. As regards Europe, figures will be less spectacular than for Asia but still higher than for the US.

---

<sup>3</sup> The graph depicts the evolution of Available Seat Kilometres (ASK) produced within the EU by the Community airlines belonging to AEA (Association of European Airlines, grouping mainly flag carriers) and ERA (European regional Airlines). To make the picture complete one should add the figures concerning charter airlines. Unfortunately statistic data available for this important segment of the market is scarce and poorly detailed. However it is estimated (Civil Aviation Authority CAP 685 -The single European Aviation Market) that in 1996 the European charter airlines carried 77 million passengers, which compares with the estimated scheduled total of around 240 million. In terms of RPK the charter share is higher, since on average the passenger distance is longer for charter service than for scheduled service. The charter industry share would be about 50% of the total.

- Opinions differ on the prospects for the next few years but, taking into account the economic difficulties in the Far East and the high financial commitments stemming from large aircraft purchases, it cannot be excluded that a less favourable period lies ahead. Generally speaking, there is a rather widespread feeling that the cycle is reaching its peak in 1998-99, and that a downturn may follow.

Like their demand, airlines' profitability is very cyclical. It depends on an airline's ability to manage costs, fares and load factors in order to adjust to the changing conditions of the market. In recent years financial performance has, on average, been good, but historical evidence shows that profits are thin and volatile and the outlook of individual airlines is not secure.



**The performance of the European air transport industry from a world-wide perspective**

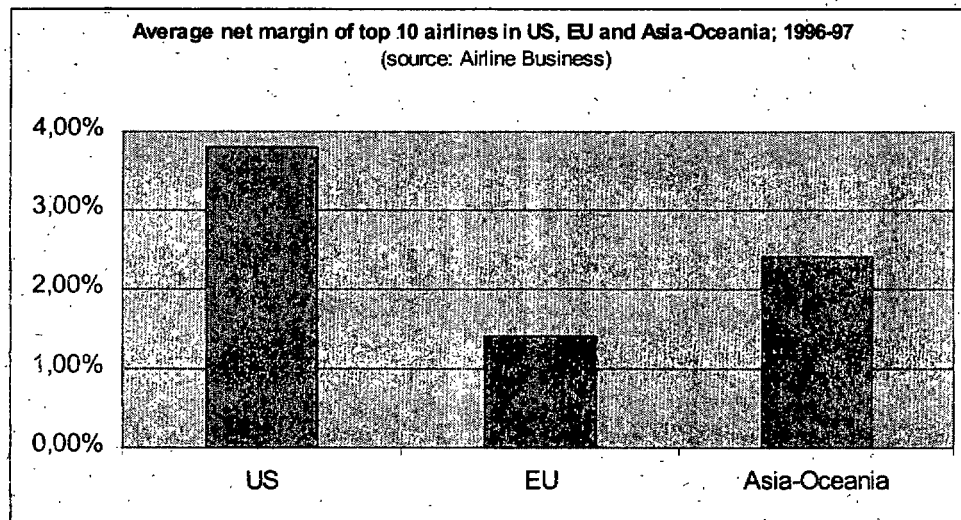
- The European air transport industry is relatively small compared to its competitors in North America. If one looks at some key figures for the 10 largest airlines in the US, the EU and Asia-Oceania, it is easy to grasp the difference. In 1996 these European airlines transported about 192 million of passengers, just as many as the Asians, against a figure of 510 million for the American carriers. The difference in size is even wider when considering the Revenue Passenger Kilometres (RPK), an indicator that combines the number of passengers and the distance over which they are transported. The different scale is confirmed by the figures concerning employment, and fleet size and revenue, as presented in the table below:

Top ten airlines in US, EU and Asia-Oceania – 1997

Source: Airline Business

	PASSENGERS (MILLIONS)	RPK (MILLIONS)	REVENUE (M \$)	EMPLOYEES	FLEET
US	524.12	900 066	86 249	461 852	3 529
EU	212.68	446 677	63 203	275 580	1 430
ASIA-OCEANIA	199.08	412 130	46 879	195 360	1 051

The largest European airlines are similar in size to the largest American ones but a typical characteristic of the European airline industry is the existence of a second layer of relatively small airlines with a global vocation. This may partly explain the limited profitability of the European industry, since in the global airline industry size is an important efficiency factor. After years of financial difficulties most European airlines recorded positive results in 1996 and 1997, but they are still more vulnerable than their competitors. Indeed in the period 1996-97 the top 10 European Airlines performed an average net margin (i.e. the ratio net result/revenue) of 1.4%, against values of 3.8% for US airlines and 2.4% for Asia-Oceania.



### Structure of the industry

- The opening up of a market previously protected from competition usually results in a first phase in which the number of participants in the industry increases. This is followed by a second phase of consolidation whereby the number of firms decreases and their size increases. Air transport seems to have followed this process in the USA. Europe, which undertook liberalisation some ten years later, still seems to be



in the first phase<sup>4</sup>. In 1993 we had 132 airlines performing commercially significant scheduled operations; in 1998 we have 164.

When comparing the air transport market in the EU and the USA one should be aware of some important structural differences. For instance in Europe average distances between cities are shorter and competition from alternative transport modes, notably road and railways, is much stronger than in the US. Of course these aspects explain to some extent the different structure, yet it is striking that Europe, whose domestic market is less than one third of North America's, has a far higher number of airlines operating large aircraft, 90 against 37. Conversely European carriers' average size is much smaller, both in terms of number of aircraft operated (average fleet of 27 against 111) and market shares. The following table shows the extent to which the European industry is fragmented.

	Domestic market % of world RPK	N° airlines	Fleet
EUROPE (geographical)	7.76%	90	2445
NORTH AMERICA	24.41%	37	4122

Source: Commission's elaboration on the "Airbus Global Market Forecast 1998", covering airlines accounting for 98% of the current global active fleet of passengers aircraft with 70 seats and more.

8. A major aspect of structural change is the emergence of new operating patterns for airlines.

In hub-and-spoke operations traffic is concentrated into a single, centrally located destination (the hub) which is used as a connecting point for passengers travelling between any other pair of destinations in the network. By reducing the number of direct routes, traffic flows are condensed, permitting the use of larger aircraft and the operation at higher load factors. This pattern is now followed by major carriers.

Some airlines pursue low-cost no-frills strategies. This alternative concept of air transport consists of serving dense and short haul markets on a point-to-point basis with frequent service. Dramatic reductions of costs are achieved through a revolutionary product planning based on features such as no interlining, no pre-assigned seat selection, no in-flight food, single class of service, use of cheap, uncongested secondary airports and uniform fleets of young and fuel-efficient aircraft. Low-cost airlines are estimated to have carried about 7-8 million passengers in 1997. Hub and spoke and low cost are the main emerging tendencies but they are not mutually exclusive. Other airlines follow patterns that are a combination of the two.

