II

(Acts whose publication is not obligatory)

COMMISSION

COMMISSION DECISION

of 6 July 1994

concerning increase in capital, credit guarantees and tax exemption in favour of TAP (Transportes Aéreos Portugueses)

(Only the Portuguese text is authentic)

(Text with EEA relevance)

(94/698/EC)

THE COMMISSION OF THE EUROPEAN COMMUNITIES,

Having regard to the Treaty establishing the European Community, and in particular the first subparagraph of Article 93 (2) thereof,

Having given notice in accordance with the above Article to interested parties to submit their comments and having regard to those comments,

Whereas :

I

By letter of 26 January 1994, registered with the Commission Secretariat-General on 31 January 1994, the Portuguese authorities notified to the Commission, under Article 93 (3) of the Treaty, their intention to increase the capital of the national airline Transportes Aéreos Portugueses, SA (hereinafter referred to as TAP). The aid was registered as notified aid No N 122/94 on 24 February 1994 with the Commission. The Portuguese authorities enclosed with the notification a copy of a restructuring programme, called 'Strategic, Economic and Financial Restructuring Plan' (hereinafter referred to as 'the plan'). The Portuguese authorities and TAP had previously announced their intention to grant aid to Tap, in a meeting held with the relevant officials of the Commission's Directorate-General VII (Transport) on 25 January 1994 in Brussels. During this meeting the Portuguese Government invited the Commission to request from TAP the information necessary for assessing the aid application. TAP later provided, additional information and a Portuguese and English version of a report by Banco Português de Investimento (BPI) and Barclays de Zoete Wedd Ltd (BZW) (hereinafter 'the consultants'), on the restructuring and strategic options of TAP.

By letter of 19 May 1993 [1] the Commission proposed to the Portuguese Government, under Article 93 (1) of the Treaty, that it should adopt appropriate measures to abolish TAP's exemption from taxation. The Commission stated in its proposal that should the Portuguese Government fail to adopt the appropriate measures it might open the Article 93 (2) procedure with regard to the tax exemption. The Portuguese Government informed the Commission that they intended to address this question in the framework of the forthcoming restructuring programme. In fact, in the abovementioned plan the Portuguese Government suggests the abolition of the tax exemption by the end of the restructuring, that is to say, by the end of 1997.

The Commission decided to open the Article 93 (2) procedure with regard to the abovementioned aid measures and informed the Portuguese Government of this decision by letter of 21 March 1994. This letter was published in the *Official Journal of the European Communities* [2] and third parties were invited to comment within 30 days of the publication. The Portuguese authorities replied to the Commission's letter by letter of 21 April 1994, registered with the Commission on 22 April 1994. The United Kingdom, Sweden,

[1] OJ No C 163, 15. 6. 1993, p. 5.
[2] OJ No C 93, 30. 3. 1994, p. 12.

Finland, Denmark, Norway, a number of European airlines, mainly established in the United Kingdom, and TAP's trade unions submitted their comments within the procedure. All the comments were duly transmitted to the Portuguese Government. On 1 June 1994 the Portuguese authorities held a meeting in Brussels with the competent officials of the Commission Directorate-General VII; during this meeting they provided a letter by which they replied to the third parties' comments. Further information was transmitted by letter of 20 June 1994, registered with the Commission on 21 June 1994.

II

The plan was approved by the Portuguese Government as the sole shareholder of the airline, at the General Shareholders' meeting of 17 January 1994. The plan aims at restoring the economic and financial structure of the company over a period of four years (from 1994 to the end of 1997). The plan provides that the company shall be recapitalized through an increase in capital of Esc 180 billion (ECU 913,7 million) to be carried out in four tranches. The Government will, in particular, increase the airline's capital by taking responsibility for its outstanding loans up to the amount of:

— Esc 50 billion in 1994 (ECU 255 426 530),

— Esc 50 billion in 1995 (ECU 255 426 530),

— Esc 40 billion in 1996 (ECU 204 341 122),

— Esc 50 billion in 1997 (ECU 204 341 122).

The granting of the aid by the Portuguese Government to TAP is subject to the following conditions:

(a) approval by the Commission of the capital increase;

(b) realization of measures foreseen in the plan relating to the achievement of the forecast operating results;

(c) rigorous control of costs;

(d) termination, at the end of the period of application of the plan, of the range of tax exemptions which TAP enjoys.

Moreover, the Portuguese Government will guarantee during the plan the airline's credit operations up to the following total amounts:

— up to Esc 162 billion until 1994 (ECU 827 581 970),

— up to Esc 169 billion until 1995 (ECU 863 341 690),

— up to Esc 129 billion until 1996 (ECU 659 000 460),

— up to Esc 70 billion until 1997 (ECU 357 597 150).

According to the Portuguese authorities the granting of these credit guarantees is necessary because of TAP's ailing financial position. The increase in capital will be spread over a four-year period and it is only at the end of this period that TAP will achieve a financial situation credible to banking institutions.

According to TAP, the total amount of the forecast tax exemptions (mainly exemption from income tax and stamp duty) will be, for the period 1994 to 1997, about Esc 8 billion (ECU 40 868 245).

III

Since its nationalization in 1975 TAP has been owned by the Portuguese Government. TAP, which is the most important Portuguese air carrier, is, with 38 aeroplanes (including the non-scheduled fleet), 9 691 employees (end 1993), and a turnover for 1993 of Esc 162 232 000 000 (ECU 808 330 000), one of the smallest of the 'national' airlines of the Community.

TAP's activities mainly consist of air transport, handling and maintenance. The company's most important business by far is air transport. In 1992 air transport turnover represented 86 % of the total operating revenues.

