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Qatar Airways: Riyal impact of embargo

QATAR Airways — the second largest of the Gulf superconnectors — proudly states that it has grown by an annual average compound rate of 28% in the 20 years since its founding, and that it is profitable. It has not stinted on growth in recent years either, having increased total capacity in terms of ASKs by 20% a year in each of the past three financial years. Initial schedule filings suggested that it had planned to grow by more than 10% in the current year. And then in June, Qatar was ostracised by its neighbours.

The airline has not been particularly open about its financial affairs — as the state-owned flag-carrier of Qatar it has been under no obligation to be so. However, it published its first publicly available set of report and accounts for the Qatar Airways Group last year covering its financial year to end March 2016, primarily as an attempt to provide a riposte to the criticisms of unfair subsidies from the US "Partnership for Free and Open Skies". (Previous years figures for the Qatar Airways QCSC bizarrely had been available through the Australian Securities and Investments Commission). Qatar Airways followed this summer with its second public report for the latest financial year to end March 2017.

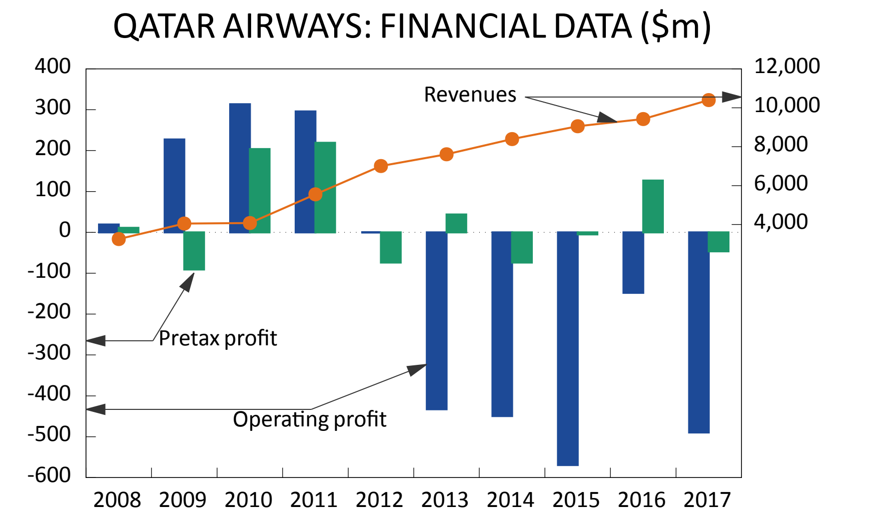
The headline figures sounded good. The group CEO, HE Akbar al Baker, stated that profits attributable to the owner had increased by 22% to QAR1.97bn ($528m) on the back of a 10% increase in revenues to QAR39bn ($10.3bn) while the number of passengers flown grew by 20% to 32m — although published operating profits had fallen by a third to QAR2bn.

However, the underlying results are anything like as positive. Unit revenues appear to have fallen by 10% in the year while units costs only declined by 6.5%. The group includes various irregular items at the operating level — including some $575m in profits on asset sales (mostly aircraft it has sold and leased-back). In underlying terms the Group appears to have generated an operating loss of $490m compared with a loss of $150m in the previous year and a pretax loss of $46m, down from a profit of $127m.

In total it looks as if the company has managed to lose some $2bn at the underlying operating level in the past six years (see chart below).

Qatar Airways's high rate of growth has added to the apparent overcapacity in the region and has no doubt had its impact on both Emirates and Etihad (see *Aviation*

This issue includes



Note; FY ending March. Excludes profits on asset sales. FY2008-2014 Qatar Airways QCSC; FY2015 on Qatar Airways Group.

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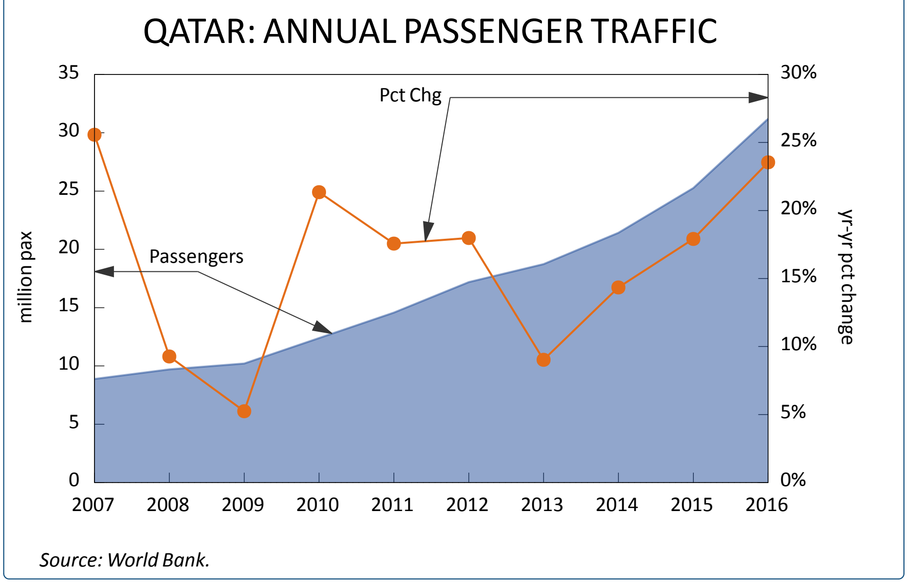
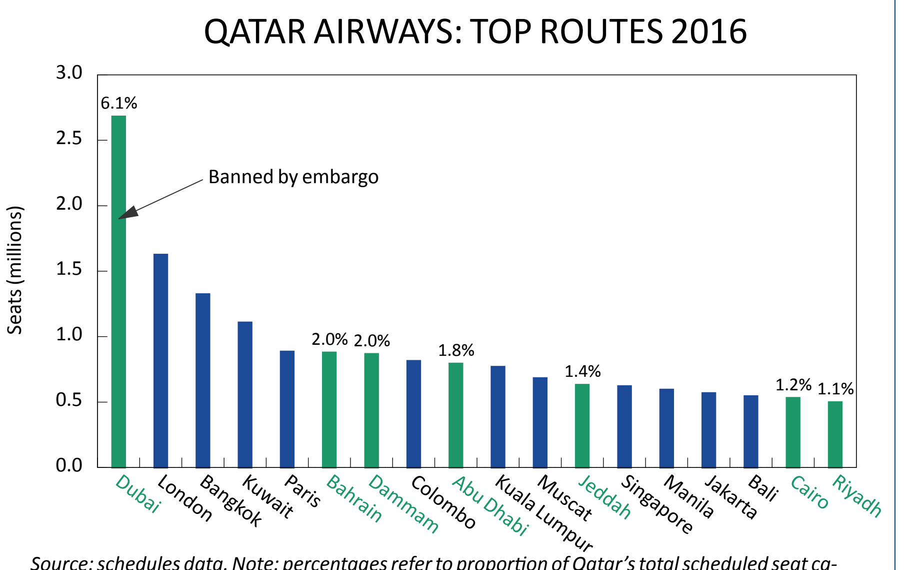


Source: World Bank.

Strategy Sept 2017). Qatar Airways does not publish detailed passenger statistics, nor does Doha airport (which it manages). However, as the chart below shows passenger numbers through Qatar have tripled in the past ten years to over 30mppa — and this is for a nation with 360,000 citizens and a total population of around 2.7m (but the highest GDP per head of any country in the world). Qatar Airways accounts for over 70% of the throughput, of which around 85% transfers.

