

Intelligence Report Dec 2007/Jan 2008

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Perhaps as befits the season of good cheer, Christmas came early for European aviation regulatory watchers, with an outbreak of goodwill. In early December, a press conference to laud what the Commission itself, with a rare outbreak of humour, dared to call the new 'omnibus aviation' legislative package – looking at all sorts of things like commission rates and price transparency – was held, with smiles all round the order of the day. The only thing missing was the big man in the sleigh. (Held up by air traffic control perhaps?)

But, then again, perhaps also in keeping with the spirit of Christmas, the wrapping was barely on the floor and the crackers pulled when normal services were resumed. It almost feels better to be back with the airports and airlines at loggerheads, whilst the Commission continues to announce new communications and new areas of review with an urgency that makes you wonder if they have a plane to catch.

The environment debate has not gone away, but is now being taken into a wider, higher level debate about Europe's emission trading scheme generally. Given the lack of consensus at the December Council meeting to review and if possible find common ground on the draft Directive, this seems like the only way to proceed. For non-European airlines, the situation looks to be getting a little clearer. The scheme will apply from flight 731 onwards. (Please see our Heads Up of December for more details).

In the meantime, slots continue to dominate thinking on both sides of the Atlantic. In the US the DoT has announced that it will introduce congestion pricing for slots at a number of New York airports. The economic arguments for slot regulation versus slot trading could fill an aircraft, a very large aircraft at that, but this is the first real life experiment that has been conducted. IATA and the airlines were adamantly opposed to the plan. The EC, on the other side of the Atlantic continues to hold closed meetings about transparency in slot trading, in the hope that the Parliament does not get its hands on the issue.

They perhaps fear that the Parliament will intervene; creating inappropriate and artificial solutions for the issue of dealing with what is a scarce resource. Rather like the current suggestions regarding aviation spectrum. In that debate, the UK first, but now coming to a European Member State near you, telecommunications regulators are proposing allocating a price (calculated by some sort of reference to other markets for spectrum, like for example that of the demand for mobile telephone spectrum) to the spectrum used for aviation: radars, beacons and so forth. This labours under the uninspiring name of Administrative Incentive Pricing (AIP).

The nightmare scenario perhaps is that some economist somewhere is given the task of finding an AIP for slots...

At the same time, the Commission has released a communication regarding business and light aircraft aviation. CRS rules were also reviewed. So was aviation security. At the base of many of these things is a debate about where the line is between the work of the Commission and the regulators in the Member States.

That is a fundamental debate broader than the aviation issues alone. Is Europe actually Federal, or about to become so, is an issue everywhere. What is clear is that as far as

the Member States are concerned, their electorates are keen to ensure that Europe does not garner too much authority. Very noble and no doubt what the polls are telling them. Perhaps those fans of an ever closer Union should do their polling at an airport amongst passengers suffering air traffic delays. For aviation, and for the future of air traffic control reform, this current swing back to States' rights (at the expense of Brussels) could not come at a worse time. The Commission has been left with few options apart from a determination to be seen to be at least doing something.

Harmony about harmonised services in Europe

The EC and the European Parliament continue to delve into all aspects of air transport, working together, diligently, on even the remotest corners of the industry – from fares available on the internet to what constitutes a 'commission' on a fare. A major step forward was achieved at the start of December, with the approval by the European Council of an omnibus piece of legislation proposed by the Parliament (after it was drafted by the Commission under the co-decision procedure) that codified and reviewed a range of issues, including price transparency and safety regulation.

No-one questions that growth in air transport in Europe has exploded in the last decade, with new airlines, flying to new airports, introducing levels of competition never seen before. Whether that is because of the regulatory environment or despite it will never be known of course. But it is true that success has many fathers, so it is not surprising that the logical flaw in claiming victory whilst introducing new legislation to correct the current system was never likely to be pointed out by Vice President Barrot when he announced that the Council had agreed a final version of the new legislation. It will now be forwarded to the European Parliament for a second reading and adoption.