In 1993 TAP started to focus on the three abovementioned main business activities. It has been selling or closing down loss-making associated companies (the airline Air Atlantis ceased its activities in May 1993 and is at present in liquidation, the airline Euroair was declared insolvent at the end of 1993, the tour-operator RN Tours was sold by the end of January 1994). At present TAP's most relevant participation is a stake in the catering company Cateringpor, 49 % of whose capital (previously 100 % owned by TAP) was sold in November 1993.

Within the Community, TAP's home market is a peripheral and relatively small one. Portugal is mainly a leisure destination characterized by low-yield traffic and in which TAP faces competition from charter airlines as well as from scheduled airlines. Deposite its limited size TAP operates a very heterogeneous network. Its most important market is Europe, where over 80 % of its operations are concentrated. The domestic market mainly comprises routes to the Atlantic autonomous regions of the Azores and Madeira, upon which the Portuguese Government has imposed public service obligations. In addition, TAP operates a number of North Atlantic routes, which are generally loss-making, and some routes to Central and South America. An important sector of the airline's network is the African one, which consists mainly of the routes to the former Portuguese colonies. No routes to the Far East are at present operated by TAP.

To serve such a varied network TAP has a mixed fleet of aircraft; it operated by the end of 1993, five different types of aeroplanes in a fleet of 38 aircraft (10 B-737-200s, 10 B-737-300s, six AB-320s, five AB-310-300s, seven L-1011-500s); the average age of the fleet which is leased in its entirety, is about 6,8 years. The fact that such a small fleet consists of so many different types of aircraft is a cause of inefficiency because it creates problems in crew flexibility, training and investment in spares and specialized equipment.

TAP is an airline which has three main problems: first, its network still relies heavily on the traditional markets within Portugal and overseas. However, its domestic market is, as stated above, characterized by low-yield traffic; the routes to the former Portuguese colonies are, because of their political instability, generally very risky markets and have in any case lost most of their former lucrativeness. The route structure has not been properly adapted to the developments in the market. Second, as mentioned above, the airline has an inefficient mix of aircraft. Third, the airline suffers from low productivity. The Portuguese authorities expressly recognized that 'from whichever the angle we analyse the present TAP productivity ratios, their figures are consistently below those of its main European competitors — a situation that obviously puts the company at a clear disadvantage'.

Even taking account of the average journey length, which is a factor having a direct bearing on an airline's productivity ratios, TAP's productivity is well below that of its competitors.

TAP's poor productivity is generated by its high cost/low revenue structure. The company has been overstaffed, badly organized, and operates too many types of aircraft.

In the past, TAP has not pursued a sound commercial policy with regard to the pricing of its product. The success of the airline was sought by high-load factors rather than through profit-oriented tariffs. It appeared more important to fill the plane (often through consolidators at marginal prices) than to optimize the operating result.

TAP's handling sector which employs some 2 100 employees, still benefits from a monopoly of third-party business, except in Madeira. In the majority of Portuguese airports, non-Portuguse airlines are only allowed to self-handle (ramp and passenger).

TAP's maintenance operation has some 2 000 employees. About 50 % of its activities are devoted to the airline itself. The sector has been suffering in recent years from the general depression in the aviation industry. Again, there appears to be room for efficiency improvements and refocusing of the business in line with the company's overall business plan.

TAP is experiencing a serious financial crisis. At the end of 1992 the airline's total assets were Esc 130,7 million while total liabilities were Esc 147,3 million. Equity has been negative since 1980 (minus Esc 16 493 000 in the financial year 1992). The situation further deteriorated in 1993. The equity at the end of this financial year was minus Esc 53 044 000. The ratio of equity plus long-term liabilities against the fixed assets, which in a balanced financial situation should be higher than 1, was 0,65; this demonstrates that TAP's capital structure is fundamentally weak; investments in fixed assets, which cannot easily be converted into cash, are financed through short-term borrowings.

Because of its negative equity TAP's gearing ratio is much worse than those of its European competitors.

Such a weak financial structure is mainly due to the heavy accumulated losses which have eroded the airline's capital. It must be stressed that since its nationalization in 1975 TAP has been consistently loss making and has had negative operating results. TAP makes losses on the majority of its network. In 1992 TAP made a profit on only 11 of its routes, while 30 routes showed a loss that exceeded 50 % of their revenues. TAP's financial difficulties began in 1974 when the company lost the transport monopoly on the routes to the former Portuguese colonies in Africa, which were characterized by intense traffic and high load factors and yields.

As regards profitability, TAP is in a worse situation than the majority of its European competitors.

The only way to overcome this situation is the adoption of a serious restructuring plan which should redress the economic viability of the company and bring its financial ratios within more prudent limits. The Portuguese authorities are perfectly aware that the present situation cannot be indefinitely maintained because it would lead to the irreversible collapse of the activity 'even with a strong effort of recapitalization, as long as this effort is not accompanied by strong measures of restructuring and redimensioning'.

IV

The new Board of Directors of TAP, which was appointed at the end of 1992, has already undertaken several measures in order to initiate the recovery process of the airline.

In particular:

— as regards the restructuring of the organization: the ground handling, maintenance and engineering departments have recently been transformed and are managed as autonomous profit centres. The activities of some minor services and departments have been incorporated in a Secretariat-General which should allow for economies of scale in the acquisition of goods and services. The administrative services of some overseas offices were transferred to the head office,

— regarding personnel, the Portuguese Government has issued in March 1993 an instrument setting out a new Administrative Labour Regulation (a measure provided for under Portuguese law), which sets out the working conditions and relations between TAP and its staff as from 1 April 1993. It is estimated that the implementation of this regulation will be to bring about an annual reduction of labour costs close to Esc 3 billion. Moreover, wages have been frozen in 1993 and 1994, and in 1993 some 1 200 jobs were eliminated (in 1993 these measures have the effect of reducing costs by some Esc 4 billion),

— regarding their fleet, TAP renegotiated successfully the terms of some aircraft lease contracts; after the liquidation of its afiliate Air Atlantis, four aircraft returned on lease to TAP (of which two were leased to Air Atlantis with TAP's warranty and the other two were leased to TAP which subsequently subleased them to the subsidiary). This increase in its fleet was offset by disposing of two B737-200s and terminating the lease contract of two B737-300s,

— regarding the associate companies, as pointed out above, TAP is reanalysing its policy of ownership by disposing of the unprofitable ones.