One of the risks for all of the superconnectors is geopolitical, and in June Saudi Arabia, the UAE, Bahrain and Egypt removed all diplomatic ties with Qatar, in the process banning all travel (and use of their airspace to airlines registered in Qatar). Apart from the aggravation that this provides Qatar Airways in extending route timings — particularly on its services to



Source: schedules data. Note: percentages refer to proportion of Qatar's total scheduled seat capacity.

QATAR AIRWAYS FLEET

		In service	Orders
Passenger	A319	2	
	A320	39	(30)
	A321	8	(16)
	A330	26	
	A340	4	
	A350-900	21	(24)
	A350-1000		(37)
	A380	8	(2)
	777-200/300	45	(12)
	777X		(60)
	787-8	30	
	787-9		(30)
	Total Passenger	183	(181)
Cargo	A330-200F	8	
	747-8F	1	
	777-200F	13	(3)
	Total Cargo	22	(3)
	Total	205	(184)

sub-Saharan Africa and South America, adding an uncompetitive extra hour or two flight times, it is a severe blow to to its expansion plans. Qatar Airways gains a significant level of feed to its long haul routes from services to the region now closed off.

Roughly 20% of Qatar Airways' total seat capacity in 2016 (but only 3% of ASKs) was to destinations in the countries that imposed the embargo. In the chart on the facing page we show the carrier's top routes by seat numbers scheduled. Dubai (both DXB and DWC) is by far the largest accounting for 6% of Qatar's total seat capacity, but Saudi Arabian services overall are the next most important accounting for 3.5%. A rough calculation suggest this could remove at least 10% of Qatar's feed traffic, severely undermining the hub economics at Doha.

Unfair subsidies?

This publication of the 2017 results may have added support to the US majors' arguments.

The Partnership for Free and Open Skies have been even more aggressive in their analysis than we have. Deducting (possibly unfairly) profits from duty free sales, its alcohol distribution monopoly and its hotel operations, the campaign group suggests the airline suffered an operating loss of \$703m in the period. It states with the usual emotional rhetoric that "Even with nearly half-a-billion dollars in new subsidies and marked-up alcohol and duty free sales, Qatar Airways remains one of the worst performing global airlines, on par with failing carriers like Air Berlin and Alitalia."

The US majors' campaign to rescind the Open Skies agreements with Qatar and the UAE for "unfair subsidies" has been gathering increasing support in Congress; and the White House with its mercurial incumbent could make a pronouncement either way (and probably through Twitter).

Meanwhile, the EU Commission had been mandated to discuss an Open Skies regime with Qatar (as with the UAE) with discussions apparently starting a year ago. This was before the adoption of the EU's new Aviation Strategy, and Brussel's acceptance that the UK (which has generally been a liberalising force on aviation within EU political circles) will be leaving the *bloc*. As the next article in the current issue of *Aviation Strategy* implies, it is possible that the more protectionist attitudes of Air France-KLM and Lufthansa will have more sway in denying greater freedom of access.

Qatar Airways flies the flag

The group's financial results are almost irrelevant. Qatar Airways claims to be (and probably is) an efficiently run airline — al Baker has a strongly focussed, and sometimes arrogant style. But the airline in reality is not subject to strictly commercial disciplines from its owner. It exists as the aviation arm of the state of Qatar, and is an integral part of the country's desire to create an economy parallel and eventually superceding the country's fossil fuel dependency (although Qatar's reserves are likely to long outlast its neighbours in the UAE).

It is also very closely linked with the aims and ambitions of the country's sovereign wealth fund to diversify investment returns for the Emirate. Like Eithad it has made investments in other aviation assets (see *Aviation Strategy* Sep 2017) but in contrast on the whole has chosen quality vehicles. It is the only one of the superconnectors to have joined a GBA — **one**world — and its investments generally reflect its attachment. It holds a 20% stake in IAG, the parent of British Airways (the Qatari Wealth Fund also holds a 20% stake in Heathrow of which al Baker is a director), and 10% of LATAM. It essayed a 10% investment in American but retired rebuffed. It has also taken a 49% holding in Italian carrier Meridiana (although the rationale for this remains to us obscure).

There is nothing that convinces a government more of the importance of its national airline than the imposition of an embargo. It is likely that the owner's support for the carrier's strategy has been strengthened rather than weakened.

Anti-competitive behaviour: New European approach

In December 2015, the European Commission published An *Aviation Strategy for Europe* (Com(2015)598 final), following a public consultation. The Commission's paper opened by emphasising that aviation is a strong driver of economic growth, jobs, trade and mobility for the EU. "It plays a crucial role in the EU economy and reinforces its global leadership position… An Aviation Strategy is needed to ensure that the European aviation sector remains competitive and reaps the benefits of a fast changing and developing global economy."

Firmly in the Commission's eye is the fact that in the long-haul markets Europe's airlines are facing increasing competition, especially from the Gulf carriers. To a significant extent, it is this elephant in the room which drove the need to review the EU's aviation strategy. The problem is fairly obvious; the solution less so.

As the *Strategy* paper notes: "The international aviation sector outside Europe has …. been witnessing some significant developments, characterised by very strong growth in certain world regions. This is associated with the shift of the world's economic centre of gravity towards the East, notably Asia. As a result, several new airlines and airports have emerged and are posing a new and considerable challenge for European hub airports and carriers."

The Commission identified three key priorities, as well as a number of secondary principles, to guide future EU aviation policy, namely:

- ✈ Tapping into growth markets by improving services, market access and investment opportunities with third countries, whilst guaranteeing a level playing field.
- ✈ Tackling limits to growth in the air and on the ground by reducing capacity constraints and improving efficiency and connectivity.
- ✈ Maintaining high EU safety and security standards by shifting to a risk and performance based mind-set.

Generalisation and substance

This is all very well, and few would take issue with the Commission's position, but there was little real substance to the generalisations. How precisely, for example, does the Commission intend to tap into growth markets, improve services, increase market access and investment opportunities with third countries, and above all guarantee a level playing field for European airlines?

The answer at least partly came in June this year with the publication of a series of measures designed to add meat to the bare bones of the 2015 *Strategy* paper. Three papers addressed Public Service Obligations (C(2017)3712 final), provided guidelines for interpreting EU rules on airline ownership and control restrictions (C(2017)3711 final) and discussed Air Traffic Management Service Continuity (SWD(2017)207 final). All important, no doubt, but hardly likely to attract a great deal of attention. It was the fourth document published in June, Proposal for a *Regulation of the European Parliament and of the Council on Safeguarding Competition in Air Transport, Repealing Regulation (EC)No 868/2004* (COM(2017)289 final), to give it its full title, which was far more interesting and potentially controversial.

This represents the Commission's response to the war of words which has been raging in Europe and elsewhere for many years between those airlines (notably Lufthansa and Air France/KLM in Europe) who contend that the Gulf carriers have engaged in unfair competitive practices, and those such as IAG who resist regulatory intervention, arguing that European airlines should stop complaining and compete. (In September this year, Willie Walsh, speaking at the World Routes conference, again emphasised his antagonism towards the approach taken by other European airlines: "I don't believe the argument that Gulf carriers are bad. It is nonsense. We will compete with them and beat them through strong fair competition and not via regulation.")

The proposal for a new EU Regulation is clearly an attempt to find a way out of the current impasse, and like many would-be compromises, it is unlikely to succeed.

