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Gulf Carriers Stakeholder Engagement Process /Docket No. DOT-OST-2015-0082, DOS-2015-0016, DOC-2015-0001

Subsidies to carriers from the Gulf – Impact on airlines of the Lufthansa Group

Dear Mr. Dean
Dear Mr. Engle
Dear Mr. Belford

On behalf of the Lufthansa Group, I am writing to you to share our perspectives with respect to the recent publication of the study “Restoring Open Skies: The Need to Address Subsidized Competition from State-owned Airlines in Qatar and the UAE” (“study”). We thank you for the opportunity to submit our comments on this matter.

I. Introduction

The Lufthansa Group is the largest European aviation group comprised of major carriers: Lufthansa German Airlines, Austrian Airlines, Swiss International Air Lines, Germanwings, Eurowings, Cityline and Lufthansa Cargo.[1] In addition, Lufthansa Technik is a leading global maintenance and repair organization and LSG Sky Chefs is the largest airline caterer in the world. The airlines of the Lufthansa Group operate 615 aircraft and carry 106 million passengers (2014). Over 118,000 employees work for the Group; more than 12,000 of them in the US. The annual turnover of the Group is about 30 billion EUR and in 2014, it generated an operating profit of 954 mio EUR.

Lufthansa Group airlines focus both on the fully liberalized EU market, offering point-to-point connections with its subsidiaries Germanwings/Eurowings, while at the same time operating international hubs in Frankfurt, Munich, Zurich and Vienna. Lufthansa Group airlines appreciate and readily accept fair competition and are fully committed to the principles of competitive and liberalized markets. In view of its vast experience, Lufthansa Group is able to assess when markets erode due to unfair and artificial forces and when the proven principles of a free aviation market are defied.

Lufthansa Group is one of the European carriers at the forefront of implementing the opportunities of a fully liberalized cross border aviation market. Shortly after the Air France/KLM merger between two EU carriers, Lufthansa was the first to integrate a non-EU carrier (Swiss International Air Lines) in 2004/2005 and Austrian Airlines a few years later to a consolidated European aviation group operating globally, taking advantage of what a liberalized market with regulatory convergence can offer in terms of opportunities. As stewards of fair competition and sound aviation policies, we seek to operate in a liberalized aviation market where privately run airlines - and not governments - compete against each other for the benefit of the consumer, the airlines, their employees and the respective economies.

During the past few years, the Lufthansa Group has been engaged in discussing certain market developments with the European Commission and with national authorities, keeping them informed about their damaging impact on the competitiveness of the industry and the connectivity. In the midst of these discussions, the findings of the study of the US carriers with

[1] It also holds a substantial equity (45%) in Brussels Airlines with its hub in Brussels.

respect to subsidies to Gulf carriers[2] have added substance to the debate which Lufthansa Group welcomes and supports.

The study demonstrates how the financial support to the Gulf carriers allows them to bring capacity into the market to an extent that cannot be explained by growth of the market. Whereas the network expansion of the Gulf carriers to and from the US has only begun, Europe has experienced several years of unprecedented market growth of the Gulf carriers. The capacity growth of the Gulf carriers is far higher than what all other international carriers are able to accomplish in the market. In the case of Europe, average annual growth in seats between 2004 and 2014 was 16.5% for the Gulf carriers (EK/EY/QR) and only 2.7% for all other European airlines. Competitive pressure has substantially increased and has led to a decline in yields affecting the results of all the Lufthansa Group's airlines.

Gulf carriers generate their growth by taking substantial portions from other market participants. There is no evidence that the Gulf carriers meaningfully stimulate market growth.[3] Taking into account the number of aircraft ordered by the Gulf carriers, the additional capacity they bring into the market will continue to exceed the market growth by far for years to come.

II. State aid is incompatible with the EU internal market

To assess the development of the Gulf carriers in the light of possible state aid means addressing an issue that can affect any market. As a matter of principle, state aid – especially on a massive, disruptive scale – is incompatible with fair competition. In fact, it erodes competition and reduces market access. In the EU, according to the EU treaty (i.e. the European "constitution"), state aid is incompatible with the principles of a liberalized internal market, regardless in which industry, i.e. from the cement market to telecommunication to energy and aviation. State aid is only allowed if it meets one of the exemptions set out in the EU Treaty (art. 107 ff). A crucial criterion is the so called "private investor test". EU law does not prohibit public entities to participate in the internal market but it expects that such government entities behave like a private investor and be fully transparent with respect to their support to private companies. The European Commission sanctions infringement of the rules on state aid regardless whether injury actually occurs. There is a presumption that state aid as such distorts the market. Consequently, affected companies are not obliged to demonstrate injury.[4]