The restructuring plan, which has been forwarded to the Commission for examination, represents a further development of the measures already undertaken in 1993. The Portuguese Government informed the Commission that this document had been established on the basis of a consultants' report which has been sent to the Commission (see Chapter I above). This report analyses eight strategic scenarios developed by the Board of Directors and the Government, for the future of TAP. These options range from a scenario of continuity, leading to the collapse of the operations, to a scenario of reduction which provides for a drastic decrease of over 5 000 employees and a shrinkage of 16 aircraft over the 1994 to 1997 period. Each option foresees TAP serving a different set of geographical markets.

The consultants' report includes, amongst others, a financial analysis of each of the scenarios and an estimate of the scale of the recapitalization required for each scenario. The Portuguese Government has based its plan on 'Scenario No 2' which has been presented by the consultants as the best available option. This scenario aims at redressing the airline's economic and financial situation within a period of four years (1994 to 1997). The productivity target of the plan consists in reaching a ratio of 242 000 available tonne kilometres (ATK)/empoyee, over all TAP's employees, or 366 000 ATK/employee, excluding the employees of the maintenance and handling divisions working for third parties. As regards the flight personnel the plan aims at reaching, for the cockpit crew, as upper target ratio, the value of 780 revenue hours per annum for the technical staff, and, for the cabin crew, the target of 13 450 available passenger kilometres (APK)/cabin crew.

According to the Government's plan those targets should be achieved by:

(a) reorganizing the company and implementing a decentralized structure to reduce bureaucracy and improve the campany's capacity for reaction. This objective should be attained through:

— focusing on TAP's core business — that is, air transport,

— running other activities (initially the maintenance and handling sectors) as autonomous profit centres,

— implementing an integrated management of all the companies owned by TAP;

(b) reducing the personnel via schemes of early retirement, pre-retirements or severance of labour contracts by mutual consent. The plan foresees a reduction of personnel from 9 691 employees in 1993 to 7 110 employees in 1997 (a loss of 2 581 people);

(c) creating a spirit of austerity by reducing all unnecessary expenses. In this respect:

— work regulations should be modified to achieve more flexibility,

— investment will be made only in the main areas of operation and with direct outcome on the results. According to the plan TAP should close its branches in North America, with the sole exception of New York, and this would bring about an elimination of 90 jobs and cost cuts of over Esc 340 million per year. TAP intends to keep investing in the former Portuguese colonies in Africa (namely in Mozambique, São Tome-, and Guinea-Bissau) where it has important 'frozen' funds which probably could not be otherwise invested. As regards the former Portuguese colony Macao, TAP is planning to buy a 25 % stake in the local airline, Air Macao, which should start operating at the beginning of 1996;

(d) adapting the commercial activity to the new market conditions in order to offer a more competitive product. In this respect TAP will rationalize its network, abandoning a number of routes and focusing its activity on some others. In the European sector TAP will eliminate from its network the chronically unprofitable routes which might be operated either only seasonally or by non-scheduled carriers. In the North Atlantic sector, which is traditionally loss-making for TAP, the airline will discontinue all routes except New York; TAP is contemplating entering into an association agreement with an American carrier which could continue serving the routes abandoned by TAP. In the central and southern Atlantic and the African sectors TAP will generally maintain its present network. As regards the Far East TAP wishes to start flying to the former Portuguese colony of Macao.

Under the chosen scenario TAP will reduce the fleet from 38 aircraft in 1993 to 32 in 1997;

(e) making full use of TAP's sales capacity through a number of newly acquired computer systems which, by improving the airline's internal organization, should improve revenues and reduce costs. In particular TAP:

— has developed a cash management system to centralize the management of its banking department. The complete implementation of this system should *inter alia* minimize financial expenses, and optimize the management of account balances,

— wishes to implement in full, as soon as possible, a yield management system, which was acquired at the end of 1990, in order to maximize revenues,

— intends to use in full and possibly improve the capacity of its computer reservation system, with regard to sales management and market analysis;

(f) introducing a coherent system of analytical accounting;

(g) reorganizing the accounting system of traffic revenue which will allow an improvement in the quality of the daily revenue control.

Regarding the recapitalization the consultants stress that a key element of any recovery plan is to provide TAP with a financial strength sufficient 'to service current and future debt with a margin for safety, and to enable it to borrow on a stand-alone basis, without Government support'. The consultants, assuming that wages were to keep pace with the projected Portuguese inflation rate of 5 %, consider that a capital injection of at least Esc 180 billion, which was planned to take place in June 1994, plus Esc 15,7 billion to fund TAP's unfunded pension liability, would be required.

In their conclusions the consultants state that 'the successful implementation of the measures assumed in each scenario will still not be sufficient to achieve the efficiency levels needed for survival'. The consultants point out that TAP does not have the critical mass to survive in the new competitive environment established with the creation of the common aviation market. Therefore TAP should, in the longer term, be compelled to seek a strategic alliance or alliances with a foreign industrial partner. This alliance may be sought only after TAP has repaired its financial situation as a consequence of the successful implementation of the planned restructuring measures. In this respect it must be stressed that the restructuring plan does not exclude the possibility of TAP's entering in future into joint ventures or other kinds of association agreements with other international carriers and states that contacts are already being made to identify the most suitable European or American partner.

