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I. Introduction

On 12 February 2004 the European Commission decided that the Irish low-cost airline Ryanair received state aids at the regional airport of Charleroi (*European Commission* 2004a). These state aids are regarded as a distortion of competition among airlines, and therefore, must be repaid. They result from an agreement between the Irish airline Ryanair and BSCA (Brussels South Charleroi Airport), an airport owned and controlled by the Walloon Region. The Commission classified the special conditions, which BSCA offered to Ryanair as state aids. Especially airport taxes and fees, like landing charges, were reduced for Ryanair during a period of fifteen years, and Ryanair achieved several other financial supports, so-called one-shot incentives. In return, Ryanair committed itself in this agreement to transfer a certain amount of passengers to and from Charleroi.
The arrangement between Ryanair and BSCA must be analysed in the context of the emergence of low-cost airlines on one side and new (regional) airports on the other. These developments lead to more intensive competition both on the market for airport services and the market for air travel. Another consequence is the new kind of matching between the new low-cost airlines and the new regional airports leading to special bilateral arrangements between both.

For the Commission such arrangements, like the one between Ryanair and BSCA, require further regulation in order to ensure undistorted competition between airlines. With this precedence decision, the Commission wants to clarify the basic criteria of a general framework, within which regional airports and airlines may collaborate (*European Commission* 2004b, p. 5): (1) The airports are not allowed to charge airlines differently for airport services (principle of non-discrimination). (2) Financial support is allowed, only when it is related to the start-up of new routes. (3) Other financial support is regarded as operational aid, which is not compatible with the Common Market.

The purpose of our paper is to provide a critical analysis of the Ryanair decision and the future principles of the Commission concerning the regulation of airport services from the perspective of state aid policy. Our contention is that from an economic point of view the argumentation of the Commission has severe flaws. This leads not only to a wrong decision in the Ryanair case, but also to principles for regulating airports, which effect competition more negatively than positively. We argue that the Commission does not distinguish sufficiently between competition among airports and competition among airlines. Therefore, it misinterprets the bilateral arrangement between Ryanair and BSCA. There is evidence that the preferential treatment of Ryanair by BSCA primarily is a kind of price differentiation, which due to the particular strategic advantages of the deal with Ryanair for BSCA, is non-discriminatory and must be regarded as a *normal* result of effective competition. Since any other airline would also have received similar conditions, assuming it had offered similar advantages to BSCA, there is no distortion of competition among airlines. Nevertheless, since it is an undisputed fact that the Walloon Region has given public funds to BSCA, the real question is whether these subsidies can lead to distortion of competition among airports. Because there are also a number of economically sound regional policy reasonings that justify public funding of infrastructure like airports, this is a very difficult and complex problem, which we cannot solve in this paper. Nevertheless, our main thesis is that the Commission is wrong by deciding that Ryanair obtained state aids, which distort competition among airlines. Additionally, it does not recognize that the real problem might be whether the public funding of airports does distort competition among airports or not.

The structure of our paper is as follows: In section II, we give a short overview about the Ryanair case. Section III describes the recent developments in the aviation market as the economic background of the case. In section IV, we argue that there is no distortion of competition among airlines. Section V deals with the difficult question that the real problem might be state aids that distort competition among airports. On the basis of these reasonings, section VI presents a critical analysis of the new principles of the Commission for regulating airport charges. Some conclusions follow in section VII.

II. “Ryanair”: The Case and the Argumentation of the Commission

In 2001 Ryanair installed its first base on European mainland at Charleroi.[1] The airport of Charleroi seemed to be very attractive to Ryanair because of its close proximity to Brussels. On 6 November 2001, BSCA signed an agreement with Ryanair. After some discussion in the press the Commission received a complaint in January 2002

1 The Irish low cost airline Ryanair, founded in 1984, has operated the flight route Dublin-Charleroi since 1997, but as recently as 2001 Ryanair decided to establish its base at Charleroi after achieving an appropriate agreement with BSCA.

concerning the agreement between Ryanair and BSCA.[2] Ryanair was accused of obtaining illegal state aid at the airport in Charleroi and that this would lead to a distortion of competition among airlines. So, the Commission demanded detailed information.

In their agreement BSCA promised to grant Ryanair, under a private-law contract, a reduction of airport taxes for the period of fifteen years.[3] Furthermore, Ryanair was promised some so-called one-shot incentives,[4] and the agreement between BSCA and Ryanair contained the start up of a joint promotion and advertising enterprise. In addition, Ryanair was promised a rebate concerning ground handling services. While other airlines have to pay between 8 and 13 EUR, Ryanair has to pay 1 EUR per passenger. Lastly, the Walloon Region committed itself not to raise airport taxes and change airport regulations like opening hours and parking fees for a period of fifteen years. Otherwise, it would have to bear the losses which are imposed on Ryanair, if the Walloon Region exercises its fiscal or regulatory powers to Ryanair's disadvantage. In return, Ryanair committed itself in the agreement to base at least two (up to four) airplanes at BSCA and "operate at least three rotations per aircraft leaving Charleroi over a 15-year period. The Irish company thus provides the airport manager with airport traffic that allows it to anticipate income, either through airport taxes or through non-aeronautical activities" (*European Commission* 2004a, L 137/3). Therefore, the contract between BSCA and Ryanair includes on the one hand some advantages for Ryanair, which no other airline receives at BSCA. On the other hand, Ryanair promised a certain quantity of airport passenger traffic, leading to a better utilization of the airport than before the agreement was signed.

The Commission had doubts, whether the financial support for Ryanair would be compatible with the Common Market. It regarded the above mentioned measures, which favour Ryanair, as state aids. State aids are public policy measures, which fulfill some criteria, established by the Commission and the European Court of Justice (e.g. *Bacon*

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2 The management of the competing Brussels Airport Zaventem claimed that *unjustified* support was granted to Charleroi Airport by the Walloon government (*European Commission* 2002, p. BEL-1). See also *Barrett* (2004b, p. 11).