In the internal market, the European Commission has applied and enforced these rules to the aviation sector. The European Commission has grounded EU airlines[5] and has forced airports

[2] In the following, the term "Gulf carriers" refers to three airlines from the Gulf, i.e. Emirates, Etihad and Qatar.
[3] See also Darin Lee and Eric Amel, "Assessing the Impact of Subsidized Gulf Carrier Expansion on U.S.-International Passenger Traffic". May 13, 2015.
[4] The European Commission is strictly applying and enforcing these principles to both EU companies and foreign companies doing business in the EU. If needed, it imposes quotas (such as against Chinese solar panel manufacturers) or countervailing duties
[5] Malev, the Hungarian airline, went bankrupt and ceased operations in February 2012. Olympic Airways also ceased operations after it was ordered to repay state aid.

into bankruptcy requiring them to repay unlawful state aid[6] without requiring competitors to demonstrate injury caused by such state aid.

The same principles should apply to state aid granted by governments of third countries. Lufthansa Group airlines are ready to compete with any airline from any other part of the world. However, competition must be based on fair and equal opportunities with the same rules applying to all parties. If there is evidence that governments finance airlines doing business in the EU or if governments directly or indirectly invest in European airlines in order to deviate traffic to their hubs, such behavior should be subject to full transparency and should be sanctioned in case of infringement of applicable laws. Such action should be enhanced by parallel measures by the US authorities.

The aforementioned investigations would be in line with what European airlines have experienced: Several times, the airlines of the Lufthansa Group were subject to respective investigations from the European Commission. One of its competitors (NIKI Luftfahrt GmbH) took the case up to the highest European court to challenge the legality of the financial support granted by the Austrian government.[7] There is no reason why foreign carriers doing business in the EU or any open market should be exempt from the scrutiny of competition authorities.

III. The expansion of Gulf carriers in Germany, Austria and Switzerland: Effects of the Gulf carriers on Lufthansa Group

1. Gulf carriers in Europe have expanded much faster than market growth

In terms of capacity and number of destinations, the three Gulf carriers have grown far above the market. This fact also holds true for home markets of the Lufthansa Group airlines: In Germany, Austria, Switzerland (and Belgium), Gulf carriers have increased their market presence in terms of seat capacity to a far higher extent than the growth of demand in the bilateral market would justify. (Germany 12,7% vs. 4,3% general market growth, Switzerland 20,6% vs. 1,3%, Austria 18,8% vs. 1%, numbers refer to the period between 2003 and 2013[8]).

In summer 2014 three Gulf airlines operated to 21 European countries, offering 808 services per week to Dubai, Abu Dhabi and Doha with a capacity of 2.76 million seats per year and direction. Gulf carriers (including Air Berlin) offer 161 weekly flights from Germany to their hubs (summer 2015). This equals a seat offer of 5.4 million annually in both directions. Today about 3.1 million passengers travel from and to Germany through the hubs in the Gulf instead of using direct services of German, Asian and African airlines.

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[6] German airports such as Zweibrücken.

[7] The European Commission approved the financial aspects of the integration of Austrian Airlines in the Lufthansa Group. In May 2015, the European Court of Justice confirmed the legality of the financial aid stating by the Austrian government (Az. T-511/09 und T-162/10).

[8] Figures 2010-2013.

Figures provided by the European Commission confirm these findings and show that in scheduled traffic between EU-UAE/Qatar the traffic share of Gulf carriers has risen to over 83%[9], despite of the fact that bilateral agreements stipulate a fair and equal opportunity to compete and that EU carriers are able to take up such competition under fair market conditions.

2. *Increase of market share by Gulf carriers attained by different methods*

The excessive growth of the Gulf carriers is achieved using two different approaches:

Emirates is using its largest aircraft, Airbus A380, mostly in European markets, not only at hub airports, but also at secondary airports. In Frankfurt, Emirates has 14 weekly flights with its A380 to and from Dubai, in Munich 13 weekly flights to and from Dubai. The example of Zurich is another point in case. Switzerland has 8 million inhabitants, the greater Zurich area about 1 million. The Swiss aviation market has shown modest growth rates of less than 5%. The market size for direct connections from Switzerland to Qatar and the UAE is app. 650 passengers per day. Some 72% of the capacity available is filled with passengers travelling to destinations beyond the Gulf. Emirates is about to introduce a second daily A380 frequency from Zurich to Dubai, upgrading the present B777- service and adding 160 daily seats to the already excessive capacity, namely offering Business and First class seats at very low prices.[10] This additional capacity is not only affecting the home carrier SWISS but also other carriers directly linking Switzerland with the Asia-Pacific region (see below 3.).