As stated above, the plan provides that, because of budget difficulties, the Esc 180 billion increase in capital should take place in four tranches and that the Government guarantees the airline's borrowing up to the amounts indicated above. As a consequence of the recapitalization, the plan forecasts that TAP will achieve in 1997 a financial autonomy ratio (equitiy against total assets) of around 28 %. The equity and the operating results will become positive from 1996, and the airline will make the first profit in 1997.

V

The Commission decided to open the Article 93 (2) procedure because it had some doubts or needed further clarifications on the following points:

1. that the plan is adequate to enable TAP to eliminate its problems and become, within the restructuring period, an efficient air carrier. The productivity and efficiency targets of the plan, which some of TAP's competitors have already achieved, appeared to be insufficient to restore viability;

2. that the recapitalization as set out in the plan is sufficient to bring the airline's financial ratios into more prudent limits;

3. that some changes (a more gradual reduction of personnel and the payment of the capital injection in four tranches instead of a one-off capital increase) made to the scenario submitted by the consultants do not jeopardize the objectives of the plan;

4. that the possible under-compensation of the deficit incurred by fulfilling the public service obligation requirements on the routes to the Atlantic islands of Azores and Madeira does not lead to substantial losses which might impair the success of the plan;

5. that the aid does not affect trading conditions to an extent contrary to the common interest.

VI

The interested third parties that have commented on the case have mainly expressed doubts on the adequacy of the restructuring measures in the plan and concerns that the aid may be used by TAP for anticompetitive purposes. In particular, with the aid TAP may dump fares and capacity on European routes to the detriment of its competitors. Moreover, the Portuguese authorities shall encourage competition by opening up handling activities to third parties at Portuguese airports.

The comments submitted by the Portuguese authorities, which provided useful information on the development of the plan, as well as the replies to the different points raised in the opening of the procedure, may be summarized as follows:

1. As regards the productivity targets, the value of 242 ATK/employee ATK-employee to be achieved by the last year of the plan represents a growth of nearly 50 % over the four years of the plan. However, if one excludes from the total number of personnel those employees (34 % of the total workforce) who in 1997 will be working exclusively for third parties in the maintenance and handling areas, this figure would reach 366 000.

2. With regard to the adequacy of the recapitalization and its modalities, some of the assumptions of the plan and the consultants' study would be different. The plan is based on more recent and accurate data. In particular, the consultants, in recommending a one-off capital injection of Esc 180 billion, were considering a scenario based on an average wage increase of 5 % per year. Instead, the plan is based on a wage freeze in 1993 and 1994 and an average yearly increase of 3 % in the period 1995 to 1997. The savings expected from these measures and Esc 13 billion at 1994 prices. Moreover, further savings expected from these measures are Esc 13 billion at 1994 prices. Moreover, further savings are expected from TAP's pre-retirement scheme. According to the consultants the cost resulting from the negotiated reduction of TAP's workforce by 2 581 employees (2 000 in 1994 and 581 in the following three years) amounts to Esc 28,9 billion. Because of the pre-retirement scheme the actual cost expected by TAP is only Esc 21 billion, which is Esc 7,9 billion lower than that forecast by the consultants. Using a 10 % discount factor (1), the net present value of Esc 180 billion to be injected in four tranches, as forecast in the plan, is Esc 159 billion at June 1994 prices. By adding to this amount the differences of Esc 13 billion and Esc 7,9 billion, resulting from the wage freeze and the use of the pre-retirement scheme, one obtains a total value of Esc 179,9 billion, which is very similar to that forecast by the consultants. This shows that the one-off injection and the payment of the aid in four tranches are equivalent solutions.

With regard to the timing of the capital injection, it is important to reconcile the company's needs with the financial capacity of the owner, which means that the recapitalization could not be carried out on a one-off basis, but only in four instalments and by the assumption of debts. The Portuguese Government considers that the capitalization level which would be attained is sufficient to support the structural changes, enabling the company to attain gradually a self-sustained and balanced situation. This conviction relies upon the

(1) The rate of 10 % represents TAP's marginal cost of borrowing. The Portuguese authorities informed the Commission that, in the last financial transactions entered into by TAP with Portuguese banking institutions; the Portuguese airline succeeded in obtaining an interest rate of around 9,8 %.

forecast evolution of the operating results, an indicator that reflects the company's real performance. The operating result, which is at present negative, improves gradually over the restructuring period and becomes positive in 1996 (Esc 5.5 billion) and increases threefold during the next year. The above considerations would show that the differences in the implementation of the plan compared with the scenario assumed by the consultants would not affect the achievement of the final targets as laid down in the consultants' study.

3. With regard to the possible adverse effects of the aid on trade and competition, TAP would not be able to use the aid to pursue an expansionist strategy by increasing capacity or dumping tariffs. TAP will not increase its market share in the areas which it is at present operating and its fleet will even be reduced from 38 aircraft in 1993 to 32 in 1997. The acquisition of four AB 340 aircraft will not have any impact on the company's supply in the European market since these aircraft will be operated only on long-haul routes. In the European market, supply (measured in seats) will be reduced from 3 499 seats in 1993 to 3 168 seats in 1997. This reduction represents a decrease of 9,5 % in the supply on the European market at a time when this market is expected to grow by 6,6 % per year. Moreover, TAP intends to discontinue some routes, including the routes which were operated by Air Atlantis. During the restructuring period TAP does not intend to open any new European routes, its only objective being to rationalize its network.

   In response to the United Kingdom competitors, Portugal maintains that TAP's market share between Portugal and the United Kingdom is relatively small (in 1993 TAP carried only 17,4 % of the total number of passengers carried between Portugal and the United Kingdom, and 2,6 % of the non-scheduled traffic). TAP is not the price leader on the routes between Portugal and the United Kingdom but it has matched some of the tariffs applied by some of the United Kingdom airlines.