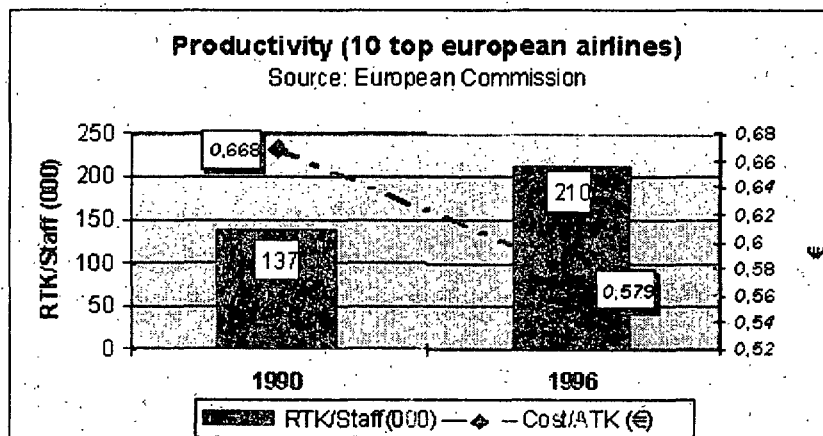
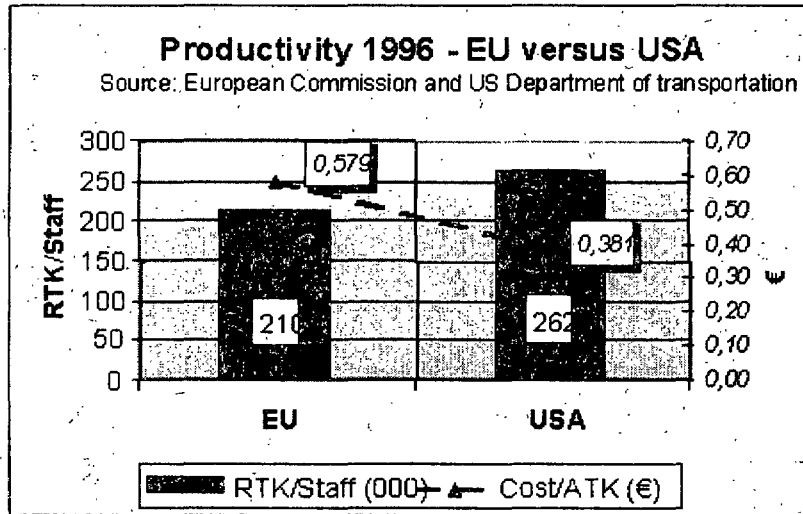
---

<sup>4</sup> See annex 1 fig. 1, p.21

## Productivity

9. The unending pressure for cost reduction and efficiency gain has yielded considerable productivity increases. This can be appreciated when considering two major indicators for productivity, output per employee, which is measured as RTK/staff, and operating costs per unit of output, expressed as cost/ATK.

Indeed in the period 1990 to 1996 the 10 largest European airlines recorded on average a 53% increase in RTK/staff, while their cost/ATK went down by 13%. Although this is a significant improvement, productivity of the 10 largest American airlines is still higher, meaning that restructuring efforts need to be continued.



### *Social impact of current trends*

The Commission assessed the social impact brought about by the evolution of the industry, and reached an encouraging conclusion: employment during the years of implementation of the liberalisation measures, far from being undermined, has actually increased. Between 1988-1996 the overall number of employees in civil aviation increased from 435,400 to 489,700 and the outlook for employment in this sector is positive, although the trend is not homogeneous across time, EU Member States and different parts of the industry. For instance, the level of employment decreased until 1994 and increased since then; it stagnated for flag carriers while increased for other airlines, although flag carriers still represent 80% of jobs in the airline industry and over half (57.5%) of the entire civil aviation sector. The results of the assessment of the social impact are presented in detail in annex 2.

The emphasis on competitiveness has brought about more flexible forms of employment. This occurred particularly with state-owned airlines, which accounted for 67% of all airline employment in 1988 (apart from British Airways, which was already privatised). It is also noticeable that conditions of employment have been modified for newly hired employees, many of whom are granted fixed term contracts and to whom, in many cases, two-tier pay systems are applied. It must be stressed that this trend is not specific to the air transport industry and can be observed in other sectors of activity where a liberalisation process has been initiated or where competition is having a significant impact. However, job security remains relatively strong at flag carriers for longer service employees. The level of wages is still higher (from 15% to 25% in most cases) than at smaller airlines for similar jobs. Performance related pay schemes tend to replace seniority pay schemes for some categories of employees; this move is not only evident in the civil aviation sector but is a more general trend of employment today.

## 2. THE NEED FOR PERMANENT RESTRUCTURING

10. Airlines are facing increasingly complex situations. Notably, ongoing demand for improved products in terms of more destinations and more frequencies, requires in turn the ability to innovate and greater financial resources. The task is even more challenging for Europe, which, despite recent progress, is still lagging behind the major international, in particular US, competitors because of the structural weaknesses described earlier. If European airlines are to survive and flourish in this increasingly competitive environment, permanent restructuring, that is ongoing improvements in efficiency and competitiveness, is necessary. Much of the increase in competition has come from the EU liberalisation measures in the industry. However it should be noted that this process has not introduced competition on all markets. The Commission's own 1996 report on the impact of the third package of liberalisation measures noted that 64% of EC routes were operated as monopolies, although many of these are new or thin routes, and that fares for business passengers had not decreased.
11. Restructuring requires that improvements are achieved in several areas: external environment, company level, industry level. Competitiveness is enhanced both through improvements of the airlines' performances and the economic and regulatory environment surrounding the airlines. This continuous drive for efficiency may take various forms, from the development of innovative concepts such as low-cost point-to-point services or hub-and-spoke and global networks to consolidation and rationalisation through mergers and alliances.

### Improving the external environment

12. In its 1994 Communication "The way forward for civil aviation in Europe" the Commission identified scarcity and cost of infrastructure as a main cause of the high costs incurred by European air travellers. To improve this situation, the Commission has, in recent years, been carrying out initiatives targeting infrastructure.
  - As of January 1999 access to ground handling market for third parties at Community airports is liberalised, as provided for by Directive 96/67. This measure is expected to help reduce operating costs and improve the quality of service for airport users. The same kind of effect is expected to be achieved through a new directive on airport charges, which is now in the process of being adopted.
  - The fragmentation of the air traffic management systems is addressed through the strengthening of the Eurocontrol organisation. For this purpose, a revised Eurocontrol Convention has been signed in 1997 and negotiations have started in order to allow the full membership of the Community in this organisation.
  - As far as safety is concerned, the Community is actively taking part in creating the European Air Safety Authority (EASA), whose main objective will be to establish a high uniform level of aviation safety in Europe.
  - Because of acoustic and air pollution, air transport is also concerned by substantial environmental regulation. In particular the strong growth of air

transport will necessitate action on the CO<sub>2</sub> emissions of this sector in the future and rules on noise need to be updated to reflect technical progress. The Commission will reflect on the issue of environmental protection and its interaction with aviation competitiveness.

### **Continuing restructuring at company level**

13. At the beginning of the 1990s, a number of airlines experienced situations of financial and commercial crisis. The causes were overcapacity, lack of productivity, high costs and undercapitalisation, made worse by the downturn in demand. Restructuring of ailing airlines relied to a large extent on state funding. The Commission acted to make these restructuring operations consistent with Community rules on State aid. Its objective was to create a level playing field for competition while accepting that some airlines carrying the financial burden of the past must have the chance for a fresh start within the framework of a reorganisation programme, provided that this does not adversely affect the situation of competitors.

In 1994 the Commission set out principles and criteria for the assessment of state aid to airlines in the guidelines on the application of articles 87 and 88 of the EC Treaty (Ex articles 92 and 93 of the Treaty) and article 61 of the EEA agreement to state aid in the aviation sector. The guidelines, and an analysis of their implementation, are presented in annex 3.

Since 1991 seven airlines have benefited from public capital injections which were considered state aid within the meaning of art 87 and granted exemption under art 87.3.C: in a few other cases the Commission considered the capital injection to be a commercial financial transaction.

#### *Characteristics of restructuring programmes supported by State aid.*

The seven airlines that received state aid had different characteristics and problems, requiring specific solutions. However, several general features recur in all or some of the restructuring programmes. The main category of measures is about cost reduction, in particular labour and financing costs, although other operating costs are also addressed by the restructuring plans. Other areas of intervention are organisation and management as well as product design and marketing.

As far as the cost of labour is concerned, the most immediate and traditional measures are temporary wage cuts or freezes, suspensions of promotions and staff reductions, usually achieved without lay-offs but through early retirement schemes. Innovative solutions are two-tier pay systems, whereby new employees are hired at lower salaries than existing ones, and redistribution of free shares to employees as a compensation for the voluntary reduction in wages. The overall cost of labour depends not only on the wage levels but also on labour productivity, hence the considerable, and successful, effort undertaken by airlines in this area.