The same holds true for Qatar, serving EU destinations with large aircraft, selling tickets at very low prices for flights namely to Asia - Pacific. Frankfurt and Munich are served with 14 weekly flights each, Vienna 7, Brussels 6 and 7 each from Zurich and Geneva to Doha, whereas the number of flights of the airlines of the Lufthansa Group reflects the reality of the market to Doha: There is one daily Lufthansa flight from Frankfurt to Doha.

Etihad is using a different approach: It acquires equity in ailing EU carriers, namely Air Berlin, Alitalia, Air Serbia and Darwin Airline, using them to expand its network and market reach. This is against normal practices as required by an open market economy according to which a financially weak airline would have to be substantially restructured and downsized. In the case of Etihad, the contrary has happened: It has injected vast amounts of money in these ailing European airlines in order to expand the feeder system to their Abu Dhabi-based network, including obliging Air Berlin to cancel one of its profitable flights (Berlin-Bangkok) in order to channel these passengers through its own hub in Abu Dhabi. More than 25% of the 63 weekly flights between Europe and the Gulf airports are now being operated by airlines with substantial ownership by Etihad (Airberlin, Fly Niki, Alitalia,

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[9] Slides shown by the European Commission at the EU-Gulf Aviation Dialogue, Brussels October 2014. Slide 9.

[10] According to Travel Inside, a review published by the travel agents of Switzerland, the reason for putting another A380 in the Zurich market may be due to an excess number of A380s in the fleet of Emirates. The airline may be able to sell the excess capacity but only at low prices, Travel Inside April 16, 2015, p 4.

Air Serbia)[11]. If these airlines would have been forced to consolidate – as warranted under normal market conditions – other European carriers would have taken up these operations. Etihad has not disclosed how it is financing its investments, which have reached over 1.5 billion EUR (2015) – an extraordinary amount for a company without any (commercially earned) profit.

3. *Excessive capacity of Gulf carriers mostly affecting routes between Europe and Asia*

The expansion of the Gulf carriers has resulted in massive shift in traffic flows. Some 80 percent of passengers occupying seats in an aircraft of the Gulf carriers are flying beyond the Gulf hubs to destinations in Asia and Africa.[12] In the Europe – Asia/Pacific market, Gulf carriers have steadily grown far above normal market rates. In the period from 2004 until 2014, Gulf carriers have grown 16,5%, whereas Lufthansa Group was only able to grow 1,9%, similar to the growth of the other EU network carriers.

The impact experienced by airlines of the Lufthansa Group seems not to be unique. Asian and African carriers are equally affected. As an example, Malaysian Airlines will suspend its daily Kuala Lumpur – Frankfurt flight in summer 2015, whereas at the same time Gulf carriers build up capacity in Kuala Lumpur. In summer 2015, Qatar Airways intends to expand its three times daily operation to 24 flights per week. Etihad is serving Kuala Lumpur twice a day from Abu Dhabi and Emirates is flying three times from Dubai. Needless to say that the flight operated by Lufthansa from Frankfurt to Kuala Lumpur competing against 60 weekly services of the three airlines from the Gulf is economically jeopardized.

This is an example on how the excessive capacity of the Gulf carriers affects both European and Asian carriers – and global aviation beyond these bilateral markets. Rather than adding choice to the market, they are reduced. 100 connections via three Gulf hubs is not the same as 100 connections via seven or eight international hubs.

Cutting direct connectivity between Europe and Asia is not in the interest of either airlines nor consumers nor the regulatory policy makers, trying to balance job security, growth, connectivity and consumer choice.

4. *Price race to the bottom due to excessive capacity*

Lufthansa Group has seen an unsustainable downward price race on routes served by the Gulf carriers. In the past twelve months, Gulf carriers offered tickets in all classes at very low prices. Interestingly enough, the Gulf carriers seem also to be waging a price war among them in order to fill their planes, oversized for the markets they serve. In order to maintain a market share or in some cases not to be forced out of the market completely,

[11] Etihad also has equity in Darwin Airline, Air Seychelles, Jet Airways, Virgin Australia and Air Lingus.

[12] Slides shown by the European Commission at the EU-Gulf Aviation Dialogue, Brussels October 2014, Slide 9.

Lufthansa Group airlines have responded and cut prices. Accordingly, the yields on routes to and from Asia Pacific have deteriorated. The yearly losses in yields on these routes are substantial but will not be publicly disclosed.