   In the general TAP has about a 3 % share of the total European passengers carried by the airline members of AEA (Association of European Airlines). With such a small market share, and considering that TAP has planned to discontinue the operation of several European routes, has forecast an increase in capacity below the average forecast by International Air Transport Association (IATA) over the restructuring period and does not intend to open new routes in the European market, it is virtually impossible to maintain that TAP's recovery is going to affect the competitive situation of its European competitors.

   The Portuguese authorities have also submitted the following clarifications regarding handling and slot allocation :

   — TAP does not have a handling monopoly at the Portuguese airports, where every airline is allowed to self-handle,

   — the Portuguese authorities have never received any complaint concerning slot allocation. In Portugal the airports are not coordinated. DGAC (Directorate-General for Civil Aviation), and not TAP, is in charge of supervising the coordination of the timetables and airport capacity.

4. With regard to the public service obligations on the routes to the Atlantic islands of the Azores and Madeira, such obligations could not jeopardize the future recovery since the State has given a commitment to compensating TAP. However, the Portuguese Government is prepared to follow a public tender procedure, pursuant to the criteria laid down in Article 4 of Council Regulation (EEC) No 2408/92 (1) on market access, for selecting the airline that from January 1996 will provide transport services between the mainland and the Azores and Madeira. It is worth noting that although the Azores are excluded from the scope of the abovementioned Regulation, the Portuguese Government intends to submit the corresponding public service obligations to the same scheme of public tendering, as mentioned above. To this end the Portuguese Government will inform the Commission, during the first half of 1995, about the contents of these public service obligations for publication in the *Official Journal of the European Communities.* Moreover, Portugal will authorize all types of non-scheduled flights on the routes between third countries and the Azores, despite the fact that these islands are excluded from the abovementioned Regulation. In this connection Portugal has confirmed that liberalization of non-scheduled air transport between all Community airports and the Azores refers to all the services that are not covered by the definition of 'scheduled air services', pursuant to Regulation (EEC) No 2408/92, including seat-only charter and one-way charter. Non-scheduled flights between the Portuguese mainland and Madeira and the Azores are authorized, provided that they do not conflict with the exclusive concession for scheduled flights, which is still valid by virtue of Article 5 of the abovementioned Regulation.

(1) OJ No L 240, 24. 8. 1992, p. 8.

5. Portugal has given the commitment not to authorize total or partial acquisition of shareholdings in any EEA airlines during the restructuring period. This commitment is without prejudice to the airline's continuing its endeavours to find one or more airline partners, through an association or cooperation agreement, to complement its network.

6. With regard to the inefficiency of TAP's mixed fleet, in the medium term this inefficiency will be attenuated. The fleet will mainly consist of Boeings to operate medium-range routes and Airbus on the long-range ones, which is the situation of most of European airlines.

7. Portugal will initiate in 1997 the procedures leading to the partial privatization of TAP's capital, in accordance with a model yet to be defined.

VII

Article 92 (1) of the Treaty and Article 61 (1) of the EEA Agreement (hereinafter referred to as 'the Agreement') provide that any aid granted by a State or through State resources in any form whatsoever which distorts or threatens to distort competition between the Member States, by favouring certain undertakings or the production of certain goods, is incompatible with the common market and the Agreement, in so far as it affects trade between the Member States and the contracting parties.

The Treaty and the Agreement establish the principle of neutrality with regard to the system of property ownership existing in the Member States and the principle of equality between public and private undertakings (Article 222 of the Treaty and 125 of the Agreement). As a consequence of those principles the Commission's action cannot prejudice or promote public entities when they inject capital into undertakings. However, the Commission must investigate financial intervention from public funds into companies to prevent the Member States from using State aid to harm fair competition within the common market.

In the present case the Portuguese Government intends to increase TAP's capital by Esc 180 billion and wishes to guarantee TAP's credit operations up to certain defined amounts over the four-year restructuring period. The Portuguese Government has already issued a credit guarantee to enable TAP to renegotiate a credit facility. Moreover, TAP benefits from an exemption from some taxes applicable in Portugal. It is opportune to examine separately the capital increase, the guarantees and the tax exemption under the relevant provisions of the Treaty.

A. *Increase in capital*

In determining whether State aid is involved in capital injections out of public funds the Commission bases its assessment on the market economy investor principle. According to this principle no State aid is involved when fresh capital is contributed in circumstances that would be acceptable to a private investor operating under normal market economy conditions [1].

The Court of Justice has specified that the behaviour of a private investor, with which the intervention of the public investor has to be compared, has to be at least that of a private holding or of a private group which follows a structural, global or sectoral policy and which is guided by profitability perspectives in the longer term [2].

The Portuguese authorities have duly notified to the Commission, pursuant to Article 93 of the Treaty, the projected capital increase as aid in favour of TAP. However, in the notification they maintain that 'a private investor, in the conditions of a market economy and having a long-range outlook, could be willing to make an investment identical to that which the State proposes to make, given that there are consistent perspectives of profitability after the period of implementation of the restructuring programme'. The Commission does not share the Portuguese Government's opinion. In the present case the Commission considers that the rational private investor, taking into due account the ailing financial structure of the Portuguese airline, would not have agreed to invest money in TAP. It must be recalled that, according to the plan, the operating results will become positive in 1996 and the company will attain its first positive net result in 1997 only. This profitability outlook, together with the huge amount of debts and accumulated losses burdening the airline's financial accounts, as described above (Chapter III), would dissuade a private investor from investing any money in TAP because it is impossible to expect a normal return on the investment within a reasonable period of time. Therefore the Commission considers that the notified capital increase is an aid.

(1) See Commission communication of 17 September 1984 concerning public authorities holdings op. cit.; Court of Justice, Joined Cases 296 and 318/82, The Netherlands and Leeuwarder Papierwarenfabriek v. Commission, [1985] ECR 809, paragraph 17, p. 823.

