Article by Tim Coombs, MD of Aviation Economics, part of RDC Aviation Economics
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Brexit Impact on Airlines and Airports

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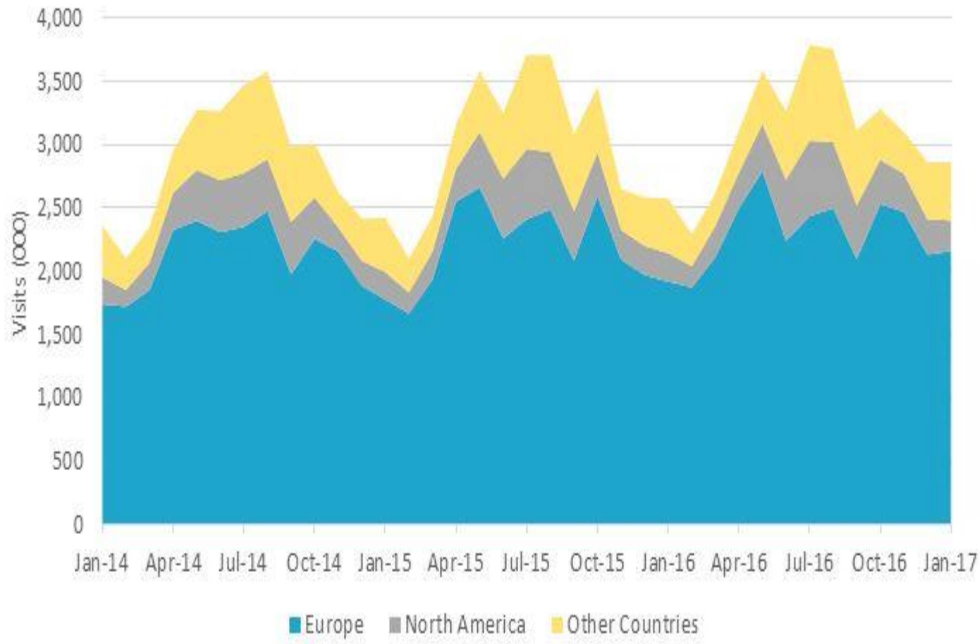
It would seem a "no brainer". Just allow the current aviation agreements to continue as is, with the UK to retain full membership of the European Common Aviation Area (ECAA), once the UK has "Brexited". Surely common sense will prevail? After all, there are huge mutual benefits of barrier-free travel between the UK and Europe today, and these benefits are acknowledged by virtually all stakeholders on either side of the Channel.

The Economics

Just considering visitors, by all modes of transport, data from the Office for National Statistics (ONS) shows the imbalance between UK visitors to Europe and European visitors to the UK. The chart below shows that European visitors account for by far the most overseas visitors to the UK, 74% in calendar year 2016.