The Commission already has limited powers to take action against unfair competition in international markets in the form of Regulation (EC) No868/2004. This Regulation has attracted considerable criticism, mostly unfairly since it was only ever intended to be a face saver, with no practical implications. The proof of this is surely to be found in the fact that it has never been used in anger, and as the Commission points out, "some of its features make it very unlikely that it could ever be (concretely) applied." It is supposed to deal with unfair pricing practices, which are defined as "air fares which are sufficiently below those offered by competing Community air carriers to cause injury."

It provides a very high hurdle to jump. For example, to mount a successful case a complainant has to go beyond just showing that a third country airline has received a non-commercial advantage. In addition, the Regulation does not address the violations of fair competition obligations contained in Air Services Agreements signed by the EU itself. Finally, only 'Community industry', defined as "the Community air carriers supplying like air services as a whole or those of them whose collective share constitutes a major proportion of the total Community supply of those services," are entitled to mount cases under the Regulation. In other words, neither Member States nor individual airlines can submit complaints in their own right.

None of this is accidental. The Commission, supported by certain Member States, especially the UK, realised that this whole area was a can of worms and best avoided if at all possible. One way of doing so, while at the same time acknowledging the concerns of countries such as France and Germany (and their airlines), was to introduce rules which superficially addressed the problem, but in practice could never be used. It should be added as well that certain other EU regulations, such as those relating to slot allocation and ground handling, also contain provisions for retaliatory action against non-EU carriers, although again such legislation has rarely been used for this purpose.

The world has changed, however. The persistence of the complaints from the likes of Lufthansa and Air France/KLM, more recently matched in the US by Delta, United and American, has drawn considerable attention to the competitive practices adopted by the Gulf carriers in particular. The debate has been underway for over a decade in Europe, but shows few signs of abating. If anything, it has increased in ferocity in recent years. At the same time, with Brexit fast approaching, the Commission is no longer able to rely to the same extent on the support of the UK in promoting a liberal EU external aviation policy and in resisting pressure to take retaliatory action against third country airlines. And, of course, despite some recent set-backs (see for example *Aviation Strategy*, September 2017), the Gulf carriers continue to grow and threaten competitors in the EU and elsewhere.

The fundamental problem is the absence of an international framework governing competition among airlines. ICAO has no such multilateral rules and air transport services have largely been excluded from World Trade Organisation agreements. The General Agreement on Trade in Services (GATS) covers only three relatively peripheral areas of aviation trade, such as computer reservation systems and aircraft maintenance and repair services. Core market access issues are left to bilateral Air Services Agreements, which normally include only generalised restrictions, such as insisting on a "fair and equal opportunity to compete." What *fair and equal* actually means in practice is left unclear, primarily because few States would be able to agree on a definition.

The Commission's 2012 paper on the EU's External Aviation Policy had clearly defined the problem which needed to be addressed, namely "…while EU airlines are ultimately responsible themselves for their competitiveness and must continue to adapt their products and business models to the prevailing market condition, … it is equally important that competition, both within the EU and externally, is based on openness, reciprocity and fairness and that it is not distorted by unfair practices." However, again the question arises: what does it mean in practice? What can the EU do to achieve this admirable objective? The June 2017 draft Regulation seeks to provide the answers.

Five Chapters and a Recital

The new Regulation, yet to be adopted by Member States, is divided into five Chapters plus a Recital:

✈ Chapter I sets out its scope, including relevant definitions.

✈ Chapter II contains the rules governing the initiation and conduct of an investigation into anti-competitive practices. Notably, it provides for complaints to be made by a single Member State, an EU airline or an association of EU carriers, or on the Commission's own initiative. It goes on to prescribe the conditions under which the Commission may decide to open an investigation and specifies the procedures to be followed. The Commission's rights to obtain and verify the accuracy of information to carry out an investigation are specified.

✈ Chapter III describes the acts through which proceedings regarding the violation of applicable international obligations are concluded, ie. with or without the adoption of 'redressive' measures.

✈ Chapter IV defines two possible purposes for an investigation, namely: a violation of applicable international obligations (the so-called 'violation risk'); or practices adopted by a third country or third-country entity affecting competition and causing injury or threat of injury to EU airlines (the so-called 'injury' track).

✈ Chapter V, arguably the most critical chapter, establishes how injury may be identified. It provides for the possible adoption of financial or operational measures intended to offset injury, requiring that the measures should not exceed what is necessary for such offsetting, bearing in mind that the objective is not to punish a third country airline but to restore fair competition.

✈ Finally, Chapter VI covers provisions to repeal Regulation 868/2004 and the entry into force of this new Regulation.

It is immediately obvious that this is a very different approach to that embodied in Regulation 868/2004. For a start, it has all the signs of a piece of legislation that is intended to be actually used. The detail would seem to cover almost any allegation of anti-competitive behaviour, and certainly the complaints voiced about the practices of the Gulf carriers (as well, of course, as other airlines around the world).

Definition of discrimination and subsidy

To take just one example, 'discrimination' is defined to mean "differentiation of any kind without objective justification in respect of the supply of goods or services, including public services, employed for the operation of air transport services, or in respect of their treatment by public authorities relevant to such services (including practices relating to air navigation or airport facilities and services, fuel, ground handling, security, computer reservation systems, slot allocation, charges, and the use of other facilities or services employed for the operation of air transport services."

This would seem to cover all the options. A similarly detailed definition of 'subsidy' then follows. It is surely not going to be difficult to put together a case alleging discrimination or subsidy by governments or airlines in any number of countries around the world. The Commission might find itself quite busy. All a complainant needs to do is provide *prima facie* evidence of either a violation of international obligations or injury or threat of injury to a Community carrier from a practice affecting competition. The history of international aviation is riddled with such examples, including European and US ones, and they continue to be found in many countries.

The Commission clearly recognises that cases brought under the new Regulation are likely to be difficult and complex. Two years are allowed for the conclusion of each case, with the option of an extension if necessary. Even where there is a risk of "immediate and irreversible injury" to an EU airline, the minimum period proceedings may be shortened to is one year.

So what will the Commission do?

The key question is: what will the Commission do if it satisfies itself that there has been injury to an EU airline as a result of anti-competitive behaviour? The answer is that it will adopt "redressive measures". These will be "imposed on the third country air carrier(s) benefitting from the practice affecting competition and may take the form of either… : (a) financial duties; or (b) any measure of equivalent or lesser value." Thus, the Commission is granted extensive options, if it is prepared to use them.

There is a precedent elsewhere in the world for a similar approach to dealing with alleged anti-competitive behaviour in aviation. As long ago as 1974, the United States introduced the International Air Transportation Fair Competitive Practices Act (IATFCPA), specifically designed to give the Department of Transportation powers to take action "in response to anti-competitive, discriminatory, predatory or unjustifiable activities by a foreign government or foreign airlines against a US airline." Complaints may be filed by a US carrier or the DOT itself can take the initiative. The DOT has up to 180 days to investigate the dispute, dismiss the complaint or resolve it, although this time-scale can be extended.

If the DOT finds that action is justified, the first step is usually to require the non-US airline concerned to seek approval for all or part of its schedules for services to and from the US. Such action is taken where the DOT concludes that the government of the country where the airline is based has:

✈ "taken an action that impairs, limits, or denies operating rights to a US airline; or

✈ otherwise denies a US airline a fair and equal opportunity to compete."