(2) See Case C-305/89, Italy v. Commission, [1991] ECR 1603, paragraph 20, p. 1641.

B. *Guarantees*

By a letter of 5 April 1989 sent to the Member States, the Commission informed them of its attitude towards State guarantees. The Commission considers that all borrowing guarantees given by the State directly or given by the State delegation through financial contribution fall within the scope of Article 92 (1) of the Treaty. The Commission will accept the guarantees only if they are contractually linked to specific conditions which may go as far as the compulsory declaration of insolvency of the recipient undertaking or any similar procedure. The Commission informed the Member States that each instance of the granting of State guarantees has to be notified under Article 93 (3) of the Treaty, whether the grant is made pursuant to an existing general guarantee scheme or of a specific measure. Moreover, as regards the guarantee scheme the Commission has made it clear that it intends only to examine schemes establishing guarantees and not every case in which a guarantee is granted under a scheme (see letter of 12 October 1989).

The Portuguese Government has notified to the Commission its intention to guarantee TAP's borrowings up to certain maximum amounts during the restructuring period. Those guarantees are not granted under a scheme but are specific aids which would enable TAP to borrow the money necessary to continue operating and to survive. As regards State guarantees, the Commission is of the opinion that the aid element involved is normally the difference between the rate which the borrower would pay under normal commercial conditions and that actually obtained under the guarantee, net of any premium paid for the guarantee. However, in the light of the airline's financial difficulty, the Commission considers that no financial or banking institution would lend money to TAP without a State guarantee. The Portuguese authorities, in justifying the need for the guarantees, confirm that 'only at the end of the period will the company show a credible financial situation with the banking institutions'. It follows from the above that TAP would not be able to borrow money if the banks could not rely on the Government's commitment to TAP. Therefore, the amount of the aid involved in the State guarantee could be equal to the amount of money borrowed with the help of the guarantee. In 1993 the Portuguese Government issued five comfort letters to cover several bank loans.

Those comfort letters have enabled TAP to obtain credit facilities from some Portuguese and foreign credit institutions. The comfort letters, by assuring the lenders that the Government is behind the airline, improve TAP's borrowing position and may be considered as guarantees. This character is undisputed by the Portuguese Government.

C. *Tax exemption*

TAP enjoys a tax exemption. This fiscal privilege was established before the accession of Portugal to the Community. The tax exemption is an individual aid because it reduces the burdens which an undertaking should normally bear. Because of the tax exemption the undertaking benefits from a competitive advantage over its competitors which do not benefit from similar privileges. The Portuguese Government informed the Commission that it will abolish the tax exemption at the end of the restructuring period only. The company estimates the total amount of the exemption, for the period 1994 to 1997, at about Esc 8 billion. Thus the tax exemption can now be considered to be another aid measure in the framework of the restructuring plan.

TAP is an airline which operates several European routes on which, as a consequence of the liberalization of the common air transport market, competition is intense. Because of the projected capital increase and the credit guarantees, TAP receives a direct competitive advantage over its competitors who do not enjoy such facilities; thus the aid distorts competition within the common market. Moreover, the aid affects trade in the EEA because it is granted to a company which operates in the air tranpsort sector which involves by its nature trans-border operations.

Accordingly, the Commission believes that the notified capital increase and credit guarantees (including the non-notified guarantees in the form of comfort letters) as well as the tax exemption are aid within the scope of Article 92 (1) of the Treaty and Article 61 (1) of the Agreement. The latter guarantees should have been notified to the Commission pursuant to Article 93 (3) of the Treaty.

The aid to TAP cannot be considered compatible with the common market pursuant to Article 92 (2) of the Treaty and Article 61 (2) of the Agreement, since the aid does not correspond to any of the hypotheses under those provisions.

Article 92 (3) (a) and (c) of the Treaty and Article 61 (3) (a) and (c) of the Agreement provide for exceptions in respect of aid to promote or facilitate the development of certain regions. The Portuguese authorities maintain in their notification that the aid could be considered compatible with the common market as regional aid because aid to air transport is fundamental in the context of regional development.

Portugal, which is a peripheral, less-favoured country in the context of the Community, would be left, as a consequence of the disappearance of its flag carrier, highly dependent on carriers based abroad and this would seriously compromise the strengthening of economic and social cohesion. Moreover, the disappearance of TAP would add to the increase in the number of unemployed people in Portugal at a time when the protection of employment is a priority policy of the Community itself. The Commission cannot accept the Portuguese Government's arguments, because the aid in favour of TAP is not an open regional scheme which is accessible to every undertaking operating in Portugal. The capital increase and the guarantees are *ad hoc* measures aimed at financing the restructuring measures. The same is true for the tax exemption which does not have any regional character.

As regards the derogations pursuant to Article 92 (3) (b) and (d) of the Treaty and Article 61 (3) (b) of the Agreement, it is apparent that the aids are neither intended to promote the execution of an important project of common European interest nor to promote culture and heritage conservation. Indeed, the Portuguese Government has not invoked these provisions in the notification.

VIII

With regard to the exception pursuant to Article 92 (3) (c) of the Treaty and Article 61 (3) (c) of the Agreement for aid to facilitate the development of certain economic activities, the Commission may consider some restructuring aid to be compatible with the common market if it meets a number of conditions (see the *Eigth Report on Competition Policy* (1978), point 176). Those conditions must be seen in the context of the two principles enunciated in the abovementioned Articles: the aid must be required for developing the activity from the standpoint of the Community and the aid may not adversely affect trading conditions to an extent contrary to the common interest (1).

