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E.CA COMPACT

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Are EC State aid rules compatible with attracting airlines through rebates?

Operating an airport profitably means generating sufficient traffic to cover operation costs at a margin which allows recovering fixed costs in the long run. Thus, airports often incentivise the opening of new routes or the establishing of hub status by individual airlines through rebate schemes. State-owned airports face the challenge to self-assess whether those rebates are in compliance with EC State aid rules. This note illustrates a simple but robust technique for such a self-assessment.[1]

Passenger traffic at an airport is to some extent supply driven, i.e., by the number of available lines and the hub status of an airport for international traffic. In this context, airports try to incentivise the opening of new routes or try to reinforce its hub status with individual airlines with rebate schemes.

State-owned airports might violate EC State aid law by doing so, however. If the state owner accepts schemes which hand out unprofitable rebates to airlines this might be considered evidence of foregoing profits, i.e. profits which the owner could otherwise have appropriated. In this situation, state-owned airports exhibit an advantage which is not available for privately owned airports, violating the market economy investor principle (MEIP) and thereby possibly leading to a finding of State aid.[2]

Principles of the MEIP

The MEIP analyses the profitability of the State aid measure from the perspective of a private investor (or here: a private owner) in order to assess whether the beneficiary received a financial advantage. In order to apply it, two important principles have to be considered.

First, the profitability of the scheme has to be established at the time of the decision making, i.e. prior to the execution of the payments ("ex ante principle").

Second, the analysis needs to be based on the relevant counterfactual ("counterfactual principle"). Thus, one needs to identify those costs and revenues which are induced by the rebate scheme.

Profitability analysis and incentive effect

A standard method for profitability analyses is the discounted cash flow calculation (DCF). This method calculates the net present value (NPV) of an investment taking current and future costs and revenues associated with the investment into account.

A rebate can be considered as an investment: The foregone revenues due to the rebate have to be balanced against any additional profits which new airlines will generate. The counterfactual principle implies that only the net profits of new routes which have been induced by the rebate can be considered on the side of positive cash flows (also called the "incentive effect").

[1] E.CA Economics (formerly ESMT Competition Analysis) has advised a European airport which conducted an internal assessment of their rebate scheme.

[2] Other elements for finding such a measure to be considered State aid are the criteria of imputability and selectivity. These criteria are not discussed in this short note. For a general introduction, see Mederer, W., N. Pesaresi and M. Van Hoof (ed., 2008): EU Competition Law. Volume IV State aid. Claeys & Casteels.

The following formula characterises this rationale:

$$NPV = p * PV(Revenues - Costs) - PV(Rebate) \geq 0 .$$

where p signifies the expected share of new airlines that choose the airport or open additional routes due to the rebate ("rebate induced effect"). 'PV(Revenues-Costs)' represents the present value of the profits associated with this additional traffic and 'PV(Rebate)' stands for the expected foregone revenues due to the rebate.[3]

The rebate induced effect strongly drives the profitability of a rebate scheme: How many additional routes will be opened in response to the rebate? How large are the windfall profits to airlines which would have come in any case? Rearranging the above formula provides us with a critical rebate induced effect which defines the breakeven point of a rebate scheme:

$$p^{crit} = PV(Rebate)/PV(Revenues - Costs).$$

The critical rebate induced effect indicates the minimum probability for which the rebate scheme is profitable: when the likelihood of additional routes to be opened due to the rebate scheme is higher than the critical probability, the rebate scheme is profitable from the perspective of a private investor. Note that a similar method has been applied in recent EC State aid cases such as in the NeoVal decision.[4]

Comparison of expected and critical incentive effects

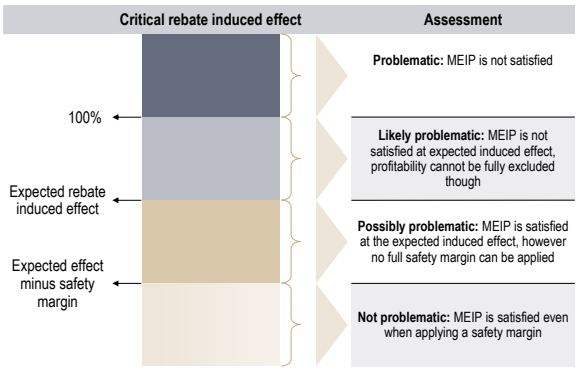
The calculation of the critical rebate induced effect can be informative in itself as it provides an estimate of the order of magnitude of the required effect for profitable schemes.

For instance, a calculated critical probability of 1 or above indicates that the rebate scheme would certainly not be implemented by a private investor, since the present value of the rebate payment exceeds the present value of the net profits resulting from new airlines.[5] It can also be conjectured that the lower the calculated critical rebate induced effect, the higher the likelihood that the MEIP is satisfied.

A more accurate assessment, however, takes the expected effect into account. A rebate scheme is in compliance with the MEIP if the expected rebate induced effect is higher than the critical rebate induced effect.

Often, one has to base the assessment on a more or less reliable estimate of the expected rebate induced effect at the time of the implementation of the rebate scheme. In order to increase the reliability of the analysis, it can thus be useful to include a safety margin in the assessment, as illustrated in the below figure.

A test for compliance



Source: E.CA Economics.

Conclusion

This E.CA Compact puts forward a simple but robust method to assess the profitability of rebate schemes under the MEIP in line with current practice by the EC. The methodology is based on calculating the critical rebate induced effect and comparing it with the expected effect. The methodology helps to focus the assessment on the critical evidence, like the additional revenue and cost flows and the likelihood of attracting new routes, and helps to balance the positive and negative factors within an economically stringent framework.

[3] The appropriate discount rate can be determined according to the Weighted Average Cost of Capital approach using the Capital Asset Pricing Model to identify the costs of equity.

[4] Commission Decision of 21.02.2007 in case N 674/2006, NeoVal.

[5] Note that we are simplifying here for explanatory reasons. Depending on the facts of the case a comprehensive assessment may or may not have to take into account aviation and non-aviation profits, positive externalities from new airlines and routes on existing traffic or infrastructure costs. For example, winning one new international route will bring additional feeder flights and will also increase the load factor of existing national flights. Those 'indirect' effects can be significant.