The legislation will include a requirement that from now on the price published will have to include all the taxes, fees, surcharges and other fees. Moreover, any price discrimination between passengers solely on the basis of their place of residence within the European Union or their nationality will be prohibited. An interesting aspect of this decision is that it will end the long running dispute, at least for the future, between airlines and agents (particularly in the cargo area) about commissions not being paid on fuel surcharges. The rate or fare will now be the rate or fare. If it includes a fuel surcharge, then the commission must be calculable on the entire sum.¹

Fuel surcharges have the potential to be very embarrassing, not only as anti-trust regulators start to impose fines on airlines for the collusion that might have gone into their creation. In mid-November, the Commission announced the results of a sweep they had done on airline websites. More than half of the 400 sites reviewed were misleading. Airlines were not named, but are being approached to rectify the problems (most of which concern misleading pricing). They have a four month deadline.

Agents and cargo forwarders know how the Commission's investigators must feel. The agents and forwarders continue to argue with the airlines about whether the usual industry commission applies to the fuel surcharge component. The airlines have

¹ Aviation Advocacy acted for the Federation of Airline General Sales Agents in this dossier.

behaved like the cigarette manufacturers faced with a national requirement to put a health warning on packets of cigarettes. That one country requires this does not mean that it should be on all packets, they would argue. For a long time, cigarettes sold duty free would be without the health warning that any country required. So it is with the airlines: that we are required by law or court decision to apply the commission to the fuel surcharge in one country does not mean that we should do so in any other, they say. Or in the best example ofchutzpah of them all, in the UK the fact that the airlines were roundly condemned by the High Court for not including fuel surcharges in the commission calculation for passenger tickets apparently does not mean that the fuel surcharge applies to rate calculations in the cargo hold, according to the airlines. Not surprisingly, we understand that the cargo forwarders and agents are planning similar litigation in the UK. They have already launched litigation in Australia.

Better news for airlines is that the legislation eases the administrative burden on the leasing of aircraft registered in the EU, but at the same time, introduces stricter requirements for the leasing of third country aircraft – especially wet leases – to ensure safety standards. This too is not without controversy. The issue is not the State of registration of the aircraft, but the quality of the maintenance. Wet leases are to be limited to six months, with the possibility for one six month renewal only.

If you thought that 2007 had seen a rather large number of applications for State Aid on the operation of airports and air services, the new legislation may also help explain that. The rules applicable to public service obligations have been revised. The EC says that is to diminish red tape. However, at the same time, they note that the new rules are aimed at avoiding excessive recourse by Member States to public service obligations for closing certain markets from competition. The Commission will be entitled to require an economic report explaining the context of the PSO and analysing its adequacy. The needs of the Outermost Regions (RUP) are taken into account by allowing, if necessary, a concession extended to 5 years. Cynics might suggest that knowing that this was coming, a number of applications for exemption were made in 2007.

On the airport side, the Regulation envisages that more effective measures for traffic distribution between airports serving the same city (or conurbation) will be put in place. Under the control of the Commission, traffic distribution rules will have to fulfil requirements such as non-discrimination. Airports will also have to set up effective transport infrastructure for the passengers' benefit. This, however, will be required to discriminate, in favour of public transport.

While the Member States also maintain an important role...

Of interest in the omnibus Regulation is the granting to national regulatory authorities in each Member State increased control over airline activities: the Regulation requires each Member State to ensure strict and harmonised application of the rules for operating licences of airlines. It calls for licences to be monitored with 'the same level of severity' in all Member States. Sadly, it is less fulsome in the explanation of how that might be able to be put into effect. Although to be fair, the legislation clarifies the criteria for the granting and validity of the licence to operate in the EU as well as clarifying the financial conditions that all EU airlines have to fulfil, as well as requiring the monitoring of these by Member States.

It is hard not to see this move in the light of the broad issue of balance between the centre and the States in the evolving experiment in Federalism that is the European Union. We have seen this come out a lot since Christmas with the new security regulation (see below). Similarly, with the new airport charges directive, again, it is the national regulatory agency of each State that has the first say on competition issues.