Those criteria have been interpreted in a sectoral (aviation) context in memorandum No 2 of 15 March 1984 on the development of Community policy on air transport (COM(84) 72 final), which stipulates that the Commission may, in certain cases, decide in accordance with Article 92 that aid may be granted to individual airlines which have serious financial difficulties, provided certain conditions are met:

(a) the aid must form part of a programme, to be approved by the Commission, to restore the airline's commercial viability, so that it can, within a reasonable short period, be expected to operate viably without further aid;

(b) the aid in question must not transfer the difficulties from that Member State to the rest of the Community;

(c) any such aid must be structured so that it is transparent and can be verified.

Taking into account increased competition, and in particular progressive liberalization of air transport, following the adoption of the third liberalization package (Council Regulations (EEC) No 2407/92 (2), (EEC) No 2408/92 (3) and (EEC) No 2409/92 (4), the Commission must follow a strict policy of controlling State aid in order to avoid its having effects contrary to the common interest.

As regards Article 92 (3) (c) the Portuguese Government maintains that the aid might qualify for this derogation because the plan is a programme aimed at restoring the viability of the company. The company would at the end of the restructuring be financially autonomous and would then be partly privatized. The plan would not transfer TAP's difficulties to its competitors because it would be impossible for it to pursue a policy of expansion. In addition, the company would decrease its supply as a whole because it would reduce its fleet and abandon a number of routes in Europe.

TAP's problems are mainly caused, was explained by the Portuguese Government, by inefficient management in the past, as well as the obligation of the airline to comply with onerous public requirements conflicting with its commercial interests. A well-structured restructuring programme could restore the airline's viability in the medium term and help it to adapt to the new competitive environment created by the achievement of the Community liberalization process.

The Commission verified whether the conditions laid down in Article 92 (3) (c) of the Treaty and Article 61 (3) (c) of the Agreement are fulfilled, to asses whether the aid is compatible with the common market.

(1) See the judgment of the Court of Justice in Case No 730//79, Philip Morris BV v. Commission, [1980] ECR 2671.

(2) OJ No L 240, 24. 8. 1992, p. 1.
(3) OJ No L 240, 24. 8. 1992, p. 8.
(4) OJ No L 240, 24. 8. 1992, p. 15.

1. The Commission verified the present situation of the civil aviation industry.

In the first half of 1994, the civil aviation industry appears to have virtually recovered from the economic crisis triggered by the Gulf war in the second half of 1990. Passenger traffic increased by 14 and 9 % in 1992 and 1993 respectively (source AEA). This strong growth trend had been confirmed by the results recorded in the first months of 1994 (January to March), when passenger traffic grew by 9,1, 9,9 and 14,1 %, respectively, over the corresponding period last year. Despite these positive results some of the European airlines are still loss-making. One of the main causes of the losses lies with the worldwide economic recession, which has amplified the effects of the Gulf crisis and has had tremendous effects in the air transport sector, which is particularly sensitive to changes in the general level of economic activity. Many passengers travelling in business class, which is traditionally a high-yield sector of activity, are seeking lower tariffs and this contributes to the poor financial results of the airlines. Another factor which has negatively affected the results of the companies is represented by investments in aircraft at the end of the 1980s on the basis of optimistic commercial programmes. The delivery of those aeroplanes has caused overcapacity because the important increase in supply has not been matched by a corresponding increase in demand. For many airlines load factors are still not sufficient to achieve commercially viable operation and thus, in order to fill the aircraft, they are obliged to offer promotional fares even in the winter season.

However, the prospects for the European aviation industry in the medium term are (1994 to 1997) quite positive. (The forecast annual increase in traffic is around 6 % ; see IATA annual report for 1993.) Overcapacity would appear to be, in the light of these dates, a temporary phenomenon that might be overcome by 1995. (See communication from the Commission, the way forward for civil aviation in Europe, COM (94) 218 final, p. 7). This is confirmed by the steady increase in load factors during the first months of 1994.

In the light of the above, the Commission considers that the European air transport market is not affected by a structural over-capacity crisis and that the state of the aviation industry does not require general capacity cut-backs.

2. The Commission assessed the plan pursuant to Article 92 (3) (c) of the Treaty and Article 61 (3) (c) of the Agreement.

On the basis of the further evidence provided by the Portuguese authorities (see Chapter VI), the Commission considers that the restructuring of TAP will contribute to the development of the air transport activity in a peripheral area of the EEA.

In this respect the Commission fully understands TAP's role as the largest Portuguese air carrier, which is entrusted, among others, with the operation of the routes between Portugal, the rest of the EEA, and the former Portuguese colonies.

On the basis of the information and clarifications provided by the Portuguese authorities in the course of the Article 93 (2) procedure, the Commission has reached the conclusion that the plan is sufficiently well structured and, if correctly implemented, could bring about a genuine restructuring.

This is substantiated by the fact that as regards the efficiency and productivity targets the Commission is of the opinion that the productivity target of 366 000 ATK/employee (excluding the employees responsible for the third-party maintenance and ground-handling activities) is an objective that is both necessary and realistic and represents a very acceptable figure. In this respect it should be recalled that TAP's handling and maintenance departments are very large and that TAP provides maintenance and handling services, in particular to third parties, to a very large degree. On the basis of information on third-party work done by other European airlines in the maintenance and handling sector, it is possible to compare the efficiency of TAP's aviation business (excluding all maintenance and handling) with the same core business of other European airlines, using averages. In fact, TAP aims at increasing its efficiency (measured in ATK/employee, excluding handling and maintenance) to 625 000. This appears to be a very acceptable target compared with the average level of efficiency of major European airlines who achieved in 1992 about 400 000 ATK/employee (again, excluding maintenance and handling). Even if one assumes that these airlines will considerably increase their productivity in the next four years TAP's efficiency target compares favourably with the developments to be expected in other Community carriers.