Restructuring programmes usually focus on fleets, aiming at modernisation and rationalisation. The number of aircraft may be reduced so that costly overcapacity is eliminated, old aircraft are replaced by new ones which are more cost-effective and

more suitable to the specific operating requirements of each airline. Eventually the reduction of the different types of aircraft making up a fleet is pursued, since this allows considerable savings in terms of maintenance costs and costs related to training of ground and cabin personnel. Further cost reduction is achieved through the disposal of assets, such as holdings in hotels, airports, other airlines, which yield no strategic advantage to the core activity while consuming resources.

Redesigning the overall business strategy is another major area for restructuring. The airline business is no longer a protected producer market but rather a very competitive industry, where the key success factor is the ability to meet the diversified demand of customers. This requires carriers to adopt an approach free from government interference and based on more advanced marketing techniques and enhancement of the service quality. In their restructuring efforts, airlines undertake to remodel the product planning. This is the combination of various product features such as route networks, frequencies, type of aircraft, type of service and fares.

### *Results*

The restructuring programmes have achieved their objectives to an extent which varies from one airline to another but, overall, can be regarded as successful, as shown by the most commonly used indicators in the industry (see annex 3 for details). Privatisation of these airlines, which was unthinkable before the public capital injections, is today a reasonable and feasible project, mainly dependent on the political will of the owners.

14. The Commission authorised state aid as a one-off measure to help airlines restructure during the transition of the industry from a heavily protected environment to a liberalised one. However, most airlines that required restructuring have now completed this process. The transition is now to be considered as being finished, and with it the need and justification for state aid measures: (see § 38 of the guidelines on the application of articles 87 and 88 of the EC Treaty and article 61 of the EEA agreement to state aid in the aviation sector)

### **Restructuring at industry level**

15. Further restructuring remains necessary in Europe because of the fragmented nature of the industry, but the focus is shifting from the company level to the industry as a whole. To ensure long term success in the increasingly globalised air transport market, European airlines need to develop into globally competitive entities. One response might be a process of simplification and consolidation, although alternative strategies such as concentrating on niche market are also available. Some signs that such a process has started are already visible: for instance the relationship between flag carriers and regional airlines is moving beyond the simple practice of commercial agreements towards more advanced forms of integration such as franchising or direct control through acquisition. Most large airlines are now engaged in a process of developing links essentially for the marketing of their products, in order to create revenue benefits through co-operation. This process should deepen eventually towards larger cost savings by means of fleet, network and staff integration.

### Global strategic alliances

Airlines have been making commercial agreements of limited scope and duration for a long time, but it is only in recent years that strategic alliances have become a feature of the industry. A global alliance can be seen as a family of networks usually made up of one or more of the main airlines from each of the North American, European and Asiatic regions. Currently the following four groups are emerging:

#### Star Alliance

United Airlines, Lufthansa, Air Canada, SAS, Thai Airways, Varig

#### Oneworld and associates

American Airlines, British Airways, Iberia, Canadian Airlines, Qantas, Aerolineas Argentinas, Cathay Pacific

#### Wings and associates

North West Airlines, KLM, Alitalia, Continental Airlines

#### Delta Swissair group

Delta Airlines, Swiss Air, Sabena, Austrian Airlines, TAP Portugal

Current alliances focus essentially on the marketing side. The various code-share arrangements are a way to develop networks without actually having to operate more flights. Alliance partners establish preferential arrangements to offer comprehensive frequent flier and corporate discount programmes. They streamline schedules so as to facilitate connections between the alliance partners and therefore shorten travel time.

### Competition law

16. Restructuring, which take the form either of a merger or an alliance, may raise problems of compatibility with the Community competition law, requiring strong enforcement of the rules. In the actual application of competition law to airline alliances the Commission has to bear in mind the need of the airlines to adapt to a new environment, but also the need to preserve effective competition on all the market concerned. It is also necessary that the passengers obtain a fair share of the resulting benefit of the alliances, particularly as far as fares and services are concerned. The Commission strictly applies the competition rules to the different areas of the air transport sector. So during July 1998 it made a draft proposal setting out the measures (mainly regarding the disposal of slots at major congested European airports) which needed to be taken in order to put an end to an

infringement of the competition rules in the BA/AA and Lufthansa/UA/SAS alliances<sup>5</sup>.

#### **Lack of an external dimension.**

17. Liberalisation has addressed so far only air service within the boundaries of the European Union<sup>6</sup>. On the contrary, there is not yet freedom to provide service between our Member States and countries outside Europe. Those routes are still regulated by the traditional system based on bilateral agreements. Under such a bilateral agreement, air service between the two signatory countries can be operated only by airlines that are majority owned and controlled by nationals of those countries. Because in this system traffic rights are linked to nationality, changes in ownership nationality result in loss of traffic rights and are therefore discouraged. Indeed, international equity investments between airlines have so far been generally quite symbolic, in the order of magnitude of a few percent of stock. As a consequence, the air transport industry, unlike other industries, cannot pursue integration and scale economies through the merger and take-over process. In this context alliances come up as a partial and provisional answer.

A particularly negative consequence of the bilateral system is that European airlines normally cannot fly to non member countries from any point in the EU but only from the territory of their home Member State. This creates an asymmetry that clearly disadvantages European airlines in comparison with their competitors. This is particularly striking in the case of the transatlantic market. American carriers can fly from whatever airport in the US to a wide range of airports in the EU. On the contrary European carriers can operate to the US from only one Member State. Actually European carriers are still operating in a way as if American Airlines (or any other American carrier) had traffic rights from Dallas but not from New York or Chicago. This situation is made even worse by the proliferation of so called "open skies" agreements between the US and some EU countries<sup>7</sup>. Consequently European

---

<sup>5</sup> Other areas where the Commission has applied competition law are airport charges and ground handling. In 1996 the Commission took a negative decision concerning discrimination on landing fees at Brussels airport in favour of Sabena. Negative decisions under Article 82 of the Treaty were adopted on a case regarding Frankfurt Airport (against a prohibition of self-handling) and on a case of discriminatory fees applied to the provision of ground handling services at Paris-Orly and Paris-CDG airports.

<sup>6</sup> A Commission's proposal to extend general Community competence was tabled in 1992 but has met with only partial success. A common Aviation Area has been created by extending the scope of the third package to Norway and Iceland. An agreement with Switzerland has been recently negotiated, and a similar one is being negotiated with 10 countries of East Europe. In 1996 the Commission received a partial mandate to negotiate with the US. This mandate did not (and does not) include market access issues.

<sup>7</sup> In the view of the Commission, "open skies" agreements constitute a major distortion of the internal market as created by the third package since they grant 5<sup>th</sup> freedom traffic rights within the Community to US airlines and discriminate between Community carriers on grounds of nationality, thereby preventing the exercise of freedom of establishment. Consequently the Commission started infringement procedures under Art. 226 of the Treaty against those Member States that have concluded "Open skies" or similar agreements with the US.



air carriers cannot effectively exploit their home EC market of some 360 million potential passengers as a base for their transatlantic operations.

Therefore it is important to complete the single aviation market with a genuine external dimension. Common agreements between the European Union as a whole and third countries have to be negotiated both at multilateral and bilateral level. The Commission will continue its efforts to achieve the creation of a Common Aviation Area with the US<sup>8</sup>. Furthermore consideration must be given to the position of air transport in the new round of negotiations under the General Agreements of Trade in Services (GATS) of the WTO, which will start in year 1999.

The solution to this regulatory obstacle lies in the completion of a single air transport market which is genuinely open to the outside. Only by concluding agreements between the European Community and third countries, especially the United States, can European companies compete on an equal footing with their main competitors.

---

<sup>8</sup> The Council has so far refused the Commission a full mandate to negotiate a CAA with the US.

### 3. TEN YEARS OF LIBERALISATION

18. In the last 10 years the European air transport industry has undergone a process in several stages of transition from tight regulation, based on bilateral agreements and duopoly with virtually no competition, towards a single market. This resulted in the reduction of the discretionary powers of national authorities and the extension of the possibilities for air carriers to decide, on the basis of economic and financial considerations, fares, new routes and capacities to be offered on the market. As a result air transport within the European Economic Area is now governed by common rules which provide for licensing, market access, pricing freedom and the application of the competition rules.