It is difficult to believe now that a few years ago the European Commission appeared to be intent on establishing a European Aviation Agency in line with the European Maritime Agency and the European Space Agency on one side of the Atlantic, and to match the Federal Aviation Agency on the other. Many of the number of new communications, directives and drafts need to be seen both in the light of an attempt to gather all aspects of airlines and aviation generally into the European fold, and a concession that the EC itself cannot do everything. An admission, perhaps, that conceding some role to the States might be the only way that many of the issues the EC (and DG TREN in particular) are currently pursuing will get through the Parliament and the Council.

Slot regulation – again

To ensure orderly and safe operations airport take off and landing slots are ultimately limited. In airports with demand for those slots exceeding capacity, traditionally international airlines and airports (except in the US) have used the IATA agreed slot coordination procedure. In Europe those procedures are amended by the European Commission. The procedure (and the EC's amendment to it) is silent on whether slots can be exchanged for consideration.

IATA's slot coordination rules attempt to provide an orderly means of allocating limited airport capacity (both runway and taxiway as well as terminal and gate space).

However, the rules are not without controversy. The rules provide for:

- Grandfather rights for existing operators at capacity limited airports;
- Use it or lose it requirements (the grandfather right is preserved if it is used 80% of the time);
- Free exchange between operators;
- A 'pool' or waiting list for operators wishing to increase operations at a particular airport.

Significantly, what the rules do not provide for is proving to be as interesting. The rules do not provide for making slots available for new entrants, nor do they address the situation where an airport in a particular country is subject to obligations under international treaties, such as air services agreements, to provide access to airports which are also busy serving domestic airlines, including new entrant airlines (such as is the case in the US with JFK). In the US, the FAA has preserved for itself the right to intervene to ensure that incumbents give up a suitable number of slots to new entrants, or to international carriers when required to do so to meet the US' obligations under air services agreements. In Europe, one of the amendments imposed is that 50% of new slots must be made available for 'new entrant' airlines. The issue of new entrant domestic airlines has not really been addressed.

That is an historical oversight perhaps. IATA has always been concerned with international carriage and international airlines. In the new Europe, that is fast becoming an irrelevant distinction. Low cost carriers can be international carriers too, after all. In the US the definition of a new entrant on a particular route that IATA uses (in the order of four flights a week) is clearly not appropriate for a new carrier entering a market. At what point is an incumbent entitled to ignore a 'new entrant' and are incumbents entitled to any sort of compensation for the work that they have done in building up the airport and its infrastructure? At that point the airport too will argue that it is entitled to compensation for the value that they have invested in the airport rather than merely asking a successful airline to forgo building a new service at that airport so that a new entrant may also serve the airport. (On the other side of the coin, of course, airports are never slow to trumpet the arrival of new entrants to their airport, so it is good to see a bit of even handed argument.)

The topic that the EC refuses to discuss is the elephant in the corner of the room: the exchange of slots for consideration. The IATA rules provide that slot transfers are without consideration, but there is no mention of whether agreeing to consider entering into such a transfer must also be without consideration. That practice has been going on for some time. With the agreement of the EU-US open skies agreement and the liberalisation of access to Heathrow, there have recently been a number of airlines announcing their intention to offer services from Heathrow – all requiring slots at a notoriously congested airport. At the same time, in the US, where generally, the airlines own their own terminal infrastructure, slots are bought and sold openly.

So the announcement by the DoT that access to the airport would include a timing element, or a congestion charge, is without precedent. Economists like it, at least in theory. The airlines are less sure. IATA spent considerable resource attempting to forestall this in the US. Brazil is also considering something similar. It will be a case of wait and see.

The issue of trading also begs the question of who should profit from the sale of a slot? Airports argue that the slot is access to their infrastructure and that they have an interest in the value of the slot. In the US, where to a much larger extent airlines own or manage on a long term basis the terminals this argument has converged somewhat; nevertheless, the question of who owns a slot has never been resolved.

Slots should only be necessary when there is a shortage of infrastructure. With the continuing rapid growth in demand for air travel, what should be a short term fix has become entrenched as a long term feature of the industry. In addition to airport runway capacity, there are significant issues surrounding air traffic control management and terminal space.