3 See for this statement and the following statements *European Commission* (2003, C 18/3).

4 These grants include: 250,000 EUR for the accommodation and subsistence of Ryanair staff, a contribution of 160,000 EUR for each new route opened. Additionally, Ryanair should receive 768,000 EUR for the recruiting and training of staff, especially pilots, working on routes to new destinations. In addition, Ryanair should obtain a contribution of 4,000 EUR for the purchase of office equipment,

2003 pp. 54-61; *Wishlade* 2003, pp. 3-18; *Gröteke* and *Heine* 2004b, pp. 139f.):[5] First of all, the measure must favour undertakings in terms of an economic advantage. Secondly, this measure is granted directly or indirectly by the state or through state resources. Thirdly, the measure favours certain undertakings or sectors over others (*selectivity principle*). Fourthly, the measure distorts or threatens to distort competition among undertakings in the Common Market. The fifth criterion is that the state measure affects trade among member states.

The Commission had some problems concerning the evaluation of the case. Although Ryanair has received advantages from the publicly-owned and -controlled company BSCA compared to other airlines operating at Charleroi, the Commission asks, if BSCA has acted as a private investor. If a private investor, which is not supported through public funds, would have signed the same agreement under the same conditions, then there would be no benefit for Ryanair and thus, no state aid. Ryanair states that it receives similar advantages at privately owned airports like Stockholm-Skavsta. Therefore, it claims that the advantages offered from BSCA do not have to be regarded as state aid. Otherwise, there would be a discrimination between public and private owned airports (*European Commission* 2004a, L 137/8-10). The Commission admitted that it would be difficult in this case to apply the market investor test to BSCA "because of the complexity of its relations with the Walloon Region" (*European Commission* 2004a, L 137/11; *European Commission*, 2003, C 18/4). Nevertheless, it separated activities of BSCA from those of the Walloon Region. Consequently, the Commission did not regard BSCA as a private investor, because the expected profit of BSCA resulting from the agreement with Ryanair is either too optimistic and/or expected from hypothetical *regular* users, who do not get advantages like Ryanair. Additionally, the Commission is of the opinion that BSCA has used its status as a public enterprise, which leads to better profit expectations. Furthermore, a private investor would not take into account positive effects of such an agreement like economic development and job crea-

free use of 100 square metres office space and 100 square metres engineering stores (*European Commission* 2003, C 18/3).

5 Some commentators have divided the definition of Art. 87 (1) EC-Treaty into three state aid criteria (e.g. *Quigley* 1988, p. 242) and others into four (e.g. *Ross* 2000, p. 410). The more recent jurisprudence of European and UK courts, however, claims that the following five criteria have to be fulfilled by a state aid (*Bacon* 2003, pp. 54-55). Since these procedural rules are relevant to the aviation sector (*European Commission* 1994, C 350/5), these criteria also apply to the case of Ryanair.

tion.[6] Therefore, BSCA has not acted like a private investor and the agreement between BSCA and Ryanair cannot be regarded as a *normal* market result in the Commission's view. The advantages must be declared as state aid from the Commission's point of view, because all other state aid criteria are met: The economic advantage for Ryanair is funded through public funds. Only Ryanair and no other airline benefit from the advantage at BSCA (*selectivity principle*). The aid distorts competition between airlines and has a negative impact on intra-Community trade (*European Commission* 2004a, L 137/43-45).

The Commission's result of the assessment is differentiated: Some advantages for Ryanair specified in the agreement with BSCA are declared compatible with the Common Market and are, hence, allowed. Ryanair does not have to pay back BSCA's contribution for the financing of the joint promotion and publicity undertaking with Ryanair. Such financial support is from the Commission's viewpoint necessary for the start-up of new air routes. This aid is crucial for a better utilization of regional airports, and therefore, contributes to the aim of the Community to promote air transport. Nevertheless, certain conditions have to be met: First of all, state aids for new routes must serve as a necessary incentive. Secondly, they must be proportional to the objective pursued. Thirdly, they must be granted in a transparent manner. Fourthly, any airline opening a new route at a regional airport has to be treated equally concerning start-up support. No airline should be discriminated. Fifthly, such state aids should be accompanied by a mechanism of penalties in order to punish the benefiting airline, if it does not transfer the promised traffic-volume. Furthermore, the amount of state aids, which can be granted for the start-up of new routes, has been determined by the Commission. The aid must be of limited duration. This means five years in the case of point to point routes and not fifteen years as in the case of Ryanair, and the aid should not exceed the maximum intensity of 50% of the net start-up costs incurred.

All the other grants are incompatible with the Common Market and are, hence, not allowed. They have to be recovered. This concerns, first of all, the reduced airport charges. Because they are only granted to Ryanair, the Commission assumes that this discriminates other airlines. Only if similar reductions are granted to all airlines operat-

6 These effects can only be considered in state aid decisions, when the region around Charleroi is categorised as an assisted region.

ing at the same airport, they are compatible with the Common Market.[7] Because this condition is not met, Ryanair has to pay back the difference between usual airport charges and the preferential charges for Ryanair. Secondly, Ryanair received a preferential ground handling fee. Such reduced fees are only allowed, if the airport can prove that losses in ground handling services are compensated by revenue from other commercial airport activities.[8] After considering these revenues, there remains a loss for the airport amounting to about EUR 4 million, which has to be recovered. Thirdly, Ryanair has to refund other financial support concerning staff recruiting, training and accommodation costs etc. as long as they are not related to costs resulting from the start-up of new routes. Although it can be possible that all these so-called one-shot incentives are related to the start-up of new routes, the Commission does not take this view. In fact, these advantages are granted on a flatrate and are not related to the opening of any new route. Hence, they must be recovered. Fourthly, aid related to the route Dublin-Charleroi has to be repaid because it is not new and the start-up was in 1997, which means longer than five years ago. Thus, the application of the *start-up rule* is not possible for this route.