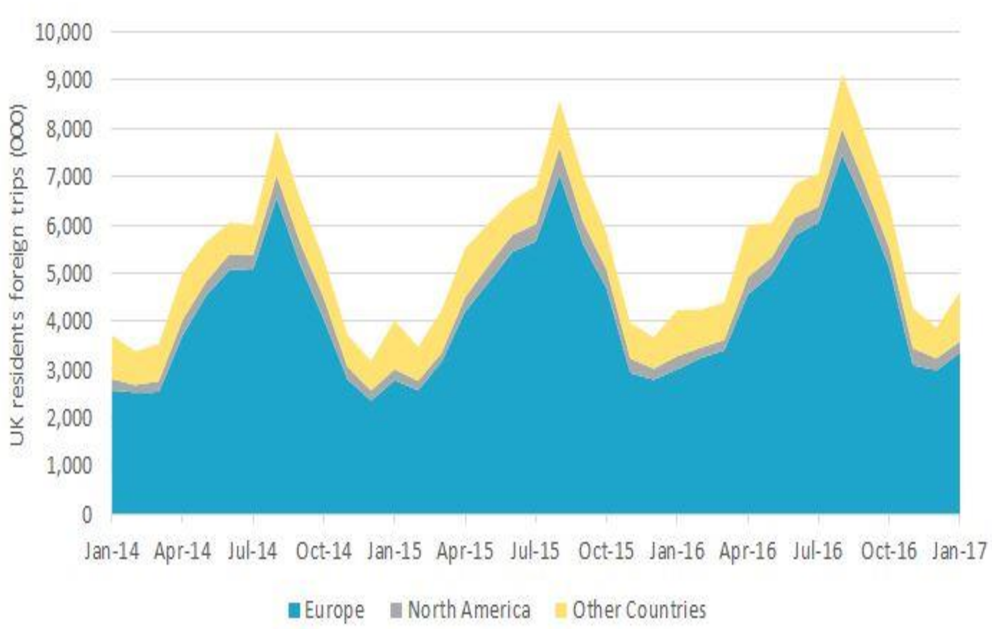
Foreign visits to the UK by month



Source: International Passenger Survey (IPS) – Office for National Statistics

The chart below shows UK visits to Europe and other destinations, with the wider European market (EU and non-EU) being by far the most popular destination accounting for 80% of all UK visits in calendar year 2016.

UK residents' foreign trips by month

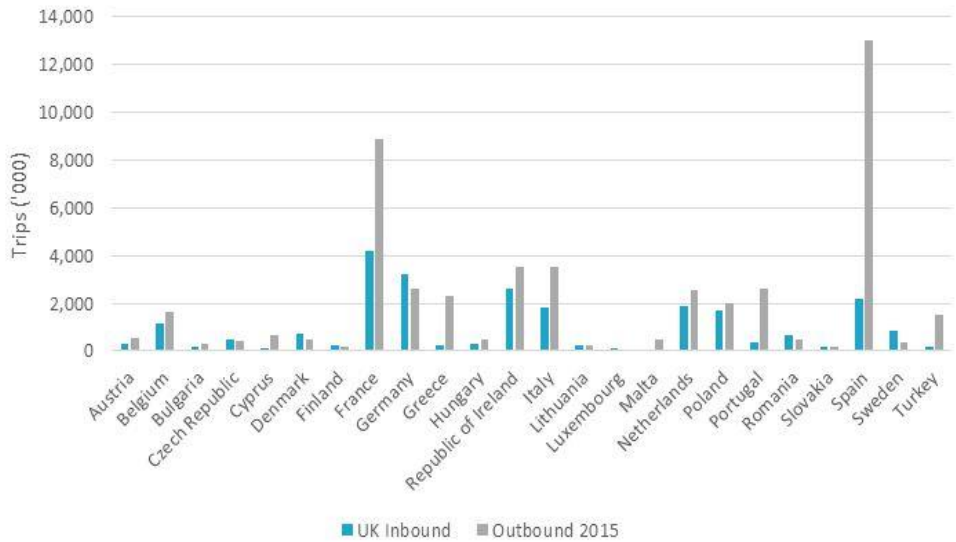


Source: International Passenger Survey (IPS) – Office for National Statistics

For calendar year 2016, there were 56.1m visits to all European countries by UK citizens, and 27.6m visits by European citizens to the UK, a net imbalance of 28.5m visits. This of course translates into spending as well where the ONS estimate that UK citizens spending is £615 per visit to all countries (the data is not split by geographic region) with foreign visitors spending £594 per visit. This equates to UK citizens spending £34.5bn overseas in 2016 compared to £16.4b of spend from inbound European visitors – a net deficit of £18.1bn.

The data can be split down by EU countries only, with the exception of Croatia, Latvia and Slovenia which are not separately split out in the ONS data. From the graph below it can be seen that the UK has a trip surplus with just seven EU member states of the 24 EU member states where ONS data is available: the Czech Republic, Denmark, Finland, Germany, Lithuania, Luxembourg, Romania, Slovakia and Sweden.

UK inbound and outbound trips (2015)



Source: International Passenger Survey (IPS) – Office for National Statistics
In total for calendar year 2015, there are 49.1 m UK outbound trips to the 24 EU countries the ONS has data for and 24.2m inbound trips from these 24 EU countries to the UK.