However, the practical implications are limited. The likelihood is that the filed schedules will be approved and the airline will continue to operate services to the US as before. The intention, of course, is to encourage the foreign government involved, as the signatory of the Air Services Agreement with the US, to ensure that its designated airline mends

Public Service Obligations

One of the aviation papers tabled by the European Commission in June this year concerned the application of Public Service Obligations, or PSOs. ('Interpretative Guidelines on Regulation (EC)No. 1008/2008', C(2017)3712 final). PSOs, like their US equivalent, the Essential Air Services Program, are designed to help regional development by permitting governments to subsidise air services which otherwise would not be financially viable. Legally, they may only be imposed on routes that are "considered vital for the economic and social development of the region which the airport serves". They have, however, become an intrinsic part of the European aviation landscape.

Did You Know That:

- There are currently 179 PSO routes in operation in Europe, as of June 2017, in 13 countries (Croatia, Cyprus, the Czech Republic, Estonia, Finland, France, Greece, Ireland, Italy, Portugal, Spain, Sweden and the UK), although other Member States have financed PSO routes in the past.
- The largest number of PSO routes is to be found in France, with 40 (just over 22% of the European total). Almost six million passengers per annum use PSO routes in France, one in every five domestic passengers.
- In Ireland, PSOs account for no less than 70% of domestic traffic.
- Most PSO routes are domestic, with only seven linking airports in different Member States.
- 136 of the current PSOs are subsidised by public authorities, involving an estimated subsidy of at least Euro300 million per annum.
- Under the EU's Slot Allocation Regulation slots at congested airports can be reserved for PSO routes.

its ways and abandons any alleged anti-competitive practices. To move to the next stage, the so-called Phase 2 of the process, and actually limit the airline's operations requires the approval of the US President, which in diplomatic terms is a far more serious step.

The DOT claims that "generally speaking the intergovernmental process has been very successful in resolving complaints filed by US airlines." It has rarely been necessary to move to Phase 2. It may well be the case that in a number instances foreign airlines have been persuaded to abandon certain practices, but it is far less clear that IATFCPA has solved more intractable problems, including those associated with the Gulf carriers.

The reasons for this are fairly obvious. The approach is a legal process defined and applied unilaterally by a single country, the United States. Although the other government involved and its airline(s) are given opportunities to argue their case under due process, the US is still effectively the judge and juror. Not many sovereign countries are prepared to accept such a situation.

Furthermore, if persuasion fails, the only weapon available to the US to enforce its decisions is what amounts to a nuclear option, namely the cessation of some or all of an airline's services to the US. If the foreign government concerned doesn't accept the judgement of the US authorities, it is hardly likely to stand by and see its carrier treated in this way. The probability is that it will also take action, either to restrict the services of US airlines to its territory or even to renounce the relevant Air Services Agreement. It is difficult to see how such an outcome can be in the overall public interest, which the DOT says is one of its guiding principles.

Finally, there may be occasions when a non-US airline's services can be restricted without any action being taken against US carriers. For example, US airlines may not actually serve the country involved (although this is increasingly unlikely given the global coverage of US all-freight carriers such as Fed Ex and UPS). Even in such a case, however, non-aviation retaliatory action is a distinct possibility. There are precedents, for example the decision by the UAE Government to restrict Canadian access to military facilities in the Gulf following Canada's refusal to allow Emirates Airlines to expand its services to the country.

It is not surprising, therefore that the IATFCPA has had only modest success in achieving its objectives. Such an outcome may well be inevitable given the regulatory structure of international aviation, based as it is on agreements between sovereign States. It is very likely that the EU initiative will face similar problems. If adopted by Member States, it may be able to address some, relatively minor issues, but the chances of successfully solving major problems such as alleged anti-competitive behaviour by the Gulf carriers are probably as remote as ever. The basic challenge faced by Air Services Agreement negotiators for many decades, how to define the 'fair and equal opportunity to compete' clause, remains unresolved.

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Latest thinking on Brexit options

As the UK stutters towards Brexit in March 2019, companies and industry bodies are demanding clarity on the process and the outcome. They are not receiving much from either the UK government nor the EU. The airline sector faces one of the most difficult transitions — from a logical, generally smooth-working Single European market to a regressive situation in which we have to (re)learn the meaning of the more esoteric "Freedoms" and manipulate transnational airline ownership structure to fit in with the new reality.

The optimal outcome would of course be the retain the status quo. But there is only a very slim chance of that happening; though there is the outside possibility of a new referendum on the *reality* (as opposed to the rhetoric) of leaving the EU, which the latest polls suggest would return a Remain decision.

That may be wishful thinking. In the meantime, Andrew Lobbenberg, airline equity analyst at HSBC, has carried out an insightful examination of the regulatory options. His report[1] lays out seven possible scenarios, ranging from a "soft" Brexit through some varieties of middling and hard Brexits to an extreme "hard" Brexit.

The Scenarios

1) *UK regains access to EU Single Aviation Market*

For the interests of the airline and tourism industries and for EU and UK consumers, the best case outcome is a UK-EU bilateral that recreates the liberal traffic rights that exist today, together with an equivalence of UK and EU airline ownership. This would preserve the traffic rights for all airlines, with the possible exception of domestic operations in third countries. This would also enable existing airline corporate structures to continue.

The challenge is to see how this can be achieved. Norway has this unfettered access to the EU aviation market, but accepts ECJ (European Court of Justice) rulings and the free movement of people. Switzerland has a similar bilateral agreement, without access to domestic markets. Switzerland accepts the authority of the European Commission (DG Comp) on Swiss-EU aviation M&A matters, but not broad ECJ governance. Switzerland also allows free movement of people, though this is not explicitly linked to the aviation agreement.

So it is not clear how such a benign outcome might be achieved given the broader political context and the UK government's sensitivities over ECJ authority and migration controls. Lufthansa and Air France are arguing that, post Brexit, the UK should be only granted full access to the EU aviation market, if it accepts the same rules and obligations as EU countries.

2) *EU-UK bilateral, liberal ownership and control provisions, constrained traffic rights*

If the EU-UK bilateral aviation agreement falls short of replicating the ex-

[1] *Brexit and airlines: Uncertainty, long to reign over us,* HSBC, October 2017

ESOTERIC "FREEDOMS" OF THE AIR

Seventh freedom:	The carriage of traffic between two foreign countries as a free standing service *eg Ryanair flies from Frankfurt to Faro*
Eighth freedom:	The carriage of traffic on a domestic route within a foreign country as part of a service to or from your country; also known as consecutive cabotage *eg Singapore Airlines carrying traffic between London and Manchester as part of a Singapore-London-Manchester service (hypothetical)*
Ninth freedom:	The carriage of local traffic on a domestic route within a foreign country as a standalone service; also known as cabotage *eg easyJet carries traffic from Paris to Toulouse*

isting open skies agreement, there are two near liberal scenarios.

this scenario of liberal ownership and control provisions, we could see a structure that treats UK and EU ownership as equivalents, but which places constraints on traffic rights, allowing unrestricted third and fourth freedom access between the UK and EU member states, but without fifth or seventh freedom traffic rights and without access to domestic.

Such a solution would sustain the ownership structures of those carriers with potentially vulnerable ownership: IAG, Ryanair and Wizz. It would also enable Air France-KLM's investment in Virgin.

However, to sustain traffic rights between the UK and EU markets that are not their home countries, Ryanair and Wizz would need to establish UK AOCs, but there would not be any need to prove UK ownership of the UK subsidiaries. The UK tax rate is notably higher than Irish and Swiss tax rates that currently apply to their respective businesses.

Unionisation is also common-place in the UK airline industry. The existing Ryanair and Wizz operations are not unionised.

SAS's new Irish subsidiary would be unable to operate SAS's Heathrow-Scandinavia flights and it too would need to establish a new UK carrier.