III. New Developments in the Aviation Markets and the Ryanair Case

In order to discuss the case of Ryanair it is very crucial to describe the general context of the decision. The general context of this case is the opening of the skies over Europe. The third step of the liberalization of the aviation market was taken in 1993 by bringing into force the third air package. Afterwards the Commission has been concerned with the promotion of this liberalization for about ten years (*European Commission* 2004a, L 137/60). Before that liberalization of the aviation market took place, there was no competition on the aviation market. Nearly everything was regulated (*Starkie* 2002, p. 64).[9] The liberalization led to the abolishment of most of the regulatory constraints on intra-EU air transport (e.g. *Graham* 1997, p. 227). Furthermore, ground handling services were liberalized and equal access to computerised reservation services was granted to all airlines (*European Commission* 2004a, L 137/60). The aviation market seemed to be highly contestable, because "it would be easy for any carrier to relo-

7 For a critical review concerning this aspect see *Soltész* (2003, pp. 1035f.).

8 Such a compensation is only allowed if the amount of passengers does not exceed 2 million.

cate aircraft and personnel so as to service a new route" (*Fridström* et al. 2004, p. 74). Nevertheless, the main obstacle to competition remains the slot[10] allocation because even today slots at most congested and central airports are allocated in accordance with the so-called *grandfather rights*. They grant an already established airline at a slot-constrained airport the "right to use a slot if it has already made use of it at the same time during the preceding equivalent season" (*Starkie* 1998, p. 112). It is obvious that this is a great barrier to entry for new entrant airlines at slot-constrained airports (*Starkie* 1998, p. 113).

An initial major development in recent years after the liberalization of the aviation market has been the emergence of low-cost airlines like Ryanair (*European Commission* 2004a, L 137/60). In contrast to established airlines these low-cost or *no frills* airlines have a new business concept and offer promotional rates, which are related to the low-cost structure of these airline. Due to their business-concept they have different demands for airport services as incumbent full-service airlines. This concerns, for example, the demand for a quick *turnaround time*.[11] Additionally, there are further demands for airport services of low-cost airlines, which differ extremely from the demand articulated by full service airlines, like the use of airbridges (low-cost airlines prefer steps) and the requirement for a quick check-in (*Barrett* 2004a, p. 37). Supply of airport services, which do not meet the demands of low-cost airlines and the existing grandfather rights, are basic problems for low-cost airlines to enter the market and to realize their business concept. In order to solve both problems, low-cost airlines are seeking to service new airports, which offer new and better perspectives (*Barrett* 2004a, p. 35).

Simultaneously, a second major development took place: so-called secondary or regional airports, including former military airports have entered the aviation market. They gain new attraction due to the fact that they are located close to established, central, and mostly congested airports. Due to free capacity there exists no comparable slot-allocation problem (*Gillen* and *Lall* 2004, p. 48). They also offer different airport services in terms of price-quality combinations, like a better turn around efficiency, than

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9 "The world of non-competing airlines was mirrored in non-competing airports." (*Barrett* 2000, p. 13).

10 A slot (start-landing-operation-time) is "the entitlement to use a runway at a particular time" (*Starkie*, 1998, p. 112).

11 This means the time between landing and the next departure of the same airplane should be very short.

established airports. Additionally, the provision of airport services complies better with the demand of low cost airlines (*Berg* and *Schmitt* 2002, p. 92; *Barrett* 2004a, pp. 35-37.). Airports, like BSCA, also clearly benefit substantially from the debut of low-cost carriers, which carry lots of passengers to the airport. This leads to a better utilization of airport capacity and raises the chances of the new international Charleroi Airport of surviving on the market (*Barrett* 2000, p. 16f.). The complementary emergence of low-cost airlines and regional airports in the aviation market is termed as a new kind of matching (*Berg* and *Schmitt* 2002, p. 92).

The Commission welcomes these new developments because they lead to a "general reduction in prices in the air transport sector in Europe in the aviation market" (*European Commission* 2004a, L 137/60). However, it insists that the competition rules must be correctly applied in order to ensure fair competition among airlines. State aid discipline is especially necessary (*European Commission* 2004a, L 137/60). Nevertheless, from our viewpoint, the Commission does not apply the competition rules correctly, as we demonstrate in the following sections.

IV. Do the Conditions for Ryanair Distort Competition Among Airlines?

It is an undisputed fact that Ryanair received better conditions in its contract with BSCA than other airlines. If we see the airports as suppliers and the airlines as customers on the market for airport services, then these better conditions have to be interpreted as a price differentiation. The crucial question is: Does this price differentiation lead to a distortion of competition among airlines?

From the perspective of microeconomics it is important to distinguish between price differentiation and price discrimination. Price discrimination means that the same product or service is sold to different customers at different prices, which are not justified by different advantages for the seller (e.g. cost differences).[12] In many markets price differentiations are a normal market phenomenon - due to a lot of different reasons. One im-

12 The problem of the distinction between price discrimination and price differentiation was clarified long ago in regard to competition policy. See, e.g., *Machlup* (1955, p. 398): "Price discrimination may be defined as the practice of a firm or a group of firms of selling (leasing) at prices disproportionate to the marginal costs of the products sold (leased) or of buying (hiring) at prices disproportionate to the marginal productivities of the factors bought (hired)." See also *Adelman* (1959).

portant reason is that in intermediate markets the customers are not completely homogeneous for the sellers. Therefore, firms are more interested in selling to some particular customers than to others. Possible reasons for such a differentiation are different quantities, different transaction and / or transportation costs or buyers have other important advantages, e.g. a better access to interesting consumer groups. This qualifies buying firms to receive more rebates or other additional incentives for contracting. For similar reasons the selling firms will also often be heterogeneous to the buyers, implying that the buying firms are willing to pay different prices to the sellers for their more or less different services. If we, therefore, have heterogeneity on both market sides, then bilateral bargaining between the firms on both market sides is a normal phenomenon. The result of this bargaining process is a large amount of price differentiation. Hence, price differentiation is a important consequence of effective competition on these markets.