The economics are therefore clear, the EU benefits considerably from UK visitors, and having an ECAA has been vital to this providing ease of cheap affordable travel with intense competition between airlines.

What may happen?

Trying to second guess what the outcome will be however, is almost impossible. Whereas the economic argument is straightforward, it is politicians and their civil servants that will decide how the UK interacts with the EU in the future.
As Article 50 has now been triggered, and the EU and the UK have two years (or a longer period if agreed) to negotiate the terms of a withdrawal before Brexit takes effect. There seems no doubt that as a member of the EU, the UK has benefited from the internal market for air transport and from air traffic rights negotiated at the EU level with third party countries such as the United States under the EU-US Open Skies Agreement.

Questions therefore arise as to whether the UK would continue to benefit from those arrangements if the UK leaves the EU. Similarly EU or other non-UK airlines who operate to the UK via air traffic rights negotiated at EU level will also need to consider whether those rights would be retained following Brexit.
It should be no surprise that UK-based airlines are clamouring to be at the front of the queue when negotiations over Brexit begin in earnest. Meetings have been

taking place between EU officials and airlines in recent weeks in a bid to flesh out the issues that need to be tackled for the travel sector.

There has been mounting concern from the airline industry that it could be hobbled if discussions between the UK and the EU turn acrimonious. The issue of Brexit is particularly acute for the airline industry given existing agreements allow companies to fly between the UK and EU - as well as between mainland European countries - and these will need be renegotiated before the UK formally exits the bloc.

Traffic rights and Airport Access

At present the UK is a member of the ECAA, which includes all the EU states plus some others, including Norway, Iceland and the non-EU Balkan states. Any airline predominantly owned by people or companies based in a member state is free to operate anywhere within the ECAA, without any restriction as to frequency, capacity, and so on. At present, both easyJet and British Airways are considered as UK-owned airlines and therefore enjoy the full freedoms provided by the ECAA. easyJet, in particular, has made full use of this freedom setting up bases across Europe.

When the UK leaves the EU, without special arrangements, the UK's membership of the ECAA will lapse and these airlines will lose all their automatic rights to operate to, from and within the ECAA. Furthermore, their rights will also lapse on routes that are now governed by agreements between the third-party country and the EU (such as the EU-US "Open Skies" agreement). It is important to note that these rights are reciprocal, and therefore US and other ECAA carriers would lose their automatic rights to fly to the UK.

Consider transatlantic traffic rights. The UK could try to remain a participant in the EU-US Open Skies agreement, as Norway is. Alternatively the UK could seek to negotiate a new bilateral deal. But it is reasonable to suppose that both the EU and the US would seek to drive a hard bargain. And unless the UK can find a way of remaining in the ECAA, the future will see the UK negotiating on a one-on-one basis rather than as part of a trading block of 500 million people.

One of the major challenges that will face the UK in re-negotiating traffic rights is the capacity squeeze in London. Whether the regulators like it or not, Heathrow is internationally acknowledged as the primary airport for London and the airport of choice for intercontinental air services. If we look at what happened when the UK-US moved to an open skies environment back in 2006, all of the US carriers that had previously been barred from Heathrow under the Bermuda II agreement switched services from Gatwick to the more lucrative Heathrow. In the proceeding decade, Heathrow has become so capacity constrained that there are now barely any available slots throughout the year. Gatwick is also operating close to maximum capacity and would struggle to accommodate a substantial amount of additional traffic; City Airport is unable to accept any widebody aircraft types; whilst Luton and Stansted are steadfastly LCC-focussed airports lacking the facilities to interest global long-haul airlines. All of this means that when attempting to negotiate new bilaterals, the UK government has its hands tied in offering access to London, weakening its ability to bring in new air services to connect the country to non-EU nations.