#### General experience up to date

19. The Commission assessed these developments in 1996<sup>9</sup>, noting that the liberalisation process has mutated the economic environment for air transport by making it an increasingly competitive market. The first 3 years of liberalisation resulted in gradually growing competition, in particular the number of carriers considerably increased. Liberalisation has brought clear benefits to consumers. However, some shortcomings might weaken the liberalisation process' ability to deliver to the consumer better services at lower cost. The report highlighted the problem of capacity restrictions and high costs for infrastructure as well as the contradictory and unsatisfactory trend concerning fares. While promotional fares have become more widespread, the prices of fully flexible fares have increased. There are still large differences in fares per KM across Europe. Recent developments after 1996 confirm the trend and are outlined in annex 1.

Whilst the increasingly competitive environment has brought benefits to consumers, some of the responses by the airlines to this environment could undermine these benefits. The proliferation of tariffs, over-booking, the availability of seats at the most publicised promotion fare, the growth in FFP's, code-sharing and airline alliances can all make it harder for consumers to compare competing offers. As competition increases, market transparency needs to be assured, if consumer confidence is to be maintained. A competitive and efficient air transport market depends as much on well-informed consumers, in a position to make rational choices, as efficient providers. The recent initiatives on denied boarding and computerised reservation systems have gone some way to address these issues. The Commission has also commissioned a study to examine the information passengers need to make rational choices.

20. In terms of the regulatory framework, the Commission has noticed that, despite the provisions laid down in the third package, there are areas where Member States still tend to have differentiated practices, which can impede the proper functioning of the single market.

---

<sup>9</sup> COM(96) 514 final of 22 October 1996, Impact of the Third Package of Air Transport Liberalisation Measures.

In the case of public service obligations, article 4 of Regulation 2408/92 provides that under particular circumstances the free access to traffic rights within the Community can be limited on the grounds of public interest. However, different ways of dealing with public service obligations in the Member States may lead to some domestic markets being less open and liberalised than others.

Leasing of aircraft registered outside the Community is another area of concern. Leases are regulated by article 8 of Regulation 2407/92 on licensing of air carriers, which requires that aircraft used by an air carrier must be registered within the Community. However, in order to meet temporary needs of the air carrier or otherwise in exceptional circumstances, a Member State may authorise short time leases of aircraft registered in non-EU countries. The Commission has noticed that Member States follow different practices for the implementation of this provision. Since non-EU countries usually adopt less stringent rules for the licensing of aircraft, different practices in this area result in very different liability, environmental and safety standards across the Community. In this light the Commission, in co-operation with the member States, contemplates for the preparation of guidelines to clarify its interpretation of the provision on short term leases of non-Eu aircraft.

21. As a follow-up to the 1996 Communication, the Commission is now investigating the regulatory and commercial barriers that restrain the complete development of competition in the aviation single market.

For this purpose it carried out a study on the impact of regulation and certain commercial practices on the development of competition in the air transport market. The study identifies and analyses factors inhibiting the growth of small and medium sized airlines following liberalisation with a view to developing policy options for removing or reducing barriers to competition. In this context a number of small and medium sized airlines have been interviewed and asked to assess the liberalisation process and its shortcomings. The study found that there is an overall consensus that the present regulatory regime is working well. However, the following matters emerged as areas of concern, in order of priority:

- Access to slots/airport capacity problems. This seems to be the single most important barrier, especially for airlines seeking to compete "head-to-head" with the flag carriers. Barriers arise from the functioning of the slot pool and the slot allocation mechanism. The pool, created by Community legislation<sup>10</sup>, is considered too small and cannot be expected to generate sufficient slots to enable a new entrant to compete against the established incumbents. Things are made even worse by incumbents' ability to indirectly control additional slots through franchisees or alliance partners. Moreover small and medium sized airlines feel that slot co-ordinators, who are frequently former employees of flag carriers, are biased in slot allocation.
- Loyalty schemes: they comprise both frequent flyer programmes (FFPs) and corporate discounts, but the majority of airlines' concerns relate to FFPs. The

---

<sup>10</sup> Regulation 95/93/EC

effectiveness of FFPs stems from the asymmetry between the interest of the corporate traveller, who enjoys the FFP benefits, and the employer, who pays for the ticket. The key barriers reside in the fact that FFPs favour airlines with large networks, which offer travellers greater chances to accumulate and use FFPs points. In contrast there is little scope for small and medium carriers to operate such schemes, because their networks are too small to make them attractive. For these types of airline the administrative costs and the costs in lost revenue of flying frequent flyers for free and therefore losing the potential revenue from their seats are high compared to the expected commercial advantage. As a consequence only larger airlines are able to exploit FFPs, by attracting more traffic and sustaining higher fares.

- Differences in regulatory environment: several of the interviewed airlines are concerned about the attitude of national authorities in some Member States towards emerging competition, in particular in the areas of slot allocation, negotiation of bilateral agreements covering access to non EU markets, award of Public Service Obligation (PSO) contracts and other special situations requiring ad hoc decisions.
- Ground handling charges and quality. Most of the airlines complain about the high cost and low quality of ground handling services. They fear that the ground handling liberalisation directive may not be sufficient to foster competition in the sector, since it includes too many safeguards, does not ensure enough competitors and does not apply to airports with less than two million passengers.

## **ANNEXES**

**Annex 1**    **Developments since full liberalisation**

**Annex 2**    **Social impact of current trends**

**Annex 3**    **Overview of Government-funded restructuring operations**

## ANNEX 1

### DEVELOPMENTS SINCE FULL LIBERALISATION

A initial view of the impact of liberalisation is given by the trend in the number of carriers within the European market. Indeed the number of scheduled carriers has grown steadily between 1992 and today (figure 1), showing that more carriers are now active, providing more services. Data on entry and exit of carriers in the market place (figure 2) pinpoints the dynamic and competitive nature of air transport.

Figure 1

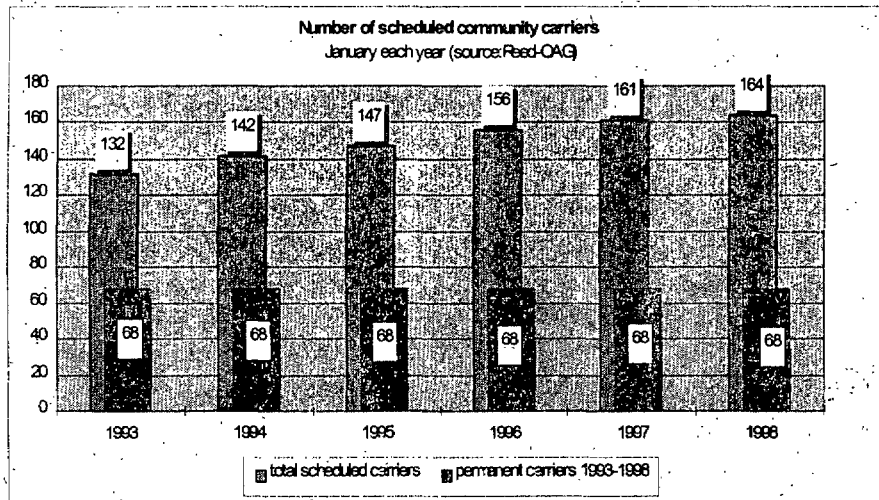
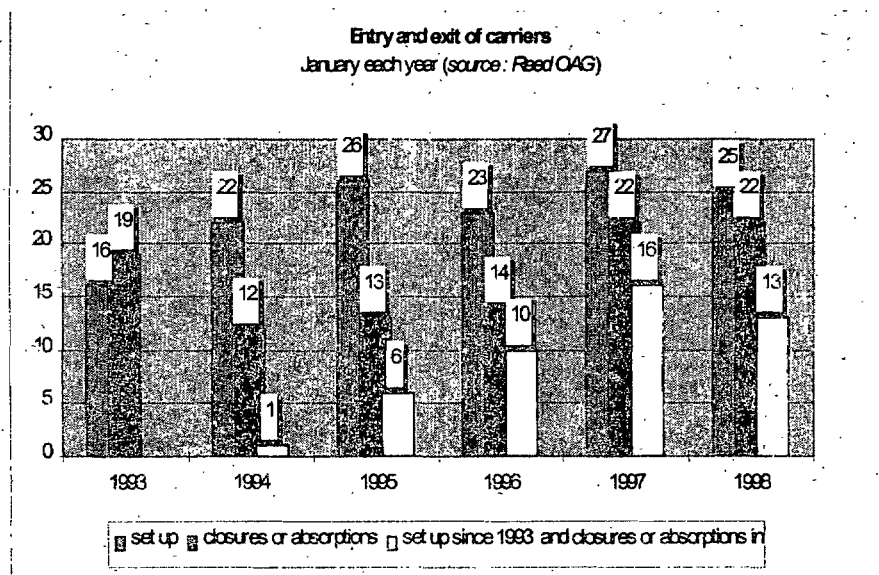