In this context, it should be noted that most bilateral air service agreements contain provisions that the tariffs applied by airlines should reflect costs. It is a question of political willpower to apply and enforce such provisions.

5. *Loss of connectivity of European hubs*

Airport Council International (Europe) published a study about connectivity.[13] The numbers presented in this report with respect to connectivity of the Lufthansa hubs (Frankfurt, Munich, Vienna, Zürich, Brussels) largely reflect what the airlines of the Lufthansa Group have experienced: As far as connectivity between EU and Asia/Pacific is concerned, the hubs in the Gulf are growing far above the market and connectivity is shifting from the EU hubs to the Gulf – mostly at the expense of the European network carriers such as the Lufthansa Group. The reduction of Asian and African destinations is also a substantial loss in view of the fact that Asia and Africa are areas with strong growth and a high trade potential. The airlines of the Lufthansa Group are unable to fairly compete for the growth in this area as it is fully absorbed by the Gulf carriers. Instead of being able to expand their operations to Asia and Africa, the airlines of the Lufthansa Group have reduced their network to South East Asia and Africa over the past years.[14]

Lufthansa has stopped service to the following destinations:
South East Asia-Pacific:
  From Frankfurt: Calcutta, Hyderabad, Manila, Karachi, Lahore, Sydney, Ho Chi Minh-City, Abu Dhabi, Sanaa, Tashkent, Katmandu, Denpasar/Bali, Pusan, Male/Maldives, Mahe/Seychellen, Colombo
  From Munich: Singapore; Jakarta not added because of dominance by the Gulf carriers
Africa:
  Asmara, Nairobi, Khartoum, Harare, Mauritius, Entebbe, Lusaka

Austrian Airlines has given up the following destinations:
South East Asia-Pacific:
  Denpasar, Melbourne, Sydney, Shanghai, Kuala Lumpur, Singapore, Colombo, Kathmandu, Bombay, Rangoon, Phuket, Jeddah, Riyadh, Beirut, Damascus, Tripoli, Baghdad
Africa:
  Nairobi, Johannesburg, Harare

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[13] Airport Industry Connectivity Report 2004 - 2014, ACI Europe, 2014.
[14] At some of the remaining destinations, Lufthansa Group airlines were able to moderately increase the number of seats, but less than market growth.

Swiss International Air Lines with its subsidiary Edelweiss Air has given up the following destinations:

South East Asia-Pacific:

Ho-Chi- Minh-City, Manila, Jakarta, Colombo, Karachi, Kuwait, Abu Dhabi, Jeddah, Riyadh, Teheran, Beirut, Damascus, Baku

Africa:

Yaoundé, Lagos, Accra, Malabo, Harare, Douala, Libreville, Tripoli, Bengasi, Tunis, Casablanca, Edelweiss Air: Kilimanjaro, Mombasa, Agadir, Djerba, Monastir, Luxor, Marrakesh, Marsa Alam, Mauritius

IV. Jobs lost due to the shift of Traffic Flows

The loss of market share sooner or later translates into the elimination of flights and ultimately to the reduction of the fleet, thus reducing consumer choice and jobs. The numbers presented in the study of the US carriers that each long haul aircraft creates about 800 direct jobs corresponds to the experience of Lufthansa Group. The impact of unfair subsidies must also be assessed through the eyes of airline employees, workers in the service and supply chains, not merely the commercial entities which are affected. The cancellation of the Lufthansa flight between Frankfurt and Abu Dhabi may seem insignificant in view of the overall numbers of flights operated by Lufthansa. But there is much more to this development. The flight is not eliminated from the network because there are no passengers wanting to travel. It is because Lufthansa as a European carrier can no longer compete with a carrier that is subsidized by its government.

V. Overcoming the Dispute about Subsidies - Reduce it to what it is: A trade dispute

Shortly after the publication of the study, the three Gulf carriers disputed the notion that they are subsidized. At a later stage they argued that EU and US carriers have equally been granted substantial subsidies from the government.