One further complication is that the EU Open Skies agreement, is overseen by the European Court of Justice, but Prime Minister Theresa May wants Britain to be unencumbered by ECJ rulings.
I recently attended an Aviation Club lunch where the speaker was the KLM Chief Executive Officer Pieter Elbers. He said that KLM said it favours a "liberal" Brexit deal that would maintain maximum access for U.K. and continental airlines. KLM is perhaps more exposed than any other continental European airline to the impact of Brexit. Britain is the carrier's second-biggest market with 6 million annual seats on flights to 17 airports.

Elbers said "The delicate balance we need to find here is how we keep the European philosophy alive and yet not create a situation which is going to be bad for business." When asked by an IAG attendee at the lunch, what KLM was doing to safeguard Britain's position in the aviation market, Elbers said that KLM was in discussions with Dutch authorities including "mapping what could be possible scenarios and possible ways to go forward."

The simple question will be whether Britain will join the European Common Aviation Area, or sign a UK/EU agreement, or perhaps have to resort to bilateral agreements of the type it last had with the Netherlands in the 1960s.

Taxation and Airline Profitability

If it comes down to the UK re-negotiating new bilateral agreements, the issue around tax may become a factor. In a report published by the British Air Transport Association (BATA) in March 2016 "Flying high? How competitive is Air Passenger Duty?", the high level of UK aviation taxes is highlighted. The report states that:

"UK Air Passenger Duty is the highest aviation tax levied on passengers departing from airports in the EU, Norway and Switzerland (collectively EU28+2) for both short-haul (Band A equivalent) and long-haul (Band B equivalent) journeys in all classes. UK APD is significantly higher than comparable taxes applicable elsewhere in Europe. It is more than three times the rate in France, more than twice the rate in Germany, and nearly twice the rate in Italy. The UK has the highest tax for long-haul destinations for travel in any class, whereas it has the 61st and 27th highest tax for short-haul destinations for travel in economy and higher classes, respectively."

With the post-Brexit focus on the UK looking to take the opportunity to increase trade with countries outside of the EU, it seems perhaps there is some anachronism that APD charges (particularly on long-haul business class fares) are so high. Couple that with the airport capacity constraints highlighted above, it may seem that the next Government may want to consider the levels of APD, though one suspects the UK Treasury will want to hold steadfast on a tax that raises over £3bn per annum.

From other pieces published on our website, using data from our Apex Profitability module, we have highlighted data that shows the UK is falling in terms of profitability for LCCs. The fall in value of Sterling has adversely impacted the revenues earned by non-UK based airlines on their UK routes and for UK based airlines, though UK revenues are not impacted, and non-Sterling revenues enhanced, UK airlines are adversely impacted by the higher US dollar costs for fuel and aircraft ownership.

The table below shows data from Apex showing average one way departing intra-EU fares for 2016 from a sample of 35 European countries, for both the gross fare and the net fare after APD and other government taxes.

Average one way departing intra-EU fares for 2016

Departing country	Gross fare	Rank	Net fare after Government tax	Rank
Croatia	€ 124.99	1st	€ 123.62	1st
Cyprus	€ 123.29	2nd	€ 123.29	2nd
Austria	€ 115.30	3rd	€ 108.30	3rd
Finland	€ 98.60	4th	€ 97.40	4th
Malta	€ 91.86	5th	€ 91.86	5th
Greece	€ 91.84	6th	€ 79.84	10th
Republic of Moldova	€ 90.29	7th	€ 90.29	6th
Portugal	€ 89.94	8th	€ 89.94	7th
Spain and Canary Islands	€ 89.39	9th	€ 88.80	8th
Germany	€ 89.19	10th	€ 75.71	12th
Switzerland	€ 83.41	11th	€ 83.41	9th
Norway	€ 80.02	12th	€ 74.88	14th
Montenegro	€ 75.98	13th	€ 75.98	11th
United Kingdom	€ 75.37	14th	€ 59.69	26th
Czech Republic	€ 75.17	15th	€ 75.17	13th
Denmark	€ 73.55	16th	€ 72.77	15th
Slovenia	€ 72.58	17th	€ 72.58	16th
Sweden	€ 71.50	18th	€ 67.05	21st
Romania	€ 70.82	19th	€ 70.82	17th
Estonia	€ 70.58	20th	€ 70.58	18th
France	€ 70.46	21st	€ 53.64	27th
Netherlands	€ 70.36	22nd	€ 70.36	19th
Bulgaria	€ 69.33	23rd	€ 69.33	20th
Hungary	€ 67.00	24th	€ 67.00	22nd
Bosnia and Herzegovina	€ 66.83	25th	€ 51.72	30th
Serbia	€ 65.92	26th	€ 64.94	23rd
Ireland	€ 62.84	27th	€ 62.84	24th
Italy	€ 61.57	28th	€ 53.19	28th
Macedonia	€ 61.31	29th	€ 61.31	25th
Luxembourg	€ 52.63	30th	€ 52.63	29th
Lithuania	€ 51.45	31st	€ 51.45	31st
Latvia	€ 51.15	32nd	€ 51.15	32nd
Slovakia	€ 45.96	33rd	€ 45.96	33rd
Poland	€ 45.48	34th	€ 45.48	34th
Belgium	€ 44.73	35th	€ 44.65	35th