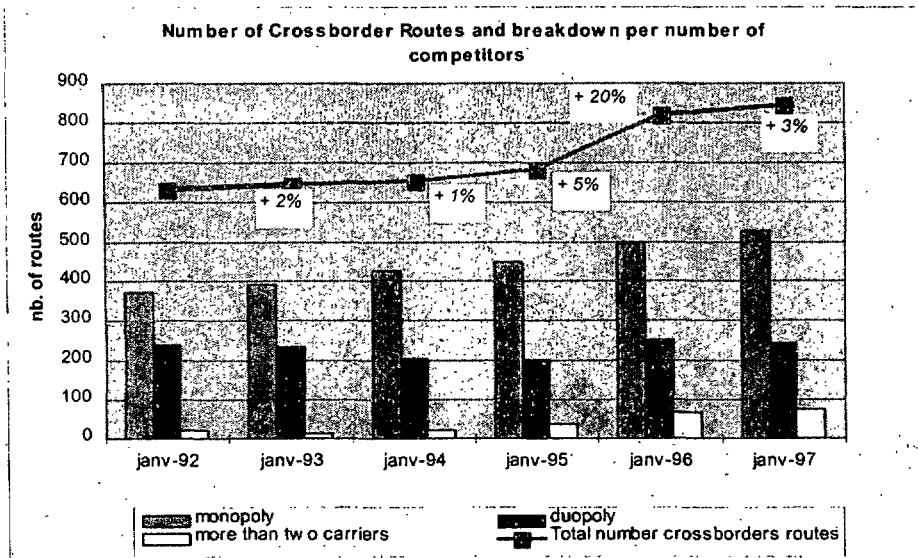
Figure 2



## The development of competition at route level

The impact of liberalisation can also be seen in the evolution in the number of routes between Member States within the Union since 1992 (crossborder, or intra-EU, routes, figure 3)

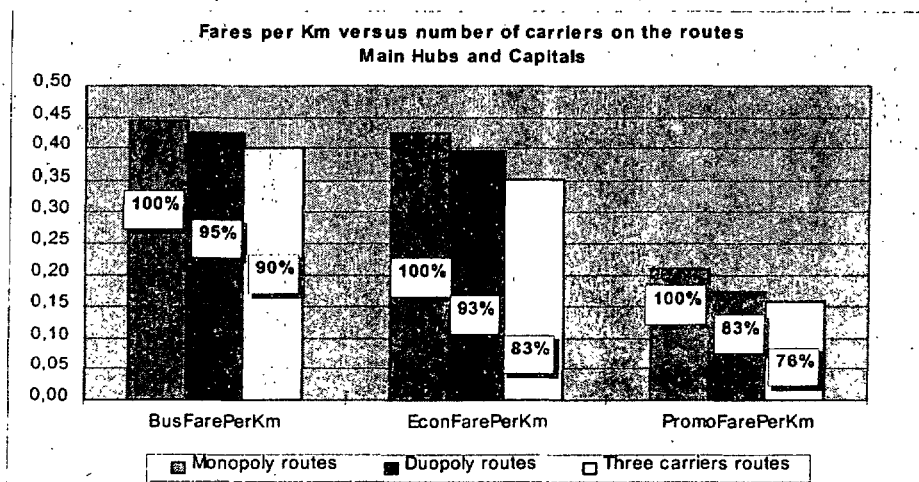
Figure 3



## Evolution of airfares

The Commission Report of 1996 pointed out that, even though an increasingly large number of promotional fares became available, which increased the range of attractive airfares available to users, flexible fares kept on increasing. It clearly appears that these fares are narrowly correlated to distance but also to the degree of competition by single route, as the following tables show.

Figure 4

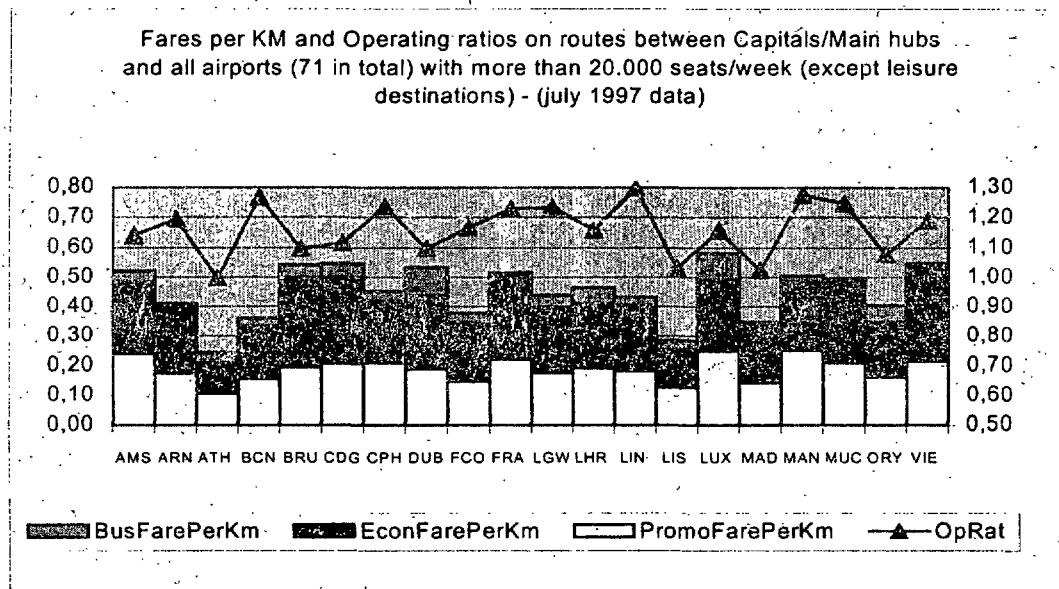


This first table (average of the fares on all Community routes, values expressed in EURO on January 1997) shows that competition has a real impact on the price travellers pay for air transport. In particular:

- the level of fares decreases when the market structure passes from monopoly<sup>11</sup> towards duopoly or routes with more than two carriers. Consumers enjoy fare reductions in a range of 10% to 24%, depending on the type of fare;
- fully flexible business and economy fares are in the same order of magnitude, while promotional fares are half as high.

Figures 5 and 6 compare fares on some major routes, namely average fares from 20 capitals and main hubs. It is clear from figure 6 that fares per Km depend on the distance flown. However, even taking into consideration distance, there are large differences across the European Union. In particular fares are higher from airports such as Vienna, Frankfurt, Paris CDG, Brussels, Copenhagen and Stockholm. There may be several factors explaining this situation, such as local cost levels, the degree of competition, congestion and local market conditions. Where appropriate the Commission will examine these factors in more detail.