Beyond this argument of heterogeneity, price differentiations also occur to a considerable extent during processes of price competition before a new equilibrium can be achieved. From the discussion on bargaining processes between retailers and manufacturers, it is well known that secret rebates are given to particular buying firms in bilateral bargaining processes. They are one of the phenomena that can be observed during processes of decreasing prices due to free capacities on the supply side. Therefore, not only price differentiations, but also price discriminations might be a normal phenomenon during adaptation processes to new equilibrium prices. State interventions attempting to prevent these secret rebates and the ensuing price differentiations would hamper the working of the price system, because it would be more difficult to attain equilibrium prices. Due to all of these reasons, competition policy must not impede processes of price differentiation.[13] The long history of competition policy also shows that even price discrimination is seen as a problem only in rare circumstances. Therefore, only in the case of dominant firms, price discrimination can be anti-competitive (under certain conditions) and, hence, an abuse of a dominant position according to Art. 82 EC Treaty. So, the first important conclusion is that price differentiation does not necessarily imply

13 The danger that prohibitions of price discrimination can impede secret rebates and therefore stabilizes collusive behaviour of suppliers is a broadly acknowledged insight in competition policy: see e.g. *Rowe* (1980, p. 506) and *Monopolkommission* (1985, n.162).

price discrimination. On the contrary, in many cases different prices are necessary for avoiding price discrimination.[14]

Considering this theoretical background the first question is whether it can be shown that the special conditions for Ryanair are discriminatory or whether they might also be interpreted as a normal form of price differentiation. In contrast to established airports, where the capacities are fully used (indicated by scarce slots), BSCA has under-used capacities, as also stated in the decision of the Commission. For BSCA it is not only necessary to attract additional airlines for attaining a full utilization of its capacities, but also to attain a certain critical mass of air routes and passengers in order to be taken seriously as a new international airport. In this difficult situation of a new entrant, an arrangement with a major low-cost airline like Ryanair is highly attractive for BSCA. Ryanair is capable of committing itself believably in the agreement with BSCA to offer a whole package of air routes and a huge amount of passengers. Therefore, the long-term agreement is very crucial for BSCA in order to establish the airport as an international airport. From this point of view, it is not surprising that Ryanair receives a number of specific additional advantages. Particularly important is that Ryanair must pay considerably lower ground handling fees than other airlines (1 EUR per passenger instead of 8 to 13 EUR). However, the different advantages heterogeneous airlines offer BSCA can justify such a price differentiation. Contrary to other airlines, Ryanair offers a much higher amount of passenger traffic to Charleroi and each additional route strengthens the attractiveness of the BSCA as an international airport. Certainly, Ryanair obtains also many advantages from this arrangement. When Ryanair entered the important Belgian aviation market, there were entry barriers at the traditional airport of Brussels (due to scarce slots). The possibility to operate at BSCA was, therefore, a great chance for Ryanair to enter this market. Even more important was the fact that BSCA was able to offer cheap airport services. To seek out these airports with cheap services is a part of Ryanair's business concept as a low-cost airline and a part of its entry strategy. The specific contractual arrangement can be understood, when taking account of the

14 See *Adelman* (1959, p.10, citing *Machlup*): "… 'price uniformity in the face of cost diversity is price discrimination' …", who critizes that the Robinson-Patman Act, which is the US-antitrust law that aims at ensuring non-discrimination, has primarily developed to a law against price differentiation, and therefore, has impeded effective competition (see also *Rowe* 1980, p.501). For a detailed discussion of the complex distinction between price discrimination and price differentiation from the perspective of competition policy see *Kerber* (1989, pp. 121-126, 414-440).

very special situation of both parties: they are both outsiders and attempt to enter the markets for airport services and airlines. And this arrangement can help both of them.[15]

The question can be raised whether the favourable treatment of Ryanair is the consequence of a dominant position of Ryanair as a buyer of airport services. Of course, in the meantime, Ryanair has a considerable market share in the market for low-cost air travel. Nevertheless, from the perspective of BSCA the relevant market consists of all airlines (and not only the low-cost carriers) which are interested in servicing the greater Brussels area. It is not plausible that Ryanair has in that respect a dominant position, which would allow it to behave abusively. Therefore, the possibility that these conditions result from a dominant position of Ryanair (buying power) can be eliminated in this case. Vice versa, BSCA has also no dominant position on the market for airports.

From the perspective of state aid policy the most important issue is whether these specific contractual conditions lead to a distortion of competition between airlines. The decisive question is: Would any other airline, which had offered or offers a similar bundle of advantages to BSCA (number of passengers and air routes, and the long-term commitment), receive the same conditions as Ryanair (*Steinrücken* and *Jaenichen* 2004, p. 99)? Of course, the Commission has to apply the state aid rules in order to prevent that member states could grant such advantages for *their own airlines* at *their own airports* (*European Commission* 1994, C 350/5). This danger emerged, when the volume discount scheme at the (formerly) congested, slot-constrained Brussels airport Zaventem mainly favoured the former state-owned Belgian airline Sabena (*Kunz* 1999, pp. 32f.; *Clayton* 1997, p. 97). Another case in this regard was the large transfer passenger discount for KLM and its partners at Amsterdam Schiphol airport (*Clayton* 1997, p. 97).[16]

15 The obligation of BSCA (and the Walloon Region) not to raise airport taxes and change airport regulations like opening hours and parking fees for this period of fifteen years, is an appropriate protection of the transaction-specific investments of Ryanair. If BSCA had entered the market of international airports successfully, it could behave opportunistically and increase its profits by raising airport taxes or parking fees. This would reduce the advantages of this airport for a low-cost airline as Ryanair considerably. Therefore, it is rational that Ryanair wants to eliminate this holdup danger by this contractual clause.