3) *EU-UK bilateral with liberal traffic rights, constrained ownership and control*

The second near liberal scenario envisions liberal traffic rights, allowing seventh freedom traffic rights to UK and EU airlines, but the loss of equiv-

BREXIT — AEROPOLITICAL SCENARIOS

			Concept	Traffic Rights	Ownership and Control	Complications & Implications
1	UK access EU Single Aviation Market	Soft Brexit	UK re-incorporated into EU Single Aviation market, similar to Norway or Switzerland	Unrestricted 3rd, 4th, 5th and 7th freedom rights for UK and EU carriers within EU and UK. Domestic flying (8th/9th freedom) probably excluded.	UK ownership and control granted comparable status to EU ownership and control	How can it be delivered, given ECJ and free movement of labour are major concerns for the UK government. Traffic rights broadly sustained, except for 8th/9th freedom domestic flying. Ownership structures sustained. UK-EU airline split would defend full traffic rights.
2	EU-UK Bilateral Agreement, liberal ownership provisions	Mid to Soft Brexit	EU-UK bilateral agreement falling short of effective UK re-entry to Single Aviation Market	Unrestricted 3rd/4th freedom between UK and EU member states. No 5th or 7th freedom services Domestic flying (8th/9th freedom) probably excluded		Seventh freedom operations not allowed to/from UK. Current Pan European ownership structures sustainable, but to access UK EU routes, Pan European operators would need UK subsidiaries.
3	EU-UK Bilateral Agreement, liberal traffic rights	Mid to Soft Brexit	EU-UK bilateral agreement falling short of effective UK re-entry to Single Aviation Market	Unrestricted 3rd, 4th, 5th and 7th freedom rights for UK and EU carriers within EU and UK. Domestic flying (8th/9th freedom) probably excluded.	UK ownership does not contribute towards EU ownership	Traffic rights broadly sustained, except for 8th/9th freedom domestic flying. Pan European ownership structures unsustainable.
4	EU-UK Basic Bilateral Agreement	Mid Brexit	EU-UK bilateral agreement falling short of effective UK re-entry to Single Aviation Market	Unrestricted 3rd/4th freedom between UK and EU member states. No 5th or 7th freedom services Domestic flying (8th/9th freedom) probably excluded		Seventh freedom operations not allowed to/from UK. Current airline ownership structures unsustainable. Demerger of UK airlines from Pan European groups.
5	National Bilaterals	Hard Brexit	No EU-UK aviation agreement. Reversion to bilateral structures	3rd and 4th freedom services only, subject to bilateral negotiations. No 5th or 7th freedom services Domestic flying (8th/9th freedom) probably excluded		Certain EU states cancelled bilaterals so no historic agreements to fall back on. Seventh freedom operations not allowed to/from UK. Current airline ownership structures unsustainable. Possible demerger of UK airlines from Pan European groups.
6	Comity and reciprocity	Hard Brexit	No EU-UK aviation agreement. Comity and reciprocity	Existing flight operations continue, new routes subject to ad hoc approvals		Concept is established in the bilateral environment. Unclear how functions in multi-lateral environment. Existing route rights sustained, but no clarity for future growth. Current airline ownership structures unsustainable. Uncertainty would severely restrict investment.
7	Empty Skies	**Very Hard Brexit**	Flights grounded	None		A temporary grounding could trigger debate to deliver a more liberal long term outcome Unlikely to last long

Source: Brexit and airlines: Uncertainty, long to reign over us, HSBC, October 2017 alence to UK and EU ownership.

Such a solution would see traffic rights maintained for UK and EU airlines, with the exception of domestic services. Ryanair, Wizz and Vueling seventh freedom services would continue, and SAS's new Irish AOC could operate from Heathrow.

However, the ownership structures of IAG, Ryanair and Wizz would be challenged. The present ownership structures would see Ryanair and Wizz uncertain of EU ownership and control, placing at risk their EU AOCs. Buy-backs or forced sales of UK-owned shares would be necessary.

Ryanair has floated the option of disenfranchising UK shareholders: conceptually this could secure EU control of Ryanair, but it would not address the ownership constraint. The licensing requirement in the legislation refers to majority EU ownership *and* control, not EU ownership *or* control.

For IAG the EU ownership and control of Aer Lingus, Vueling and Iberia would be in question. In this circumstance, IAG may need to demerge into IAG UK (British Airways) and IAG Europe. Air France-KLM's investment into Virgin would be at risk.

4) *A basic UK-EU bilateral*

The more basic outcome might be a UK-EU bilateral with constrained ownership and control and constrained traffic rights. It might allow for liberalised third and fourth freedom services from the UK to EU member states for national airlines of those countries, but not airlines of third countries. It would not establish equivalence for UK and EU ownership.

Such a scenario would still call into question the traffic rights of Ryanair, Wizz on routes from the UK to points other than their home markets. This scenario would also call into question the ownership structures of IAG, Ryanair and Wizz.

That said, with at least a defined regulatory regime, companies would have some confidence to undertake corporate restructuring to mitigate the constraints. The carriers would probably need to demerge into UK and EU businesses, with ownership structures that illustrate EU ownership and control of the EU businesses. Whether demonstrable UK ownership of BA, Wizz UK and Ryanair UK were needed would depend on UK policy, which might take a liberal stance towards ownership and control. As noted above, the establishment of UK subsidiaries could have tax and industrial relations consequences.

5) *National bilaterals*

If the EU and UK fail to reach any bilateral agreement, there would be massive uncertainty for the aviation industry. Ryanair's stated view that this would ground air travel between the UK and the EU, but there are too many vested interests that benefit from air transport to and from the UK for this to be a likely outcome.

The regulatory structure might fall back to the legacy bilateral agreements in place before the establishment of the single market. As the UK was the arch proponent for aviation liberalisation, most bilateral agreements were very liberal. Flying would continue, but subject to massive uncertainty, with pan-European operators like Ryanair and Wizz being restricted to services to their home markets of Ireland and Hungary from the UK.

The ownership structures of IAG's EU airlines, as well as Wizz, and Ryanair would be in question. These pan-European businesses could defend traffic rights by demerging into UK and EU businesses. Yet, with a less stable regulatory regime, the risks of establishing UK businesses would be greater, and there may be a greater need to demonstrate genuine UK ownership and control of UK AOC airlines.

6) *Comity and reciprocity*

The alternative to falling back to legacy bilaterals could be that operations continue on the basis of "comity and reciprocity", the established aeropolitical concept which allows airlines to continue trading with schedules and capacities as they have been, subject to any adjustments agreed mutually by the countries. However, this structure historically applied in the old bilateral regulatory regime. It would be uncharted territory to apply this in a multilateral market.

Compared with operational planning in the deregulated era, such a scenario would place extreme administrative burdens on both airlines and regulators.

7) *Empty skies*

Ryanair's stated view is that the failure to negotiate an EU-UK agreement would ground air travel between the UK and the EU, and one echoed disturbingly by the UK Chancellor of the Exchequer. However unlikely, this (temporary) outcome cannot be excluded with absolute certainty.