Other Airport Regulations – the new Charges Directive goes to Parliament

As airports deregulate there has also been growing concern that the airports' charges need to be regulated. Airlines in particular want the introduction of strict regulations on all airports. Airports argue that their charges reflect an increasingly competitive environment for airports and should only refer to airports that breach normal competition

law obligations. As previously reported, the European Parliament has had to consider a compromise package put forward by the Transport and Tourism Committee at the end of November on airport charge regulation.

The proposal of the Committee was that the Directive apply only to airports larger than 5M passengers pa, or otherwise engaging in anti-competitive behaviour. That package, and its amendments, was discussed in its first reading in the middle of January, and that is when we knew that things were getting back to normal. Airports thought the package good, airlines did not.

What is interesting in this package is the tacit recognition and admission that whilst airports were traditionally considered to be 'natural monopolies' that is no longer the case. Forward thinking airport economists have been arguing this for some time, and the evidence of airports competing for business is not new. Low cost carriers are now in a position to select airports and do so aggressively. Furthermore, countries with regulatory caps on airport charges (such as the UK) increasingly report that charges do not approach the theoretically capped limit.

As far as the airlines are concerned, the draft Directive has a number of very major faults: the draft does not impose a cap on airport charges, (rather it notes that fees are a necessary source of revenue for financing infrastructure improvements, tightening security and accommodating rising passenger numbers and growing air traffic); the directive does not require airports to give up their 'dual-till' business model. This is hugely inflammatory to the airlines which argue that this allows airports to take all returns from the non-aeronautical revenues, for example from shops and restaurants, rather than sharing them with the consumers who generate them, in the form of reduced airport landing and handling charges. Airlines argue that but for the airlines the customers of the shops would not be in the building, so as the main attraction, they are entitled to share the benefit.

Instead, the draft Directive requires airports set their prices in a transparent manner and prohibits them from discriminating between airlines; under the new rules, prices may only vary if the service varies.

At the same time, the draft Directive also includes a provision that allows airports the right to pre-finance future infrastructure developments by increasing their fees on existing users. Perhaps not surprisingly, this has angered airlines, who feel they are already paying too much in return for accessing airport facilities and services, which they claim are 'not always of irreproachable quality'. However, during the discussions that the Parliamentary Committees had on these provisions, the airlines were not publicly vocal about their opposition to the provisions, so crying foul now is something of a surprise. And in any event, isn't this exactly the sort of real world, standard business practice, that the airlines were pushing the airports to adopt.

Finally, and in the mood of the moment, as noted above, the draft Directive also requires member states to establish an independent national regulator that will have the power to impose settlements in cases where airlines and airports fail to agree.

Based on the reaction to the draft Directive, those regulators will be very busy. Already the airlines and airports seem to be in disagreement. The Airports Council International Europe (ACI-Europe) said it was 'appreciative' of Parliament's work to improve the proposal. The Forum of European Regional Airports (FARE) welcomed Parliament's amendments, saying: 'Parliament's decision is an important step towards safeguarding the development of regional airports. This is a great success.'

However, the Association of European Airlines (AEA) said it was disappointed that Parliament - usually a 'great champion for customer protection for the individual' had failed to rectify the weaknesses in the Commission's proposal. Instead, it has left airports with a monopoly pricing power that allows them to raise 'substantial streams of commercial revenue derived from the passenger volumes that the airlines delivered to them' without passing on the benefits to airline customers through lower fees. The International Air Carrier Association (IACA) criticised the decision to "grant a blank cheque to airports in respect to the choice of Single/Dual Till business model". The European Low Fares Airline Association (ELFAA) also lamented MEPs' failure to impose a single-till business model on airports, saying: 'The dual-till principle encourages dominant airports to abuse their position, encourages them to focus solely on retail activity, and is an unfair practice that should simply be outlawed by the legislator.' They went on to point out that the pre-financing of future facilities from charges on existing users 'is in breach of the user-pays principle as it forces airlines that may never use the facility to pay for it. Airlines do not pre-finance their future aircraft from charges on current passengers, so why should airports be any different?' This is a fascinating insight into the airline business model. It might explain a lot.