16 Then, of course, discrimination between airlines operating at Brussels or Amsterdam airport can occur for two reasons: Firstly, the granting airport and the benefiting airline are both state-owned. Secondly, other airlines cannot get the same advantages. Due to the fact that the airport is slot-constrained they suffer from a lack of slots, which prevents those airlines from serving the same amount of passengers as established airlines. Therefore, there can be discrimination between airlines caused by the introduction of volume discount schemes at slot-constrained airports. A further example demonstrating that member states grant state aids to their own airlines is the case of Olympic Airways. See for this and other cases *Hartwig* (2004, p. 285).

However, in our case Ryanair is a Dublin-based Irish airline operating at an Belgian airport. It is not plausible to assume that BSCA (or the Walloon Region) has favoured Ryanair over other airlines. Hence, there is no evidence for such an assumption although BSCA has made no call for bids. However, BSCA made enough efforts to search for the most profitable way to solve the specific problems of entering the market for international airports. The airport has bargained with 35 airlines before and after the agreement with Ryanair. Therefore, it has obviously looked into the possibility to enter into similar arrangements with other airlines (*European Commission* 2004a, L 137/14). Additionally, there is no evidence that Ryanair has bribed officials of BSCA or the Walloon Region. Furthermore, there are still free capacities at BSCA. Hence, one can assume that any other airline, which would (have) offer(ed) a similar attractive arrangement for BSCA, would (have) receive(d) the same favourable conditions in this particular situation of entering the market for international airports.

If any other airline had offered similar advantages and received similar favourable conditions, then no distortion of competition between airlines could be derived. If Ryanair is more attractive to airports like BSCA than other airlines, it can bargain for special rebates. Other airlines with different business concepts and characteristics cannot offer similar advantages and cannot obtain the same rebates. The granting of different rebates is, therefore, a normal outcome of effective competition in imperfect markets, in which there is heterogeneity on the supply and the demand side. Even if Ryanair would on average receive better conditions than other airlines, then this might only be the normal (and necessary) reward for a more efficient competitor in effective competition among airlines. For example, the business concept of Ryanair (and other low-cost carriers) can be understood as an organizational innovation in the terms of Schumpeterian competition (*Steinrücken* and *Jaenichen* 2004, p. 99). If competition law and state aid policy forbid price differentiation at airports regarding their services, this impedes the reaping of profits from the introduction of innovations. All possibilities to reward superior innovative business concepts of airlines will be eliminated.[17]

17 For a detailed analysis, why the prohibition of appropriate price differentiations can eliminate the incentives for innovation activities in competition, see, particularly in regard to the relationship between manufacturers and retailer, *Kerber* (1989, pp. 429-440).

V. The Real Problem: Distortion of Competition Among Airports?

Nearly all airports in Europe have received subsidies to some extent. Although in recent years, there is a tendency of private initiatives concerning the building or expanding of airports; traditionally state, regional and local authorities have paid for those activities. Therefore, even at regional airports public funds have been made available to finance those activities. Sometimes they also finance current losses, which occur during the operation of the airport (*European Commission* 2004a, L 137/53). This can be justified by arguments of regional policy: According to insights from the new economic geography, an airport has a great impact on the development of the region. It is a very important promoter of local/regional agglomeration and causes a lot of positive agglomeration externalities (*Pelkmans* 2001, p. 305): It generates a lot of jobs inside and outside the airport (*Wolf* 2003, pp. 6-12). It is an important location factor, which helps to attract new firms from elsewhere (*Steinrücken* and *Jaenichen* 2004, pp. 100f.) and also grants incentives to set up new firms. Therefore, an airport has a great impact on the structure of the economy in the region and it also promotes a structural change of the economy of even underdeveloped regions (*Soltész* 2003, p. 1034). So, there can be good reasons for granting subsidies to an airport. Nevertheless, there is a great danger, that subsidies may be too high. Then the question arises: What is the effect of granting unjustified subsidies on competition among airports?

Competition among airports means that airports compete for passengers and for airlines which provide the transfer of passengers. Of course, such competition depends on the amount of potential passengers living nearby the airport in the so-called catchment area. It can be possible that the catchment area of one airport does not overlap with the catchment area of the next airport. Then both airports have a local or regional monopoly. Contrary, in many cases like BSCA, there are overlapping catchment areas.[18] Then potential passengers can choose among two or more airports. Such potential passengers in Brussels can choose between Brussels Airport Zaventem and BSCA. Due to good TVG connections Zaventem also competes with Charles de Gaulle Airport in Paris. Concerning the potential passengers in the north of Belgium Amsterdam Schiphol Air-

18 The catchment area of Brussels Airport Zaventem includes passengers, who have a drive time of 1.5 hours by car or 1.0-1.5 hours by train in order to get to the airport. This covers all potential passengers in Belgium, Luxemburg and a small region of northern France (*European Commission* 2002, p. BEL-7).

port is another competitor (*European Commission* 2002, p. BEL-7). So, the success of BSCA depends on its proximity to Brussels. BSCA can be reached in 40 min. from the city centre of Brussels. (*Barrett* 2000, p. 23). The establishment of BSCA as an international airport and as a competitor to Zaventem was driven by "the wish of the local government of the region to promote economic development" (*Barrett* 2004a, p. 35). "Charleroi now dominates the Irish routes from Dublin and Shannon and is a hub for nine routes serving Glasgow, ... Carcassone, Pisa, Venice, and Rome in addition to Dublin and Shannon. It has 22% of London-Brussels traffic" (*Barrett* 2004a, p. 35). Of course, due to heterogeneity of passengers, airport services, and the routes that are served, Zaventem and BSCA mainly compete for the low-cost EU market, particularly to London (*European Commission* 2002, p. BEL-7).