BREXIT AND LCC ZONES OF UNCERTAINTY

Seats millions 2017 est	Ryanair Ireland (EU)	easyJet UK	Norwegian Norway (EEA)	Vueling Spain (EU)	Wizz Hungary (EU)	TOTAL
Home base to/from UK	8.2	na	1.1	2.0	1.0	12.3
Europe to/from UK	40.9	39.4	3.5	1.0	7.0	91.8
UK Domestic	1.6	9.2	na	na	na	10.8
Other to/from UK	0.4	1.5	1.2	na	0.1	3.2
Within Europe International	62.1	28.7	24.9	30.1	20.2	166.0
Within Europe Intra-country	24.0	7.8	5.3	0.8	0.3	38.2
Other to/from Europe	3.1	1.0	2.2	1.3	2.5	10.2
TOTAL	**140.3**	**87.6**	**38.3**	**35.2**	**31.1**	**332.5**
UNCERTAIN ZONE	**51.1**	**78.4**	**5.8**	**3.1**	**8.2**	**146.5**
% of total seats						
Home base to/from UK	6%		3%	6%	3%	4%
Europe to/from UK	29%	45%	9%	3%	23%	28%
UK Domestic	1%	10%				3%
Other to/from UK	0.3%	2%	3%		0.4%	1%
Within Europe International	44%	33%	65%	85%	65%	50%
Within Europe Intra-country	17%	9%	14%	2%	1%	11%
Other to/from Europe	2%	1%	6%	4%	8%	3%
TOTAL	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**
UNCERTAIN ZONE	**36%**	**90%**	**15%**	**9%**	**26%**	**44%**

Source: Aviation Strategy

Brexit: Quantifying the Zones of Uncertainty

These tables represent Aviation Strategy's attempt to highlight the impact of Brexit on airlines (LCCs only) and market segments (measured in terms of total scheduled seats in 2017).

First some geographical definitions: Home base means country where the airline is legally established; Europe now means EU 27 (minus UK) plus EEA (Norway, Switzerland, Iceland); Others mean countries outside Europe (US, Egypt, Israel, Russia, etc); Europe International means, for example, Ryanair flying Brussels-Athens (so-called 7th Freedom); Europe Intra-country means, for example, easyJet flying Milan-Rome (9th Freedom or Cabotage); and UK still means GB and N. Ireland (though NI may possibly end up as a special EU zone)

Uncertainty comes in various degrees, but is likely that close of half of the LCC business, which has depended on the Single European Market, will face some form of disruption; in the tables the affected segments are marked in red.

It is hoped that operations from the home country bases of the LCCs and the UK, as well as other European countries will revert, under Comity or some another negotiated arrangement, to liberal Bilaterals on Brexit day (and Ryanair's intra-UK flights will continue); but there are no guarantees and, if this doesn't happen, the very worst fears about Brexit will be realised.

UK-Europe operations where the LCCs fly between the UK and a third European country is a major area of uncertainty, impacting in particular Ryanair (29% of capacity) and Wizz (23%), as these traffic rights currently depend on the Single Market. Some 45% of easyJet's capacity is between the UK and European countries — these routes may well be secure but again there is no new regulatory framework ready to replace the Single Market.

Norwegian's business model partly depends on a smooth transition from US-EU open skies to a new US-EU plus UK regime; only 3% of Norwegian's seat capacity but a much larger proportion of its revenues.

The EU/EAA LCCs do not have to worry about their other intra-European and ex-European operations, but easyJet does. Another 45% of its capacity is within this zone of uncertainty, and 9% is Cabotage, the most vulnerable segment of all.

easyJet has a mitigation strategy in place through the use of multiple AOCs — it has a Swiss AOC (as the result of buying TEA many years ago) and has obtained an Austrian AOC to maintain EU status. Ryanair and Wizz are applying for UK AOCs. However, there are then issues of beneficial control in the new AOC countries, and lots of opportunities for the Euro-Majors to frustrate the LCCs' plans.

Michael O'Leary is fully justified in his exasperation with Brexit. In fact, he is being quite restrained.

Traditional charter AIT declines, LCC AIT rises?

THE FUNDAMENTAL decline in the traditional All-Inclusive Tour (AIT, which combines holiday accommodation and charter capacity) is continuing apace — but the big two European tour operators are trying to compensate by offering "differentiated" holidays with higher margins. How are they doing?

Available data clearly shows that the decline in traditional package holidays that began in the early 2000s shows absolutely no sign of halting. As can be seen in the chart below, total charter passengers out of the UK yet fell again last year — for the 15th year in a row — and the 2016 total of 15.2m is well under half the 2001 figure of 34.5m charter passengers. And the fall is set to continue in 2017 — in the crucial summer months of July and August, UK charter passengers were a substantial 17.1% down on passengers flown in July and August 2016.

As further evidence, in terms of the split of scheduled versus non-scheduled capacity offered by UK airlines (see chart on the facing page), non-scheduled ASKs also dropped yet again in 2016, to 10.5% — its lowest ever proportion — and is substantially down on the 37% that non-scheduled ASKs represented in 1989.

Internet power

As we have argued for years (see *Aviation Strategy,* June 2016, for our last analysis), the structural decline is relentless, thanks to the internet essentially destroying the legacy utility of the AIT by allowing anyone to research, build and book their own holiday packages of accommodation, flights, care hire (etc) from multiple suppliers online very easily.

High-street travel agencies that used to be as ubiquitous in the 1970s and 1980s as charity and mobile phone shops are today, have effectively been disintermediated — although of course there is a dwindling proportion of the population who still frequent these places for one reason or another (mostly an inability to use the internet, or a lack of time).

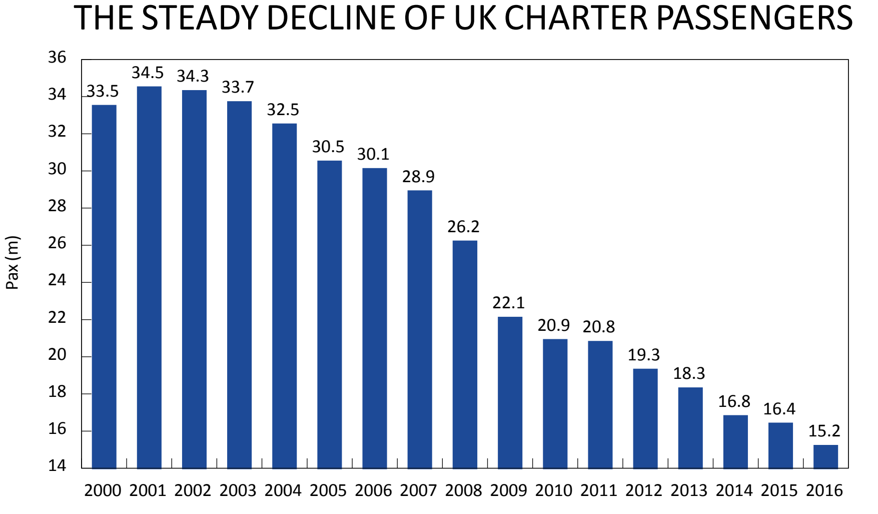
That remaining AIT-loving population is the fuel that keeps the two remaining behemoths of the European AIT industry — TUI and the Thomas Cook Group — going. Clearly though, with a structural decline in the traditional charter holiday business model, these two companies have been diversifying furiously and trying to build up "differentiated" holiday experiences and services that are harder to replicate online, and which (theoretically) have higher margins than the mass market package holidays of old.

The good news is that — after slow starts — both AIT giants are starting to reap the rewards of this upmarket strategy (which increases average revenue per customer); they also benefit from having multiple source markets (ie not just the declining UK market).

