

Intelligence Reporter February 2008

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The Environment is getting even murkier

Just when you might have thought that clarity and harmony was arriving, the situation for aviation environmental regulation gets more complex. In the great tradition of air transport, it might be a case of hurry up and wait.

In the last month there have been a number of interesting developments. First, in Europe, the Commission (meaning DG Environment) announced a broad, Europe wide array of environment measures, including full auctioning of emission certificates for industries such as power and chemicals. Whilst it did not specifically target aviation, it did throw into contrast the current progress in getting air transport included in the emission trading regime. At the very least, it moved the goal posts.

And the goal posts are now a long way further away. If industries such as power generation must have 100% auctioning of emission certificates, suddenly aviation arguing over zero (the airline position) or maybe up to 20% (DG Environment's position) looks somewhat out-dated. At the moment, airlines would be ill-advised to expect anything under 100% auctioning by 2020, at the very latest. As the Rapporteur on the Committee for EU ETS for aviation of the Parliament said in late February, the new main directive 'changes everything'. You have been warned.

The one thing that might be working in the airlines' favour is that the date for any commencement of the Emission Trading Scheme (ETS) for airlines keeps slipping. Of course, each country, on assuming the presidency of the EU, makes it clear that finalising this dossier is one of their key priorities. The Slovenians followed in this long and glorious line. The French, next in line, are also saying the same thing.

Best guess then is that there will be an attempt, brokered by Slovenia, to reach a common position in the Council by May, followed by negotiations with the European Parliament starting in September, brokered by France, culminating in a common text, adopted under the co-decision procedure in December.

But there is a least one joker in the pack. There is a strong sense abroad in Brussels that a new US administration (whatever its political hue) will change the overall balance and thus give strength to those arguing that the easy thing to do would be to include aviation in the main ETS Directive from the start. The main ETS Directive, as announced this month, will be fully overhauled and revamped in 2009. That may see aviation's contribution delayed, but included in the main ETS Directive. A delay, to be sure, but one that is likely to result in a more stringent outcome.

It is clear that things are on the move in the USA. A coalition of "green" groups this month petitioned the US Environment Protection Agency to introduce ETS style measures. The petition quotes the European system as a good starting point. At the same time, nevertheless, the US continues to threaten legal action under the Chicago Convention against the EU's unilateral action to introduce ETS and to make it apply to all international flights. We understand that other States are looking at their options pursuant to the Kyoto Protocol. Perhaps we are looking at a lawyer-led recovery from the current economic downturn as a result of the inevitable litigation.

To their enormous credit, the Commission is able to filter out this noise and push on. The consultants designing the reporting scheme for the aviation ETS have put forward their first version: fuel viscosity will be one of the factors taken into account, so airlines would be well advised to install viscosity-meters in their fuel tanks. There is no escaping the conclusion that the proposals seem to favour local (European short haul) carriers, rather than long haul inter-continental ones.

In the meantime, the Commission has also commissioned CE Delft (a Dutch consultancy) to conduct a consultation on NOx emission reduction. NOx has been somewhat overlooked to date in the environment debate, being overshadowed as it has by carbon gas emission issues. But that it has been overlooked is no reason to continue to do so. Particularly as the Commission appears to be considering applying a multiplier on emissions (to acknowledge the impact NOx gases have).

That puts the airline industry into a very difficult lobbying position. It is very hard to see how they can mount a determined joint defence to these developments. IATA is conflicted out (representing both European and non-European airlines); the AEA is clear in what it needs to protect; the ELFAA (the European LCC industry group) thinks this is better than any alternative because it is suited to their operating model. Every airline for itself might be the order of the day.

IATA seems to have abandoned the fight in Europe. This week, in Asia, IATA's DG advised Asia's carriers to not do what 'we' had done in Europe. Rather, he suggested, with what can only be described as a wistful look at the open barn door, that getting ahead of the communication issues was important, and whenever possible: blame the air traffic controllers. I paraphrase, but only just.

State Aid to Europe's Airports

There was a rush of state aid decisions at the end of last year. Now we see why. With the passing of last year's omnibus legislation (see our Intelligence Reporter: http://www.aviationadvocacy.aero/pdf/January_08.pdf), the boom has come down. First to feel the new regime appears likely to be Alghero Airport in Sardinia. The Commission has invited comments on payments made by the regional authorities to the airport worth more than €8million between 2002 and 2006. Interestingly, the invitation for comments claims that these payments are in connection with the commercial agreements the airport has with Ryanair. In addition, there is a question over a €4million injection for capital works.

There is then also an allegation that the commercial arrangements between Ryanair and the airport, including unfair and/or discriminatory ground handling charges and a marketing arrangement, may also infringe the state aid prohibition. Interestingly, the Commission goes on to note that ground handling contracts also entered into with various other European airlines (including Air Post, Air Dolomiti and Alpi Eagles) were also discriminatory. One can only assume that the Ryanair arrangements were somehow even more discriminatory than the others.

Under Articles 86 and 87 of the EC Treaty, such grants from a government entity are not compatible with the European Common Market unless it is clearly necessary start up aid, digressive in nature, and structured to provide an incentive effect. The Commission feels that the 10 year arrangement with Ryanair, (which also includes an optional 10 year renewal) is unlikely to be digressive. If anything, it includes an incentive. 'The aid does not follow a downward trend' the Commission notes.

Secondly, in the Commission's view, the negative impact of the aid, discriminating against other competing airlines *and competing airports*, outweighs the positive effects.

Two important things come out of this notice: first, there is an aside that sets out what the Commission might consider to be a reasonable period for start up aid:

The Commission considers that a start-up aid with a duration of ten years is not necessary, as the information which has been collected on the airline sector for the preparation of the 2005 guidelines suggests that a maximum period of three years should be sufficient for an airline to find out whether a particular destination is economically viable or not.