This discussion demonstrates the fundamental differences between the affected countries. In the US and the EU, any public support is subject to public and regulatory scrutiny and relevant information is transparent, publicly available, including via the internet. Financial investments in airlines are subject to national approval procedures and in most cases parliamentary votes.[15] In the EU, regulations require all relevant information to be submitted to the European Com-

[15] The aid granted by the Swiss government is a point in case: Swissair went bankrupt because it had acquired too many ailing airlines. After the grounding, the Swiss parliament approved a loan of 1,17 bn. Swiss Francs. In the still pending bankruptcy proceeding, this loan is listed and the Swiss government will participate in the proceeds of the liquidation of the assets of the former Swissair. The equity of the Swiss government in the new airline Swiss International Air Lines was also fully transparent (600 mio CHF) and when Lufthansa acquired SWISS, the Swiss government was paid for its equity like the other shareholders.

mission and the appropriate and lawful use of the funds is constantly monitored. Last but not least, the amounts European governments have invested in their airlines are a fraction of the amount in comparison to the Gulf region. They were spent because these governments wanted to preserve their carriers to connect their economy with other countries in accordance with local demand, not to inundate markets with unprecedented capacity surplus.

In the Gulf countries, however, such transparency and regulatory scrutiny is completely lacking. In order to assess whether the – undisputed – support provided by the governments in the Gulf is compatible with their activity in the fully liberalized EU internal market, transparency needs to be established.

Equally as important as creating transparency, the controversy should be reduced to what it actually is: a trade dispute. Both the US and EU have trade experts who are experienced with the multilaterally-agreed subsidy rules of the WTO, and they should be called upon to determine whether the financial support granted to the Gulf carriers amounts to subsidies as defined in the context of WTO agreements.

VI. Conclusions

The unprecedented growth of the three Gulf carriers is a challenge global aviation has not experienced in its long history. The aviation policy of the UAE and Qatar are true game-changers, putting capacity in the market at prices that airlines working under normal market conditions cannot reasonably match. This has led to a radical shift of market shares and connectivity from Europe to the Gulf and this process has only started. What has happened in Europe may well be the blueprint of what is going to happen in the US. Many of the routes operated by Lufthansa Group airlines between Europe and the Gulf as well as between Europe and Asia/Pacific have seen an alarming deterioration of yields. As a consequence, Lufthansa had to relinquish a number of valuable destinations in the South East Asia - Pacific area, whereas the network of the Gulf carriers both in Europe and South East Asia - Pacific has steadily grown.

The downsizing of the intercontinental network of the Lufthansa Group to and from its hubs means that the European and domestic feeder network is also suffering. On each Lufthansa flight to and from its hubs, at least 30% are transit passengers. If these passengers are travelling through hubs in the Middle East instead of European hubs, the European feeder flights to and from Lufthansa Group hubs are in danger of becoming economically unviable.

So far, neither authorities nor airlines from the Gulf have been fully transparent in demonstrating how such growth far exceeding normal market patterns is financed. The study undertaken by the three US carriers has produced sufficient evidence that the Gulf carriers' rapid expansion is attributable in great measure to the governmental aviation policy and not the carriers' private initiatives in line with the principles of a liberalized market. Lufthansa Group believes that the European authorities need to apply the same principles to aviation as in other fields of international trade. Foreign companies doing business in Europe need to adhere to the same principles which apply to European companies doing business in Europe. The EU has applied

its competition rules to Chinese steel manufacturers and manufacturers of solar panels; it is investigating whether Google is playing by the rules of the European market to protect the interest of European consumers and European companies. As long as the Gulf carriers do business in open Western markets, namely Europe and the US, the respective governments should apply the same principles as it does in other industries. Gulf countries have demonstrated that they have a deliberate approach on how to organize their aviation strategies and policies in their countries. Yet in the spirit and letter of the law of global liberalization, they need to abide by the well-established principles of liberalized aviation markets.

The issue at stake is a trade dispute and should be dealt as such by the international aviation community and the relevant governments around the world impacted by such by the described market developments.

In view of the exceedingly high number of aircraft ordered to be placed into operation by the Gulf carriers in the coming months and years, action is needed. With respect to the US, such action is especially required in view of the fact that Gulf carriers are now also entering the EU – US market (flight of Emirates between Milan and New York), affecting a market on which so far EU and US airlines compete – some in Joint Ventures which are subject to comprehensive competition rules. Competition in the Trans-Atlantic market is a shared objective of Lufthansa Group and the key objective of the EU-US and the EU-Canada and possibly soon the EU-Brazil agreements. Such competition should take place on a level playing field.

Lufthansa Group respectfully submits that the EU and national authorities of Member States as well as the authorities of the US government should assess the extent to which the Gulf carriers are receiving subsidies before permitting further expansion of capacity and investments by Gulf airlines in their jurisdictions. In order to evaluate whether the support granted to the Gulf carriers is state aid, the criteria as defined in WTO agreements should be used as a basis for applying and enforcing fair competition.

Thank you for your attention to this matter of vital importance to the aviation community.

Sincerely yours,

Lufthansa Group

Thomas Kropp
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and Government Affairs