TUI turns the corner

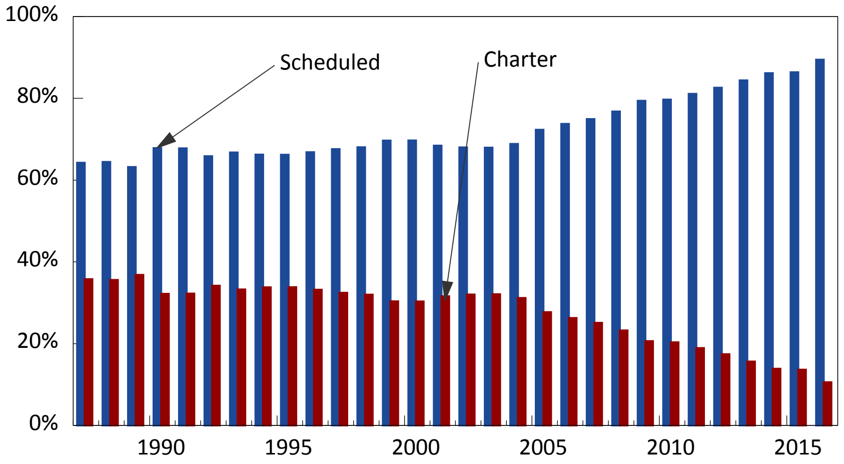
In order to survive structural decline in the AIT market, TUI AG (the Hannover-based travel and shipping conglomerate) and UK-based TUI Travel (itself a merger of TUI AG's travel assets with UK-based tour operator First Choice in 2007) merged in December 2014 to become the world's largest integrated tour operator/tourism business.

The "new" TUI Group's strat-



Source: UK CAA

CAPACITY OF UK AIRLINES (% of ASKs)



Source: UK CAA

egy was clear — to become a globally-scaled, integrated vertical business in the AIT market, and move upmarket into more-defendable, higher margin segments (such as long-haul and cruises) with "exclusive content" — whether holiday packages, hotels or cruises

Excluding discontinued operations, in the 2015/16 financial year (ending 30 September), revenue fell 1.9% year-on-year to €17.2bn but EBITA was up 13% to €898m and net profit was up 14.1% to €465m. In the first three-quarters of its 2016/17 financial year — the nine-month period to end June 2017 — the TUI Group's revenue was €11.1bn (7.1% higher year-on-year), the EBITA loss was €52m (compared with a €104m loss in the first nine months of the previous year) and the net loss for continuing operations was €85m (-€271m a year earlier). However, note that northern hemisphere tour operators typically make a loss in all but the summer season. The group gives guidance of a 10% rise in EBITA in the latest financial year (the 12 months ending September 30th 2017).

As can be seen in the table below, the critical summer 2017 holiday season has generally been good for TUI, although the large UK source market has been flat year-on-year in terms of passengers. However, average selling prices (ASPs) have increased, which is a confirmation that the more upmarket mix of AITs offered is proving popular with the rump of customers left in this market.

Elsewhere in Europe, increased ASPs have also been accompanied by a rise in the volume of passengers, thereby accelerating the growth in revenue.

Fleet overcomplexity

The TUI Group fleet currently stands at 152 aircraft (see table on the following page), and they carry around 13m passengers a year to more than 180 destinations around the world.

TUI Group currently has 56 aircraft on firm order, including 51 737MAXs, with five arriving in the 2017/18 financial year, 18 in FY2019, 15 in FY2020 and 13 in FY2021. The remaining orders are for 787-9s (one arriving in the remainder of FY2017, two in FY2018 and two in FY2020). TUI also has options for a further seven 737MAxs and a single 787-9, all of which are slated for FY2021 delivery if confirmed.

The aircraft operate within six core airlines, the largest of which is Luton-based TUI Airways, which has 62 aircraft including 33 737-800s, 14 757s, 11 787s and four 767s. It formally owns the group's future orders, and the growing 787 fleet is the key driver behind the parent company's expansion of long-haul AIT revenue. At TUI Airways the 787s will also replace 757s, which will be phased out by 2021.

The next largest carrier is TUIfly, based at Hannover airport and which operates four 737-700s and 27 737-800s. Completing the Group airlines are TUI Airlines Belgium (based in

TUI SUMMER 2017 BOOKINGS

	Change on summer 2016		
	Average selling price	**Customers**	**Revenue**
UK	7%	Flat	7%
UK *including Thomson Cruise*	8%	1%	9%
Nordics	9%	5%	14%
Germany	3%	3%	6%
Benelux	2%	4%	7%
Total	**4%**	**3%**	**8%**

Note: As at Sep 24th compared with figures at the same date a year earlier.

TUI GROUP FLEET

	Corsair	TUI Airways Fleet	TUI Airways *(Orders)*	TUIfly	TUI Airlines Belgium	TUI Airlines Netherlands	TUIfly Nordic	Total Fleet	Total *(Orders)*
A320					1			**1**	
A330	4							**4**	
A340	1							**1**	
737-400									
737-700				4	6			**10**	
737-800		33		27	18	8	5	**91**	
737 MAX			*(70)*						*(70)*
747-400	3							**3**	
757-200		14						**14**	
767-300ER		4			1	2	1	**8**	
787-8		9			1	3		**13**	
787-9		2	*(4)*					**2**	*(4)*
ERJ-190					4			**4**	
Total	**8**	**62**	***(74)***	**31**	**31**	**13**	**6**	**151**	***(74)***
Average age	17.1	9.1		9.1	8.6	9.1	10.1	9.4	

Brussels and previously known as Jetairfly until October 2016) with two A320s, six 737-700s, 18 737-800s, one 767, one 787 and four ERJ-190s; TUI Airlines Netherlands (Schiphol) with eight 737-800s, two 767s and three 787s; and TUIfly Nordic (Stockholm) with five 737-800s and a single 767.

The group also includes Orly-based Corsair International, with four A330s, one A340 and three 747s, which operates scheduled and charter routes to destinations in the Africa and the Americas, but which the Group still has not disposed of despite frantic efforts to offload the loss-making carrier.

As ever, even after ignoring Corsair, the five constituent airlines still contain seven different models, so the group's effort to reduce the number of variants is progressing painfully slowly. At the time of the merger in 2014 management also vowed that the multiple airlines would be re-branded under one TUI airline brand, but this process took far longer than ideal, with the largest airline — UK's Thomson Airways — only changing its name to TUI Airways in October this year.

Thomas Cook still behind

The other major European AIT company, Thomas Cook, has also embarked on a major strategic effort to differentiate its products, improve margins and offer (according to Peter Fankhauser, group chief executive) a "modern package and flight offer".

It's fair to say though that Thomas Cook reacted to the structural changes of the AIT market later than the TUI Group, and as a result the group's results are significantly behind those of its key rival.

In its last full financial year — 2015/16 (ending 30 September) — Thomas Cook's revenue fell by 0.3% compared to 2014/15, to £7.8bn, with EBIT down 2.8% to £205m and net profit down by 52.6%, to £9m. In the third quarter of 2016/17 (the three months to end June 2017), the group's revenue increased to £2.3bn (22.8% up year-on-year) while EBIT was £6m, compared with an EBIT loss of £25% in Q3 of the previous year.

But like its rival, Thomas Cook has had a good summer 2017 season (see table on the next page), although pressure in the UK market meant that AIT price rises were not possible

THOMAS COOK SUMMER 2017 BOOKINGS

	Change on summer 2016: Average selling price	Change on summer 2016: Bookings
UK	Flat	8%
Continental Europe	3%	13%
Northern Europe	4%	5%
Airlines Germany (Condor)	Flat	12%
Total	**1%**	**11%**

Note: As at Sep 16th compared with figures at the same date a year earlier.