There are several consequences of granting too much subsidies to an airport: One consequence might be that airports, although operating more efficiently, might be hampered in their competition with not so efficient, but more subsidized airports. Distorted market shares between competing airports, or, in an extreme case, even the displacement of a more efficient airport through a more-subsidized competitor can be a second consequence. A third consequence is the existence of too many airports, which only survive through subsidies. There is evidence that this is true for Europe, including Germany, and also the US (*Gillen* and *Lall* 2004, p. 48). Any airport is subsidised "with goals such as the promotion of regional or local development" (*Barrett* 2000, p. 17). Therefore, the danger arises that subsidies to airports can distort competition between airports and lead to an inefficient allocation of resources to airport infrastucture.[19]

Whether the subsidies of the Walloon Region to BSCA are justified or not is a crucial point. If they can distort competition among airports and have to be regarded as an issue of EU state aid policy is a difficult issue due to the following considerations:

(1) Nearly all airports in the EU receive or have received public funds, either by funding the infrastructure investment of the airport or by giving (direct or indirect) subsidies for the running of the airport. Whether particular subsidies distort competition among airports can only be assessed, if they are compared with the public funding of

19 It should be mentioned that competition among airports in the same catchment area can also be restricted by common ownership as, e.g. in London, where Heathrow and Gatwick are in the same ownership (*Starkie* 2002, p. 66f.), or in Frankfurt with Fraport as the owner of the airports of Frankfurt/Main and Hahn.

other airports, which are the main competitors. The crucial point concerning the distortion of competition among airports is the overall amount of public funding. This is relevant, because if an airport receives a high subsidy it can offer airport services to airlines at very low prices. An airport, which receives lower subsidies has to require higher charges for airport services from the airlines.

(2) The Commission has no competence to influence the member states concerning the building and expansion of infrastructure, including the building and expansion of airports. Therefore, decisions about financial support for infrastructure investments or about the size or other characteristics of airports fall outside the scope of European State aid control. Such decisions remain in the competence of the member states and regional or local authorities (*European Commission* 1994, C 350/8).

(3) Partly linked to this problem are the different kinds of positive externalities, which are generated by a regional or local airport (regional policy considerations). They might also justify current subsidisation of an airport to a certain extent, and not only the set up-costs of an airport. If regional airports permanently generate positive externalities, then these subsidies are justified from purely allocative reasoning.[20]

(4) Beyond this, financial support for airports can also be justified by their contribution to regional development in disadvantaged regions (Art. 87 (3) (a) and (c)). The Commission even allows regional state aid for investments of undertakings settling down on the airport or nearby. Furthermore, such regional state aid can also be accompanied by support from the European Structural Funds. These funds also support infrastructure investments in disadvantaged regions. This includes not only the building and expansion of airports, but also efforts of the region to attract and maintain undertakings (*Südekum* 2002, p. 122).

(5) An even more complex picture emerges, if we consider the principle of subsidiarity and the theory of interjurisdictional competition. From the perspective of competitive federalism as a concept for European integration the supply of infrastructure is part of the locational conditions of regions and member states. The supply of infrastructure and its quality is an essential parameter in the competition of jurisdictions for mobile individuals, firms, and production factors. Competition among airports can, therefore,

20 The emergence of externalities, e.g. caused by R&D activities or vocational training, are typical and accepted reasons for granting state aids (*Meiklejohn* 1999, pp. 28f.).

be regarded as a part of interjurisdictional competition. Consequently, regions and member states should be free to decide themselves on the amount of public infrastructure, as long as they finance this infrastructure from their own taxes (principle of fiscal equivalence). To this extent, different subsidies to airports might not be a problem because the amount of subsidisation is controlled by interjurisdictional competition. From this viewpoint, it is not a problem that the Commission has no competencies to control the investments in airports by local and regional authorities. This lack of competencies might be even necessary for maintaining effective interjurisdictional competition.[21]

The assessment whether the funding of BSCA distorts competition among airports is a very complex one. Of course, subsidies for airports can constitute a problem from the view of EU state aid policy. However, due to the fact that nearly any airport gets subsidies, only the overall amount of public funding of airports is the crucial criterion and not particular fractions of this funding, like the favourable conditions for Ryanair. Nevertheless, the Commission has not provided any analysis whether the overall subsidies to BSCA are excessive, e.g., compared to the overall subsidies for its state-owned competitor Brussels Airport Zaventem.

VI. The New Principles of the Commission for Assessing Subsidies to Airlines: A Critical Evaluation

With its decision in the Ryanair case, the Commission explicitly intends to establish some general principles for the treatment of state aids in the realm of the aviation sector. It attempts to clarify certain conditions, which are important for carriers “operating out of regional airports” (*European Commission* 2004b, p. 1). The main problem with these principles of the Commission is that the basic economic analysis of the Commission is already misleading. The main error of the Commission is that it does not clearly distinguish between competition among airlines and competition among airports. Therefore, the Commission has not recognized that the real problem is, whether the subsidies distort competition among airports, and not, whether they distort competition among airlines. The evidence in the case clearly supports the assessment that other airlines could have also received the same favourable conditions from BSCA, if they would have of-

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21 See e.g., *Kerber* (2000, 2003) and *Siebert* (2002). For the complex relationship between state aid policy and interjurisdictional competition see *Kerber* (1998), *Gröteke* and *Heine* (2003, 2004a).

fered the same long-term advantages as Ryanair did.[22] Therefore, the criterion of selectivity is not fulfilled in regard to competition among airlines. In turn, there is also no distortion of competition among airlines. This result has crucial consequences for the principles of the Commission.

The most important principle of the Commission is that all airlines should get the same conditions at the same airport. The aim is to create transparency and "to ensure fair competition for everyone in the single market of air transport." (*European Commission* 2004b, p. 4). According to the Commission fair competition perfectly exists, if a level playing field can be established in the aviation sector (*European Commission* 2004b, p. 1).[23] Therefore, the Commission particularly attacked that Ryanair received considerably lower airport charges and ground handling fees at BSCA than other airlines.