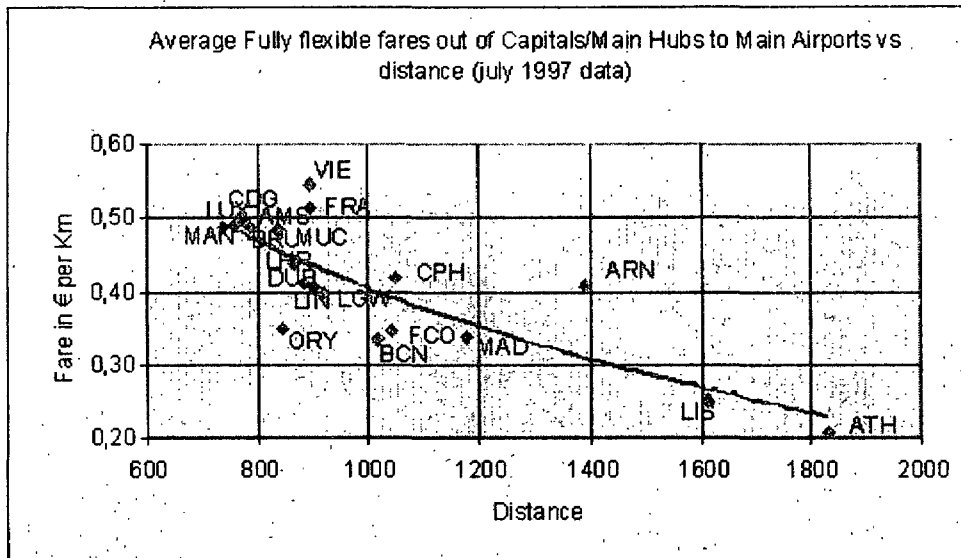
Figure 5



<sup>11</sup> Monopoly at route level should not necessarily be interpreted as a failure of liberalisation. It may well be that on some newly operated routes the volume of traffic is too thin to support more than one carrier. Still liberalisation is successful, in that it allows airlines to create new markets for air transport.



Figure 6



## ANNEX 2

### SOCIAL IMPACT OF CURRENT TRENDS

- **Development of employment**

Following the restructuring measures adopted by airlines, between 1988-1996 the overall number of employees in civil aviation increased from 435,400 to 489,700 and the outlook for employment in this sector remains positive.

Air traffic (AEA statistics) and total number of jobs in the civil aviation sector grew at a different pace over three distinct subperiods. They both increased considerably before liberalisation and the world economic recession of the early 1990s. Then, when most airlines undertook in-depth restructuring, traffic growth slowed down while employment decreased. Eventually, when restructuring started working, growth resumed.

	1988-90	1990-94	1994-96
<b>Traffic growth</b>	8%	5.9%	7.9%
<b>Employment growth</b>	6.1%	-1.9%	1.8%

The following table shows in more detail the evolution of employment.

Employment ('000)	1988	1989	1990	1991	1992	1993	1994	1995	1996
Airlines	324.9	351.4	365.9	357.1	351.1	342.0	338.2	345.2	350.5
Airports	79.1	83.4	88.5	89.0	89.5	88.3	88.0	88.2	89.2
Ground handling	7.3	7.8	8.5	8.8	9.3	9.7	10.2	11.7	13.0
Catering	24.1	25.5	28.4	30.0	32.3	32.0	34.0	36.3	37.0
<b>Total</b>	<b>435.4</b>	<b>468.1</b>	<b>491.3</b>	<b>484.9</b>	<b>482.2</b>	<b>472.0</b>	<b>470.4</b>	<b>481.4</b>	<b>489.7</b>

The overall trend in employment has not been reflected consistently across EU member states.

1988-1990	1990-1994	1994-1996
All countries but one (Greece, with -0.7%) experienced annual growth in employment ranging from +3.5% (Spain) and +3.8% (Italy) to +9.0% (Germany)	More positive and negative trends were evident. Only Germany, Austria (+3.6%), and Luxembourg (+1.4%) experienced annual growth, while employment decreased in all other countries, down by -3.1% in Belgium and -4.2% in Italy	The annual growth was once again evident in countries from France (+1.0%) to Finland (+6.7%), apart from Italy (-1.3%), Portugal (-4.7%) and Greece (-11.5%).

In 1996, more than half of the total jobs in the civil aviation sector (55%) were concentrated in three countries, i.e. the United Kingdom (19.8%), Germany (19.5%) and France (15.7%).

In 1996, airlines represented the major component of the sector's employment (72%), followed by airports (18%), airline caterers (7%) and ground handlers (3%). The rate of growth in employment has stagnated from 1988 to 1996 for flag carriers (+0.04%) while it increased for other airlines (+4.6%). Major airlines generally decided to focus on core business since 1990, creating subsidiaries or subcontracting parts of their activity to smaller airlines and also to ground handling and catering companies. In addition, several new niche carriers emerged and, like the smaller airlines, these have enjoyed growth in their own networks.

#### Overall annual rate of growth of employment (1988-1996)

Flag carriers	Other airlines	Airports	Ground handling	Catering
+0.04%	+4.6%	+1.5%	+7.4%	+5.5%

Employment is expected to grow slightly for airlines in the UK, Austria and Finland but remain stable for airlines in the other EU member states.

- **Social effects**

One of the main features of the period under review is the spreading of new forms of employment aimed at increasing flexibility. This applied particularly to state-owned airlines which accounted for 67% of all airline employment in 1988 (apart from British Airways, which was already privatised). Conditions of employment have been modified, particularly for newly hired employees. Many of them are now granted fixed term contracts and, in many cases, a two-tier pay system is applied. Performance related pay schemes tend to replace seniority pay schemes for some categories of employees.

It must be stressed that this trend is not specific to the air transport industry and can be observed in other sectors of activity where a liberalisation process has been initiated or where competition is having a significant impact. However for longer service employees job security remains relatively good at flag carriers. Furthermore, the level of wages is still higher (from 15% to 25% in most cases) there than at smaller airlines for similar jobs.

The most notable change observed in ground handling and catering is the emergence of the practice of subcontracting the main base activities by major airlines as well as its extensive use by smaller airlines, especially new entrant low-cost airlines. Although some attempts have been made by European airlines to outsource activities to low-cost economies in Asia, this practice remains limited.

## ANNEX 3

### OVERVIEW OF GOVERNMENT-FUNDED RESTRUCTURING OPERATIONS

#### **The Commission's approach to public financing of airlines**

The European approach to air transport liberalisation acknowledges that interests, in addition to those of air carriers, are at stake and need to be accommodated: air transport users, employees (in safeguarding and creating jobs and working conditions), national authorities (in the role of air carriers as public service providers) as well as environmental and safety issues. In order to balance these interests, liberalisation was phased in gradually, along with safeguards. This acknowledges that the market alone may not always be able to serve all policy objectives (public service, environment). Controlling state aid for restructuring the European air transport industry fits into this framework. The Commission's policy in this area aimed at striking a balance between the need to protect the single market from the distortive effect of subsidies on the one hand, with the useful role aid can play in restructuring the industry, if granted under strict and clear conditions, on the other hand. The Commission aimed at creating a level playing field for competition, while accepting that some airlines carrying the financial burden of the past must have the chance for a fresh start within the framework of a reorganisation programme, provided that this does not adversely affect the situation of competitors.

#### **The guidelines and the market economy investor principle**

In 1994 the Commission set out principles and criteria for the assessment of state aid to airlines in the guidelines on the application of articles 87 and 88 of the EC Treaty (Ex articles 92 and 93 of the Treaty) and article 61 of the EEA agreement to state aid in the aviation sector.

The guidelines require first of all a preliminary assessment as to whether the provision of capital, loans or guarantee by public institutions to an airline is to be considered aid or a normal commercial transaction. The basis for this assessment is the so-called market economy investor principle (MEIP): under the MEIP a capital transaction may be regarded as state aid if an investor, operating under normal market economy conditions, would not be prepared to make an equivalent investment in the airline.