THOMAS COOK GROUP FLEET

	Thomas Cook Airlines				
	(UK)	Belgium	Scandinavia	Condor	Total
A320	5	5		11	**21**
A321	24		8	8	**40**
A330	8		4		**12**
737-300	1				**1**
757-300	5			10	**15**
767-300	2			16	**18**
Total	**45**	**5**	**12**	**45**	**107**

(which effectively means a price cut, once inflation is taken into account — and the decline of sterling against the Euro has significantly increased costs for the major parts of the AIT product that are bought outside the UK, such as hotel capacity). The picture is better in all other European source markets other than Northern Europe, where a rise in bookings of 5% this summer was behind the UK rate.

Like TUI, the fleet is still overly-complicated at Thomas Cook, with four carriers operating a total fleet of 107 aircraft in six different models.

The marquee brand is Thomas Cook Airlines, based in Manchester and which has a 45-strong fleet that comprises five A320s, 24 A321s, eight A330s, one 737-300, five 757s and two 767s. Based at Frankfurt is Condor, which operates 11 A320s, eight A321s, 10 757s and 16 767s, while the other group airlines are Copenhagen-based Thomas Cook Airlines Scandinavia (eight A321s and four A330s), and Brussels' Thomas Cook Airlines Belgium (five A320s).

LCC AITs

What both TUI and Thomas Cook are struggling to achieve is make their legacy charter airlines become one single-branded, low cost carrier operation that can provide cheap seat capacity for their AIT operations.

That hasn't gone unnoticed by the LCCs, who have benefited significantly from the trend of consumers to assemble their own packages, and it's no surprise that the LCCs are also now launching their own tour operator subsidiaries to complete a pincer movement on the remaining charter tour operators.

easyJet Holiday was launched in 2011 before partnering with TUI's Hotelopia in 2014 to sell package holidays across multiple European markets. Ryanair was late to the game, but in December 2016 launched Ryanair Holidays across Europe in partnership with Spanish tour operator Logitravel and hotel room provider World2Mee.

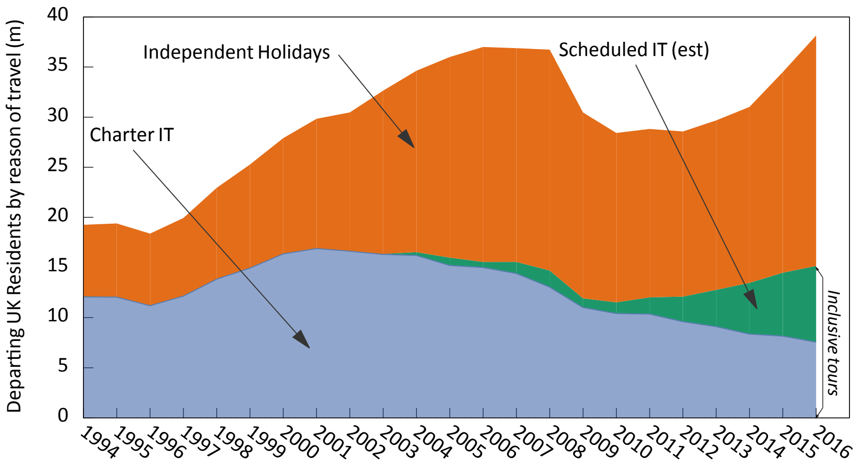
Elsewhere, Jet2.com is an LCC based at Leeds Bradford airport in the UK that dates back to 1983 and today is owned by the Dart Group, a British aviation services and distribution company. It launched Jet2holidays in 2007 and has now became the UK's third largest tour operator.

It currently operates 74 aircraft — including one A321, one A330, 20 737-300s, 41 737-800s and 11 757s. The fleet has an average age of more than 17 years, and the airline has a further 18 737-800s on outstanding order to replace the 737-300s, which have an average age of more than 25 years.

Jet2.com's aircraft operate to almost 60 destinations across Europe from Leeds Bradford and 10 operating bases, including Alicante, with operations at Birmingham and London Stansted (its first base in southern England) launching in March 2017. Stansted will be the base for Jet2.com's first non-European route, to New York Newark that will start in November and utilise the airline's single A330.

As can be seen in the chart on

UK HOLIDAYS BY AIR

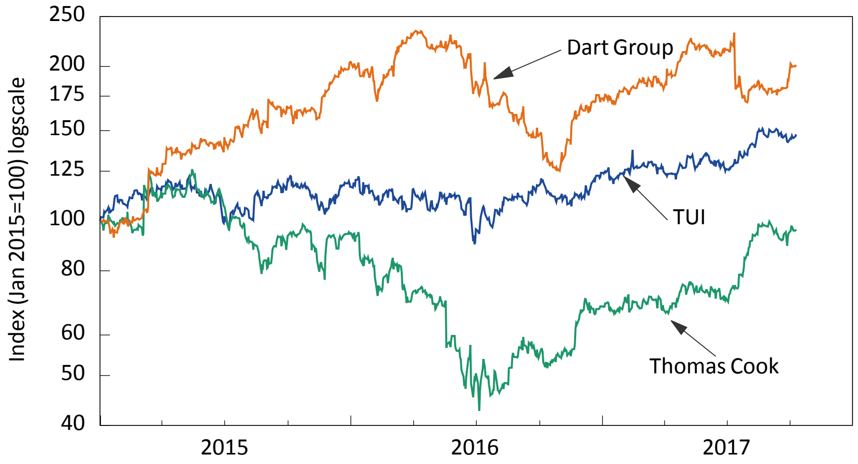


Source: UK ONS International Passenger Survey. Aviation Strategy analysis.

JET2.COM FLEET

	In service	Orders
A321	1	
A330	1	
737-300	20	
737-800	41	(18)
757-200	11	
Total	**74**	**(18)**

SHARE PRICE PERFORMANCE



the preceding page, AITs that use scheduled rather than charter capacity are rapidly growing, and are likely to overtake the dwindling volume of charter package holidays very soon. Whether scheduled AITs will provide enough utility to survive against "self-assembly" by consumers in the long-term remains to be seen, but in the short-term the LCCs will use the model to put even greater pressure on the charter operators.

Monarch decapitated

Meanwhile former UK charter carrier Monarch Airlines has now been put out of its misery and gone bankrupt. Based at London Luton airport and in existence since 1968, it struggled for many years before being acquired by London-based Greybull Capital in October 2014, just hours before its licence with the CAA expired.

Monarch operated a fleet of 10 A320s, 25 A321s and a single 737-800 to more than 40 leisure destinations. In 2014 (just a few days after the change of ownership) Monarch placed an order for 30 737 MAX-8s (plus options for a 15 more aircraft), for delivery from 2018 to 2020; in total Monarch's order book stood at 32 737 MAXs and seven 757s.

MONARCH AIRLINES FLEET

	In service	Orders
A320	9	
A321	25	
737-800	1	
737 MAX 8		45
Total	35	45

The airline's turnaround strategy was based on clearing out older models in its fleet at the time (such as the A330 and the 757) — which it had done — and eventually becoming a 737 MAX 8 specialist. It adopted an LCC model, though still provided significant seat capacity for its own UK outbound tour operation.

However, in 2016 Monarch requested a 12-day Atol licence extension from the UK CAA while it looked for emergency funding. The company survived that crisis, but ran short of cash again at the end of September this year. The administrators hope that the 4% of slots that Monarch represented at Gatwick may have some value. The rest of the industry hopes that its demise will provide potential for better financial returns.

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