It is true, however, that the Commission accepts some kinds of price differentiations among airlines, if they are cost related, transparent, non-discriminatory, and objective (*Court of First Instance* 2000, n. 66-70; *Kunz* 1999, pp. 33f.). Different airport charges at the same airport might be justified in terms of noise-related charges, peak charges, and emission charges (*Clayton* 1997, p. 96). This might also be true for low-cost airlines, which require different levels of infrastructure than other airlines at the same airport, e.g., for check-in or for using steps instead of airbridges, etc. (*Barrett* 2004a, p. 37f.). While on the one hand the Commission takes such reasons into account, on the other hand it strongly supports the principle "of identical charges for intra-EU flights, regardless of length of flight or type of passenger" (*Clayton* 1997, p. 96). The assumption is that all airlines get the same standard conditions of use, and must, therefore, pay the same landing charge per departure and passenger charge at the same airport. This implies, for example, that price differentiations resulting from quantity discounts are not accepted by the Commission at state-owned airports, because they are regarded as discriminatory (*Kunz* 1999, pp. 32f.). From an economic point of view, this position is very surprising because in normal markets quantity discounts are the most widely used and

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22 For this result, it is not necessary that the conditions should have been made ex-ante transparent and public under the conditions of effective competition. In this setting the bargaining of prices and conditions is made bilaterally between the parties and both market sides have enough incentives to consider alternative offers or make counter-offers.

accepted form of price differentiation, particularly in situations with free capacities as in Charleroi.[24]

The Commission's approach can be explained to some extent by the traditional method of calculating airport charges in the past: Usually total costs of an airport were divided between total traffic, after income from commercial activities and granted subsidies were subtracted (*Clayton* 1997, p. 98). It seems that the Commission follows this approach when setting up a general framework for airport charges. In contrast, our argumentation about the heterogeneity of the airlines for the airports requires that airports must be free to differentiate prices according to the different advantages the airlines offer to the airports. If the Commission wants to establish effective competition on the market for airport services and for air travel, it has to accept price differentiations. They are not only a normal outcome of effective competition, but also necessary for airports. Airports - like any other firms in normal markets – should have discretionary scope to make entrepreneurial decisions. This implies that airports assess different airlines concerning their function as an important strategic partner for the airport's future development. The approach of the Commission to establish an uniform system for user charges with only some predefined types of price differentiations (including specific rules for determining the amount of price differentiations) is a regulatory straitjacket. It precludes free bilateral bargaining between both market sides. The result of such a practice is a highly regulated market for airport services and a step backwards in the liberalization-process in the highly dynamic aviation market.[25]

What about the regulation of one-shot incentives? The granting of such incentives is only permitted for opening up new routes (including the limitation of their duration), but not for established ones. In this case, the fundamental misunderstanding is that the Commission implicitly assumes that the airport charges and ground handling fees should be identical for all air routes. Therefore, price differentiation according to air

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23 This is not a specific rule for the aviation sector, it is a general aim of European State aid control (*Miert* 2001, p. 46; *Wishlade* 2003, p. 1; *Sinnaeve* 1999, p. 14; *Gröteke* and *Heine* 2004a, p. 328; *Gröteke* and *Heine* 2003, p. 258).

24 The situation might be different, if there is no free allocation of slots as in most airports so far, because in that case not all airlines have the same chances for getting quantity discounts due to grandfather rights in the slot-allocation. The main problem to be solved is then the wrong form of slot-allocation and not quantity discounts.

routes is excluded. However, flights from different destinations might (1) cause different costs and (2) have different other advantages for the airport. Different flight destinations might differently contribute to the international reputation of the airport or to the utilization of capacities on other air routes (positive externalities).[26] Due to these different costs and benefits for the airport, a profit-maximizing airport would not charge the same prices to all air routes. Some routes might be particularly valuable for the airport. Consequently, it can be expected that price differentiations between air routes are a normal result of effective competition between profit-maximizing airports. So, an airport should be free in bargaining different prices for different air routes and price differentiations between air routes should be allowed generally.[27] Hence, the Commission's regulation concerning one shot incentives is irrelevant and unnecessary.

However, might these different prices contradict *levelling the playing field* principle? In section IV we already demonstrated, that price differentiations are even necessary for giving heterogeneous airlines with different business concepts equitable chances in their effective competition. The real problem about the equitability of the competitive chances for airlines is the slot-allocation at the established and congested airports. Here the traditional type of slot-allocation still considerably favours the established airlines and constitutes important entry barriers for new airlines. Although this problem is a very grave one and well known for a long time, so far only first cautious steps have been made to solve it. Economists have claimed that slot auctions should be made or slot trading between airlines should be allowed (e.g. *Kunz* 1999, p. 24; *OECD* 1998; *Wolf* 2003, pp. 266-270).[28] According to the Commission's *liberalization* policy, each airport can decide itself how to allocate slots. Nevertheless, this might not be sufficient, be-

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25 An important exception, however, might be the case that this airport is itself a dominant firm according to Art. 82 EC Treaty, implying that competition policy can control airports for not abusing their market power, e.g. by price discrimination (*Kunz* 1999, pp. 33f.).

26 For example, if the route Dublin-Charleroi with many passengers from Ryanair has positive externalities due to transfer passengers, why should there not be specific lower prices on this route than on other routes without such positive externalities?

27 Again, this argument does not apply for airports with a dominant position according to Art.82 EC Treaty.

28 "The slot values would be a function of airport charges and the degree of infrastructure scarcity at the corresponding time" (*Kunz* 1999, p. 24). A special type of such a solution might be peak charges. They were introduced by BAA (which manages privatized airports) in order to make users during peak hours pay the associated costs of peak infrastructure. The importance of slots for effective competition is also shown in merger cases between airlines: the merging airlines must cede slots to other competitors, which is a crucial remedy in order to ensure effective competition among airlines.

cause airports are still allowed to allocate slots according to the grandfather principle. This still leads to a distortion of competition between established and new airlines.[29] The *levelling the playing field* argument should, therefore, strongly emphasize the necessity of a sufficient solution to the problem of slot-allocation at airports as the primary problem for effective competition among airlines.