#### **The Market Economy Investor Principle**

There are two stages in the Commission's assessment of a State aid case. First it has to determine whether aid is involved, by evaluating the circumstances of the financial transaction: the MEIP is the tool for assessing whether the measure is a normal commercial transaction or aid. In a second stage, if the Commission considers the transaction to have aid elements, it determines whether the aid is compatible with the common market. According to the guidelines a market economy investor would normally provide equity finance if the expectations of the present value of future cash flows (discounted at the company's marginal cost of capital) accruing via dividend payments and/or capital gains, and adjusted for risk, exceed

the new outlay. The application of the MEIP test requires the Commission, assisted by its financial advisers, to estimate parameters such as the expected growth rate of future cash flow, the marginal cost of capital for the airline, the "hurdle" rate of return, below which the private sector would not be willing to invest in the project. These estimates rely on the forecasts of the business plan, whose robustness and credibility are assessed on the basis of the airline's financial performance, the economic and technical efficiency and the commercial strategy.

If the assessment under the MEIP leads to the conclusion that aid is involved, then the Commission assesses whether the aid may be considered as compatible with the common market. According to Article 87(1) of the Treaty, State aid which distorts competition and affects trade between member States is incompatible with the common market. However exemptions are possible; in particular under art 87(3)(c) aid may be considered compatible with the common market if it facilitates the development of certain economic activities without adversely affecting trading conditions to an extent contrary to the common interest. This provision enables the Commission to approve restructuring aid; but also requires it to set out appropriate conditions the recipient and the donor have to meet so that the possible adverse effect of aid on competition is limited or prevented.

The guidelines set out the following conditions:

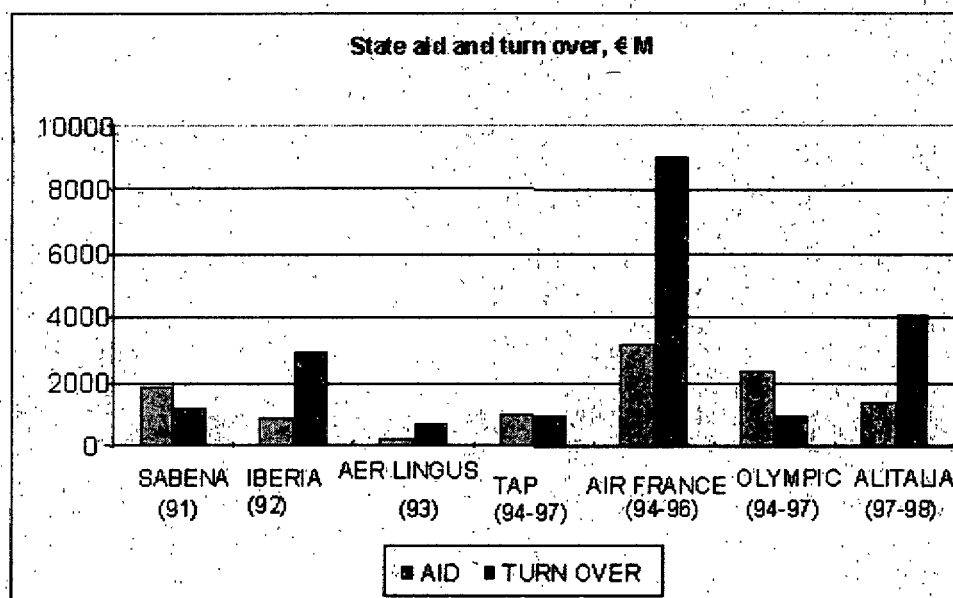
- aid must form part of a comprehensive restructuring programme and be of limited duration. It must be approved by the Commission and aims at restoring the airline's health, so that it can, within a reasonable period, be expected to operate without further aid;
- the programme must be self-contained, meaning that no further aid is necessary for the duration of the programme or is envisaged in the future. Aid should be granted only once;
- capacity reductions must be included in the programme, if restoration to financial and commercial viability so requires;
- the programme must not be expansive, in the sense that it must not lead to an increase in the number of aircraft and offered seats. This condition is of the utmost importance to make sure that the difficulties of the airline receiving the aid are not transferred to its competitors;
- the Government must not interfere in the management of the company, which must be run according to commercial principles.

The Commission usually seeks the advice of independent experts for the assessment of the plan. The findings of this assessment eventually lead the Commission to decide under what conditions the MS is authorised to grant the aid to the airline, if at all. However the decision does not mark the end of the procedure, since the implementation of the restructuring plan must be carefully monitored. Indeed the Commission has to check that the commitments and conditions set out in the decision are fulfilled. For this purpose progress reports are to be submitted for evaluation and approval of the Commission: if aid is paid in instalments, payment of

the next instalment is conditional on approval of the progress report. Even for the assessment of the progress reports the Commission may, and usually does, use the assistance of external consultants.

Of course each case has its own facts, however, when analysing the situation of the crisis and its causes as well as the restructuring plans and the effects of the aid, it is possible to identify some basic elements common to all the reforming airlines. The consideration of aid in comparison with turnover allows a first, rough appreciation of the order of magnitude of the aid measures. Figure 7<sup>12</sup> shows for each airline the year when the aid was granted and authorised by the Commission, the amount of the aid and the turn over the year before. Aid is in a range of 30% to 35% of the turnover as regards Iberia, Aer Lingus, Air France and Alitalia, while it is far bigger for Tap (slightly higher than the turnover) Sabena (50% higher than the turnover) and Olympic Airways (more than double the turnover).

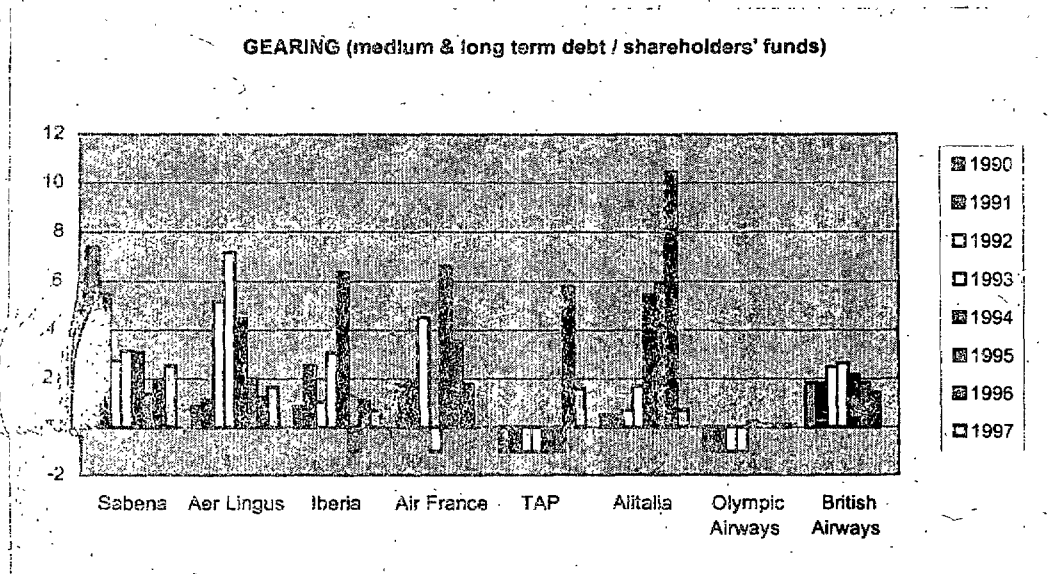
Figure 7



<sup>12</sup> The Commission assessed the performance of the seven airlines that received State aid on the basis of a number of financial, productivity and operating indicators. All figures are Commission's elaboration on data provided in the airlines' official annual reports.

The scale of the crisis experienced by these airlines before receiving restructuring aid is evident when considering their economic performances, which are characterised by a marked and prolonged lack of profitability coupled with high levels of debt. Operating results are negative, as suggested by the values of the operating ratios (see below figure 9), while net results are even worse since they reflect the huge interest costs generated by debt. Debt in turn usually records a sharp increase in the few years preceding the recapitalisation: it is common opinion that in the air transport industry a normal, healthy value for the gearing ratio (long term debt/equity) is around 1.5 to 2, the assisted airlines reach levels in a range of 6 to 17 while there are some cases of negative owners' equity. ( figure 8).

Figure 8 \*



\* In case of negative equity value the ratio is meaningless and is conventionally assumed to be -1. As one would expect, the ratios sharply improve in the years after the recapitalisation.