The single/dual till debate ultimately finds its way back to ICAO. ICAO's recommended practice on airport charging conveniently sits on the fence on the issue. Arguably, Article 15 of the Convention (perhaps the most passed over article in the entire Chicago Convention) seems to have more teeth than the more recent documents. But ICAO's members (the States) no longer seem keen to resolve this disagreement. As you sow, so shall you reap.

Security Charges

One thing on which the airlines and airports do agree on, however, is the issue of security charges. Security issues often lead to bizarre debates, as no-one wants to be seen as 'soft' on security, but European regulators see this as a chance to point out 'joined up thinking' that makes the US security processes look cumbersome and ineffective (not that we would say that out loud, you understand).

But at the end of the day, there are a few basic truths about aviation security: one is that it costs money. The second is that no-one wants to pay that money. Or putting it another way, everyone thinks that someone else should pay. Indeed, everyone thinks that anyone else should pay, as long as it is not them.

It is possible for even airports and airlines to agree on this one: as far as they are concerned, the government should pay. Unfortunately for that new found alliance of interests, it is also the governments that make the rules. Revisions to the regulatory

framework for aviation security that the Commission had been proposing went down to the wire on that point. The Commission and the Parliament wanted Member States to shoulder a major part of the cost (as did the airlines and airports). Finally, at the very end of the timetable set down for such negotiations, after several tense negotiations, the Council, and thus the Member States, prevailed.

The main bone of contention had been Parliament's demand that the cost of measures for fighting terrorism in airports and on aeroplanes be shared by national governments, and that, in cases where a Member State wishes to impose more stringent measures than those set out at EU level, it would have to cover the whole cost by itself. It was felt that such provisions would help avoid any distortions of competition between airports and air carriers in different countries, while at the same time ensuring that security measures are carried out to the highest standard in all airports, rather than at the lowest cost.

But Member States rejected the idea and in the final compromise text, it was decided that each government should remain free to determine "in which circumstances and to what extent the costs of security measures should be borne by the State, the airport entities, air carriers, other responsible agencies, or users".

In the meantime, the Commission has been given until the end of 2008 to carry out a review and produce a formula for calculating these costs. So security issues look to dominate much of the EC work for this year: the Commission has recently announced a tender process for a range of consultants to consider and review security options. Stand by for further announcements.

The EC turns next to Business and General Aviation

Keeping up the pace on new areas of reform and review, the EC has also announced a communication on business and general aviation. It reviews a number of contentious issues including the capacity issues, environment and safety regulations for the fast growing sector of the market.

This is yet another space that will need to be monitored.

Where to next for the dream of a Single European Sky?

The first round of the Single European Skies Directive can only be described as a failure. Four years later there has been no movement at all: not one single Functional Airspace Block has emerged and no rationalisation taken place. If talking and conference going was of value the situation would be looking good, but sadly for the dream of the Single European Sky it is not. A high level group was set up but all it could say was already obvious: A single European sky and the current governance of ANSPs in Europe are incompatible.

Venting its frustration the Commission released a new communication setting out what it thinks will teach the recalcitrant ANSPs a lesson. Or maybe, in a sideways way, slap the

recalcitrant Member States that are making their lives misery in so many other ways. The communication sets out a new way to make things happen: heavy handed economic regulation on the old skin of the existing national governance structures of each country's ANSP.

Nor does the Communication acknowledge an increasingly obvious truth: the obligations that are already in place under the SES Directive have imposed considerable cost on each ANSP. Costs that in many (if not most) cases exceed any savings that may have been derived.

At the same time, the Communication proposes a 'European Network Manager'. That person has the task of ensuring the delivery of consistent service across Europe. One might argue that service delivery is something that must be left to the ANSPs, rather than bring in a new layer of oversight. Better perhaps might have been a European Consistency of Regulatory Oversight by Each Member State Manager. That might start to address the real issues whilst leaving the ANSPs to do their job. But it would have required some sort of resolution of the entire Federal-Member State debate. Don't go there.