VII. Conclusions

For the European Commission the Ryanair decision was a precedence case. With its state-aid decision the Commission wants to ensure undistorted competition among airlines operating out of regional airports. In order to clarify conditions, which promote *undistorted competition among airlines*, the Commission sets up general principles about the structure of user charges for airport services. From this point of view, Ryanair has received state aids at BSCA. Our analysis showed that this decision is wrong because the specific conditions for Ryanair can be seen as a normal form of price differentiation in a competitive market for airport services. Consequently, any airline could have received similar conditions, if it would have made a similarly attractive offer to BSCA. As a result, the contract between Ryanair and BSCA does not lead to distortion of competition among airlines as claimed by the Commission. Hence, it is compatible with the Common Market. As a consequence, the principles of the Commission for state aids in the aviation sector are also misleading. This concerns particularly the interpretation of non-discriminatory behaviour and the criterion that only set up-costs for new air routes might be subsidized.

Based upon our results: What are the long-term perspectives for state aid policy in the aviation sector?

(1) As long as there is effective competition on the market for airport services, airports and airlines should be free to negotiate prices and other conditions for airport services. As far as the slot-allocation is an impediment of competition, this problem should be solved with priority. Price discrimination can only be a problem, if either airports or airlines have dominant positions. In those cases, the Commission can control discriminations according to Art. 82 EC Treaty. In the Ryanair case there is no such

29 In that respect, the question can be raised whether this behaviour is discriminatory between airlines, and, therefore, should be an issue for EU state aid policy.

problem. Therefore, the Commission should not introduce a general framework for regulating prices and price structures for airport services, which still sticks to the traditional user charge system. This is unnecessary for ensuring undistorted competition among airlines. It is rather a straitjacket, which considerably hampers effective competition both among airports and among airlines due to the narrow restrictions for bilateral bargaining. Therefore, it causes more negative than positive effects on competition.

(2) Despite these general conclusions it cannot be excluded that, in particular cases, discriminatory behaviour regarding airport charges may be used by regions or member states in order to favour particular airlines. In the Ryanair case, there is no evidence, why the Walloon Region should have favoured the Irish airline Ryanair over other airlines. Nonetheless, there can be other (presumably rare) cases in which this indirect way of granting state aid to a probably domestic airline may be chosen. Such a practice is – especially in combination with the current mechanism of slot-allocation - incompatible with the Common Market. In these cases, the Commission should be able to control and prohibit those state aids, although it might be difficult to differentiate between normal price differentiations and those state aids. Nevertheless, this should be no pretext for an all-encompassing regulation of price differentiations.

(3) The most difficult problem, however, is the question, whether competition among airports is being distorted by public funding of airports. This problem needs a very thorough and careful analysis. Although it cannot be denied that public funding of airports can distort competition among airports, there are good reasons in regard to regional policy, why public funding might be justified to a certain degree. Additionally, crucial questions regarding the competencies of the Commission and the member states arise, if the Commission would like to control the overall public funding of infrastructure like airports. There are good reasons to let the regions and Member states have the freedom to decide on their own infrastructure, because it can be regarded as a consequence of the principle of subsidiarity and a necessary precondition for interjurisdictional competition in a European system of competitive federalism.

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Summary

For the European Commission the case of Ryanair is a precedence decision about the application of state aid policy on agreements between regional airports and airlines. In a long-term contract with the regional airport of Charleroi (near Brussels), the Irish low-cost airline Ryanair received better conditions than other airlines. In return, it committed itself to transport a certain number of passengers to this airport for a period of fifteen years. This alleviates considerably the entry of the so far non-established Charleroi Airport into the market for international airports. The Commission interprets these better conditions as a discrimination, which distorts competition among airlines. Contrary to that, a thorough economic analysis shows that these conditions must be regarded as a normal form of price differentiation in effective competition. Any airlines would have received similar conditions, if they have offered similar advantages to the airport. Con-

sequently, the decision of the Commission in the Ryanair case is wrong. Additionally, the principles of the Commission, which entail the danger of an all-encompassing regulation of prices for airport services, are misleading from an economic point of view, because they tend to impede effective competition in the aviation sector. The real state aid problem is, however, whether and under what conditions the public funding of airports leads to a distortion of competition among airports. This problem remains unsolved. This is also true for the problem of the slot-allocation on airports.

Zusammenfassung

Der Fall Ryanair – Die EU-Beihilfenkontrolle auf der falschen Startbahn

Im Fall Ryanair hat die Europäische Kommission eine Grundsatzentscheidung über die Anwendung der Beihilfenkontrolle bei Vereinbarungen zwischen regionalen Flughäfen und Fluglinien getroffen. Die irische Billigfluglinie Ryanair erhielt in einem langfristigen Vertrag mit dem regionalen Flughafen Charleroi (nahe Brüssel) wesentlich bessere Bedingungen als andere Fluglinien. Sie verpflichtete sich aber im Gegenzug, über 15 Jahre eine hohe Mindestmenge an Passagieren über diesen Flughafen zu transportieren, und erleichterte damit wesentlich den Eintritt des bisher unbedeutenden Flughafen Charleroi in den Markt für internationale Flughäfen. Im Gegensatz zur Kommission, die in diesen besseren Bedingungen eine wettbewerbsverzerrende Diskriminierung anderer Fluglinien sieht, ergibt eine genauere ökonomische Analyse, daß nur eine in funktionsfähigen Wettbewerbsprozessen unproblematische Form der Preisdifferenzierung vorliegt. Auch andere Fluglinien hätten diese Bedingungen erhalten können, wenn sie dieselben Vorteile angeboten hätten. Insofern wurde der Fall Ryanair falsch entschieden. In gleicher Weise wirken die von der Kommission aufgestellten Prinzipien, die die Gefahr einer umfassenden Regulierung von Preisen für Flughafendienstleistungen beinhalten, in eine ökonomisch grundsätzlich falsche Richtung, da sie den wirksamen Wettbewerb im Luftfahrtsektor eher beeinträchtigen werden. Das eigentliche Beihilfeproblem, nämlich ob und unter welchen Umständen die öffentliche Finanzierung von Flughäfen zu einer Verzerrung des Wettbewerbs zwischen Flughäfen führt, bleibt dagegen ebenso ungelöst wie das Problem der Vergabe von Start- und Landerechten (Slots).