Source: rdcapex.com

So while the UK market looks strong versus some other markets, once APD has been taken into account, average fare levels look less attractive, especially considering the Sterling devaluation impact for non-UK based airlines. The UK ranks 14th in terms of gross fares in this sample, but only 26th in terms of net fares. It seems likely that for some regional airports the threat of losing routes would seem a strong possibility if airlines are struggling to make profits in the UK market.

Opinions on what will be the final outcome of Brexit vary widely.

ACI Europe

ACI Europe Director Jankovec said recently that "As responsible businesses, at this stage we simply cannot rule out a cliff-edged scenario for Brexit and aviation. The potential impact of this on air connectivity, consumers and the wider economy needs to be addressed by Brexit negotiators - on both sides. This means that adequate contingencies need to be established promptly in case the UK would exit the EU without any agreement on its future relationship with the bloc."

As previously stated, the economic case to ensure the status quo is strong. ACI Europe figures show 53.5% of passengers handled by UK airports were flying to or from the 27 EU member states while more than one in 10 passengers handled by its EU airports are flying to or from the UK. Nearly 40% of Ireland's air traffic comes from the UK while the figure is 33% for the Slovak Republic, 31% for Malta, 20% for Poland and 17% for Spain.

easyJet

easyJet is often viewed as the airline most exposed to a hard Brexit because it is based in the UK and has only a UK and a Swiss air operator certificate, or AOC. To fly between EU states post-Brexit, it is likely to need another AOC, (because Switzerland is not a member of the EU), and the carrier has stated it has plans to put this in place.

Just weeks after the EU referendum in June easyJet said it was in the process of applying for an EU AOC, which should be enough to allow it to operate intra-European flights after March 2019.

Whilst currently only EU-owned airlines can operate flights within the EU - this means that 50.1% of shareholders must be based in Europe, there is some flexibility to this geographic limit. For example Norwegian Air is based in Norway, and therefore outside the EU can operate intra-EU services as Norway is a member of the European Economic Area, which includes all EU countries as well as Iceland, Liechtenstein and Norway, and allows the three latter nations to be part of the EU's single market.

It appears increasingly unlikely that the UK will be a member of single market after Brexit.
At least for an airline such as easyJet in terms of a new ownership and control structure, i.e. having multiple AOCs and operating companies – is the same as that of Air France-KLM, and therefore unlikely to be challenged successfully.

Ryanair

The doom-mongers include Ryanair. The LCC has warned that Britain could be left "without flights" to the EU without certainty on flying rights. Of course Ryanair remains an EU company once Brexit is finalised, and therefore can continue to operate flights between EU states. However the UK is an important market for the airline accounting for 36.6% of its total seat capacity in summer 2017 according to OAG data within our Apex product, and so it will be hoping for the existing regulations to be replicated to ensure barrier-free flying between Britain and the EU. If this does not happen and the existing EU Open Skies policy is not replicated, it will probably need to apply for a domestic UK AOC to fly its intra-UK routes.