Second, and perhaps more ground breaking, is that the Commission now appears to acknowledge that airports compete with one another. The contestability of airports is a new science (or perhaps branch of witchcraft), but it is one that is now starting to become important in regulatory circles.

There is a certain irony here, of course. Airports (and regional tourism authorities and regional governments – very often, as in this case, the owners of the airports) have become increasingly frustrated by Alitalia's slow and painful demise. Alitalia has been ignoring these regions, and turning away from these airports, for years. The Alitalia demise has been made longer and more painful by healthy injections of state aid over a long period of time. From the perspective of the airports, the steps they are now getting in trouble for is not state aid, it is self help.

The second irony is that apparently when an airport does enter into commercial arrangements with its customers, including negotiating differing ground handling rates, they risk being accused of state aid. The Commission, having made the point that airports compete, must now also accept that to do that there are a number of commercial arrangements that are par for the course: volume incentives, service based pricing and so forth.

This would not be an issue if the airport was not owned by government entities (in this case the regional government). If this was a privately held airport, none of these issues would apply. Consequently, the easy way for an airport to avoid the Commission looking at its commercial arrangements would be for it to be privatised.

State aid to Olympic Airlines is also illegal

There is a short novel, or perhaps a tragedy, in the saga of Olympic Airways/Airlines that has been running now for 15 years. In the role of the Chorus the European Court of

Justice this month moved to centre stage to denounce various moves by the Greek government to funnel aid into Olympic. The most Herculean effort was the splitting off of Olympic Airlines, that was given all routes and assets (at very fully stated values) leaving Olympic Airways with the debt. Olympic Airways was then sent to Hades. But as befits all actions by the hero in a tragedy, it was to no avail.

The Commission, in the role of the Gods, had ruled that this wondrous something-out-of-nothing manoeuvre was actually the provision of state aid, albeit very creative, but as the Chorus noted at the end of Act 1, points are not awarded for novelty in this competition. The ECJ ruled that the Greek government, in not acting on the Commission's findings, was in contravention of the EC Treaty and the Common Market. The Greek government had not acted on it because Olympic (and the Greek government) had appealed the decision on the basis that it was vague, imprecise and otherwise illegal. None of those arguments were accepted either.

So the state aid issues come into focus: there are still a large number of publicly owned entities in European aviation, and the Commission, emboldened by the support of the ECJ, can be expected to flex their muscles.

The BAA inquiry goes on

Privatised airports, too, can be subject to long and difficult inquiries of course. Just ask BAA. The inquiry into what to do about BAA continues to draw crowds to the Competition Commission in the UK. The Competition Commission is looking into the BAA position in relation to London's airports after the Office of Fair Trading referred the matter to it last year. The UK seems determined to undermine that age old joke about countries having only one competition authority by having two. It is not yet clear that this second review is going to be better.

In the meantime, the UK CAA has started gently looking at contestability, holding workshops of experts to discuss the issue, and the Competition Commission inquiry continues. The big issue, on which there does not currently appear to be a clear way forward, is on how to ensure contestability. If the push for deregulation is to continue, prices should be deregulated.

How does one engineer free and unregulated competition when there is clearly a capacity shortage? The currently most mooted proposal, to force the break-up of BAA by requiring the sale of one of either Heathrow or Gatwick, does not really address this point. We have seen airlines being prepared to pay £30million for a pair of slots at Heathrow. The airlines do not see these as substitutable product offerings at all. And neither does BAA. It has airport-by-airport pricing, but group financing.

Another alternative might be to break up the ownership of terminals at each airport; but then the benefit of scale and scope are completely lost. BAA argues, too, that it is about to invest in the Heathrow East Terminal (HET) to replace terminals 1 and 2. That would not happen if this level of competition was imposed on them. Destroying Terminal 1 should be a national imperative for the UK, if only on aesthetic grounds. BAA likes to

point out that by 2012 (and the London Olympics) there will be in essence a new airport where Heathrow used to be.

Security: My screening is tougher than your screening

As predicted last month, there is already movement on the security front. In a lengthy and impassioned presentation, the Commission unveiled a new, high-tech, unified border-control package. In doing so, it made very clear that it was disappointed with the way in which the United States has gone about security issues of late. Whilst one might have thought that the Commission might have had to impersonate a passenger at Heathrow and stand in a very long queue to make that complaint, it is not so. There is a 'fast track' facility, in the form of an EU-US summit on security matters scheduled for 13 March.

The ultimate vision of the high-tech system includes:

- A completely integrated intra-European system for internal visa-free travel amongst the members of the Schengen Agreement
- The use of biometric measures to identify arrivals at the Schengen border, including retina scans and fingerprints, using new technologies well above those in use now
- A 'fast-track' airport arrival line for registered third-country nationals, willing to pre-register, and supply certain information, including biometric retina scans and fingerprints
- The tracking of exits as well as entry, on grounds that an unknown number – anywhere from 20 million to several hundred million—overstay visas regularly in the EU

As befits all good Commission initiatives, these measures are contained in a new anagram: the European Border Security Surveillance System – EUROSUR.

At same time, Jonathan Faull, the Director General of DG JLS (Justice Law and Security) threw out several challenges to the US government and the Department of Homeland Security, in particular. In his view, the US was lagging behind on its obligation to extend visa-free access to all EU countries, although no visa is required reciprocally for Americans by European Union countries. He cited the Czech Republic in particular. He was also particularly irritated that the US seemed to be backtracking on some PNR commitments, and worst of all, was trying to do bilateral arrangements with some EU countries. Divide and conquer may be a time honoured strategy, but it was "disrespectful," he said, for US to try to bypass the Commission.

That, at least, should make the EU-US Summit next month very interesting.