This commercial and financial weakness has its origin in the high cost and low productivity structure combined with the decreasing load factors and yields which affected the industry in the difficult early 1990s. In this situation the revenue generated by the operation of aircraft was not sufficient to cover the operating costs, leading therefore to negative operating results. The operating results were then worsened by the interest expenses brought by the growing debt. Debt was determined by the cumulation of losses in several years in a row and by the financial burden generated by the large purchase of new aircraft which occurred at the end of the 1980s.

Several factors may explain this high cost - low productivity. Indeed the recipient airlines have been characterised by an excessive number of employees compared to capacity, resulting in very low productivity, measured in terms of output per employee (ATK/employee indicator). This circumstance, coupled with the high level in labour costs, is the main explanation for the operating costs being far in excess of the level attained by healthy and profitable airlines. A factor frequently



recurring is the inefficient fleet mix. The presence of many different types of aircraft involves higher costs for maintenance and repair, and staff training and skill requirement: this also results in higher operating costs. Further problems were the presence of loss-making non core activities, poor product planning which resulted in too widespread networks including not profitable routes and corporate culture being scarcely open to flexibility and innovation.

## Results

The restructuring programmes have achieved their objectives to an extent which varies from an airline to another but that on average can be regarded as satisfactory. This is brought out by the financial and commercial performances assessed on the basis of a number of financial, productivity, and operating ratios: in 1995 and 1996 the airlines which received aid were able to achieve satisfactory and encouraging levels of viability. A glance at some basic indicators can highlight this positive evolution. One of the most used indicators in the industry is the operating ratio, that is the ratio between revenue and costs related to the principal activities, regardless of financial and exceptional elements.

Figure 9

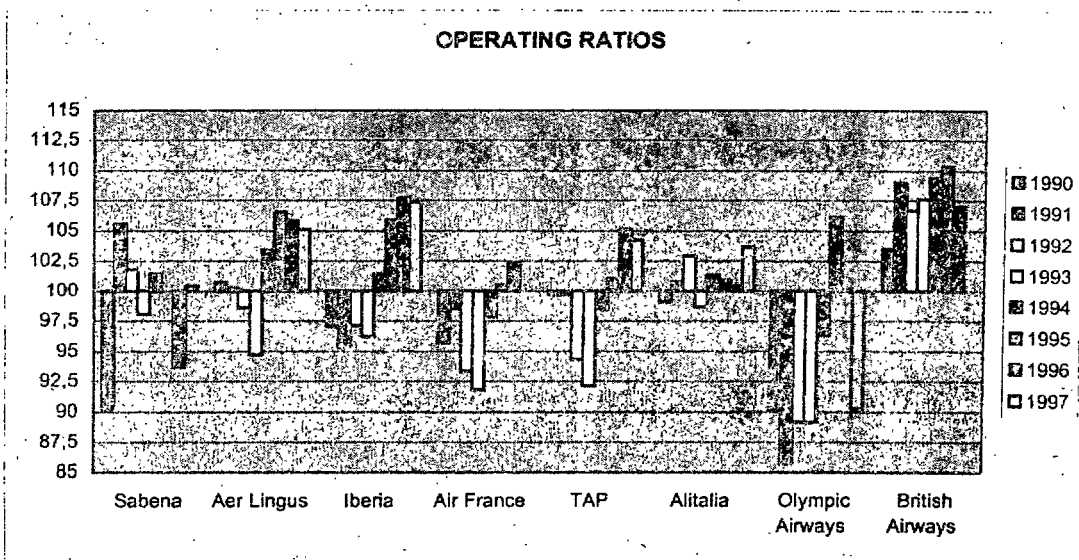
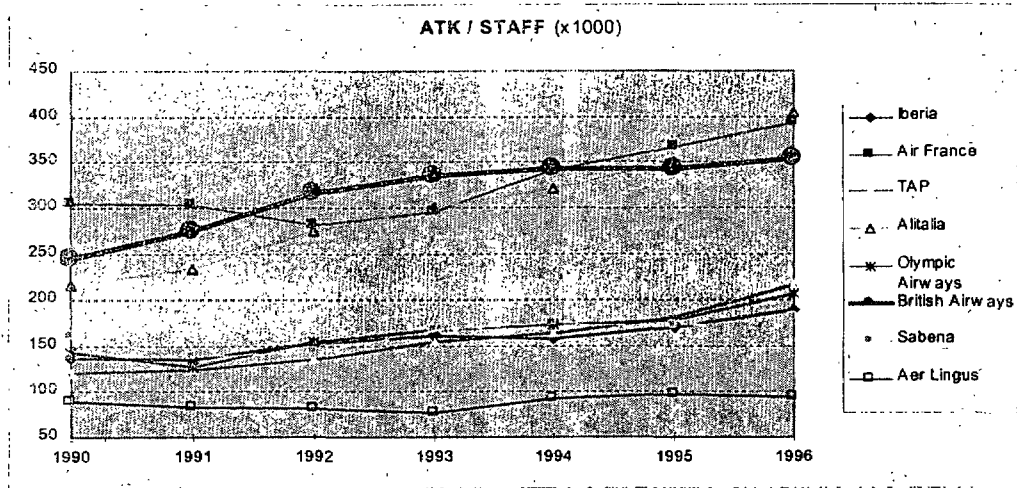


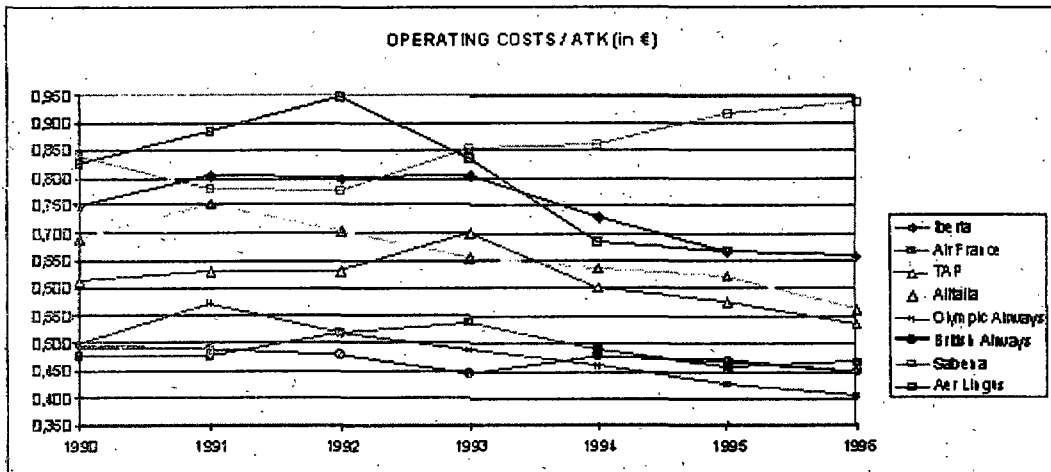
Figure 9 shows that there is a positive evolution in the operating ratios for all the state aid recipients, with the exception of Olympic Airways, although the trend needs to be consolidated and strengthened when compared to British Airways, here taken as a benchmark. Important improvements were also achieved in terms of productivity. Figures 10 and 11 show the evolution of two classical productivity indicators. The first, ATK/Staff, is the ratio between the capacity, or potential output, expressed as available tonne kilometres, and the number of employees. One can observe two groups of airlines with different level of productivity, but all the companies succeed in increasing the output per employee.

Figure 10



The evolution of the operating costs per unit of output, depicted in figure 11, is to be interpreted with some caution, because of the influence of stage length. Since the average cost per kilometre for short flights is higher than for long haul and airlines have networks of different average length, the comparison is not fully homogeneous. However even this indicator shows a general trend towards increased productivity.

Figure 11



ISSN 0254-1475

COM(1999) 182 final

# DOCUMENTS

EN

07 10 15 16

---

Catalogue number : CB-CO-99-179-EN-C

---

Office for Official Publications of the European Communities

L-2985 Luxembourg