A potential issue for Ryanair is the make-up of its shareholders, over half of which must be in the EU for it to operate as an EU carrier. With much of the stock held by UK institutional investors, once the UK leaves the EU, the percentage of EU-based owners could drop below the 50% level. To overcome this, fund managers can switch ownership from their UK-domiciled retail funds, known as Oeics or unit trusts, into either Irish or Luxembourg-based equivalents, known as Sicavs.

Ryanair is expecting to begin looking at measures such as UK air operator's certificate requirements within the next year, to prepare for a possible unfavourable outcome from UK-EU negotiations. Ryanair argues that the best result would be continued membership of the 'open skies' partnership in which the UK currently participates with Europe, and that a failed negotiation and adoption of a World Trade Organisation structure would be the worst.
Ryanair says that while there is no immediate threat to air traffic, there is a "distinct possibility" that flights between the UK and Europe would have to be suspended for a period after the negotiation deadline expires in March 2019 – adding that airlines have long seasonal lead times and will need to prepare ahead of this date. Ryanair has urged the UK government to provide clarity on flying rights in time for the airline to finalise its 2019 summer schedule next year.

IAG
As British Airways does not fly any intra-continental routes it should not be impacted if the UK fails to remain a member of the ECAA after March 2019. Furthermore, IAG's other airlines include the two Spanish-based airlines Iberia and Vueling, as well as Ireland-based Aer Lingus, meaning the wider group already possesses permission to fly within Europe.

As for ownership, IAG is the listed entity and trades on both the London Stock Exchange and Madrid Bourse thanks to its Spanish registered office. The company has declined to provide a breakdown by nationality of its shareholders but it said it would comply with EU regulations.
Qatar Airways owns 20% of IAG, but it does so via its Luxembourg-based company, something that is likely to help it maintain the necessary 50.1% ownership by EU-based investors to continue its operations.

British Airways chief executive Alex Cruz has dismissed concerns about the impact of Brexit on flying rights saying "We'll have no problem. We're not discouraged. The complexity of the Brexit process is large. But we'll go through all the regulatory hurdles to ensure BA can go on flying all over the world. I'm sure we'll have no problem from a flying rights perspective." This might be one area where being a "legacy" airline benefits British Airways in that it is the named carrier on most of the UK's pre-EU bilateral air services agreements.

UK exposure

The exposure of a select number of carriers to the UK market is shown in the table below using our in-house Apex data for summer 2017. Taking Ryanair, it can be seen that the LCC has a relatively small exposure to the UK domestic market as a percentage of their total offer, just 1.5%, but for all their flights touching the UK, Ryanair has an exposure of 36.6% as a percentage of their total summer 2017 seat offer.

Summer 2017 seat capacity by market

	UK-UK	UK-Europe	Non-UK
Ryanair	1.5%	35.1%	63.4%
easyJet	10.9%	45.6%	43.5%
Wizz Air	0.0%	28.6%	71.4%
Flybe	64.5%	35.2%	0.3%
Norwegian	0.0%	13.9%	86.1%

Source: rdcapex.com

It is perhaps interesting to note that since the Brexit vote on June 23rd, as of mid-April 2017 shares in Ryanair have risen by 12%, easyJet shares have fallen by 30%, shares in Norwegian fallen by 31%, Flybe shares down 20% and shares in Wizz have fallen by 14%.

Conclusions

For UK aviation, potentially securing its place in the ECAA or, perhaps more realistically, signing a bespoke UK/EU Agreement and replacing other EU Open Skies Agreements (most importantly with US) would seem to be a key objective for the forthcoming Brexit negotiations. This outcome is important not just to the UK but to consumers and businesses (Spanish hoteliers, Greek restaurants owners etc.) right across the EU.

The feeling at the moment from industry on the UK remaining a member of the ECAA seems to be that it is a non-starter and what the UK will be looking for is some sort of bespoke UK/EU agreement - perhaps with a transitional arrangement if needed - which provides as much of the current level of market access as possible.