The Commission acknowledges that the plan presented by the Government and the scenario examined by the consultants are based in part on different, but not necessarily incompatible, assumptions. In particular the plan is based on the assumption of no yearly wage increase in 1993 and 1994 and an average yearly increase of 3 % in the period 1995 to 1997, while the consultants assumed an average wage increase of 5 % per year. Another important factor is represented by the savings from TAP's pre-retirement scheme, which are not taken into account by the consultants. The pre-retirement scheme will entail a cost of only Esc 21 billion, which is Esc 7,9 billion lower than the cost forecast by the consultants (Esc 28,9 billion). The paper drawn up by the consultants must be regarded as a preliminary study which has been taken into account by the Portuguese authorities when drafting the plan.

The company will greatly improve its operating results, which reflects the real operating performance, over the restructuring period. The operating result, which was negative in 1993, shows steady improvements during the period of restructuring to become positive in 1996. The fact that the net result reaches a positive value only in 1997 is mainly explained by the financial charges that TAP will bear in the first three years of the plan. A successful implementation of the plan will allow TAP to wipe out its short-term liabilities and achieve an interest cover ratio (operating result/financial charges) of 1,72 by 1997. This figure appears to be acceptable under the terms of the restructuring which will only be finalized by the end of that year.

The overall aid under examination is to be granted to restore the financial balance and enable the airline to achieve a financial situation credible to financial institutions. It cannot be doubted that the recapitalization of a company which because of its negative net worth cannot borrow on a stand-alone basis, is an essential element of any restructuring plan. The Portuguese Government considers that the aid is proportional to the needs of the restructuring and is sufficient to finance return to commercial viability. Moreover, the tax exemption will be abolished by the end of the restructuring. The Commission takes note of this statement and points out that the aid must be the last for the duration of the plan (1). As regards the guarantees the Commission notes that they will allow TAP to raise part of the funds necessary to its restructuring and requires that the terms and conditions of its letter of 5 April 1989 be adhered to.

The Commission notes the commitment from the Portuguese authorities to initiate in 1997 the procedures leading to the partial privatization of TAP. The Portuguese Government has provided figures which show that TAP has already successfully implemented its plan during the first months of 1994 (for example: according to the plan the operating result for the first quarter of 1994 should have been minus Esc 7 985 millon, whereas the actual operating result was minus Esc 6 944 million. As regards the implementation of the social measures of the plan, the Commission notes that there is steady progress on job reduction as well as discussions with the unions.

On the basis of the above the Commission considers that it can positively assess the plan in question. However, the Commission needs to be assured that the plan will be correctly implemented in accordance with the abovementioned objectives. To this end, the Portuguese Government has agreed to report to the Commission on the progress of TAP's restructuring programme; this report will be submitted to the Commission at least four weeks before the payment of the second, third and fourth instalments in 1995, 1996 and 1997, in order to give the Commission the opportunity to comment if necessary.

With regard to the method for calculating compensation of the deficit on the routes to the Atlantic islands, the Portuguese authorities have shown that this method involves compensation which is equal to or slightly lower than the deficit incurred. Consequently, the chosen method cannot lead to substantial losses and jeopardize the success of the restructuring.

In the light of the foregoing the Commission considers that TAP's restructuring contributes to the development of the air transport sector from a European point of view.

3. The Commission verified whether the aid does not affect trading conditions to an extent contrary to the common interest.

In the light of the state of the European air transport industry (see above) and the characteristics of the plan, the Commission has concluded that the possibility that the aid might adversely affect the competitive position of TAP's competitors is more speculative than real, as is explained below. The clarifications and assurances provided by the Portuguese Government (see Chapter VI.3) have enabled the Commission to rule out the possibility that the aid might have adverse effects on competition. With regard to commercial strategy, the Commission notes that TAP has no market share expansion objectives; it does not intend to open any new European routes, its only objective being to rationalize its network. Furthermore, by abandoning a number of European routes, the airline should reduce its total market share, and capacity (measured in terms of seats) for the European market will be considerably reduced (from 3 499 seats in 1993 to 3 168 seats in 1997). This reduction reflects a decrease of 9,5 % in the supply on the European market at a time when this market is expected to grow by over 6 %. This is further substantiated by the fact that TAP, whose supply was 4 688 million APK in 1993, forecasts for the European market in increase in capacity of only 11,4 %:

(1) See Commission Decision 94/118/EC of 21 December 1993, Aer Lingus; OJ No L 54, 25. 2. 1994, p. 30.

— 1994 : 4 877 million APK,

— 1995 : 4 949 million APK,

— 1996 : 5 085 million APK,

— 1997 : 5 225 million APK.

This growth, which is well below the forecast increase in traffic for the industry (according to the statistics of AEA/RB4-County Forecasting Models of 16 June 1993, traffic should increase by 6,8 % per year, which represents 30,1 % over the restructuring period), will be readjusted on an annual basis, in case the real growth of the relevant EEA market is lower than TAP's growth indicated above.

The Commission takes note of TAP's forecast of supply and considers that the abovementioned ceilings must be adhered to, so as to avoid any risk of the aid's being detrimental to the position of TAP's competitors.

Moreover, the Commission has obtained assurances from the Portuguese Government that the aid will be only used for the restructuring purpose and not to buy additional shareholdings in other EEA airlines.

The Commission takes duly note of the assurances and commitments given by the Portuguese Government regarding the implementation of the rules on access to the common aviation market and the interpretation to be given to certain provisions. The Commission is of the opinion that the removal of constraints protecting TAP from competition represents an appropriate compensatory justification for the granting of the aid, which serves the common interest pursuant to Article 92 (3) (c) of the Treaty and Article 61 (3) (c) of the Agreement. In particular, the Portuguese Government has :

— confirmed that the liberalization of the non-scheduled transport between all Community airports and the Archipelago of the Azores, refers to all the services, as expressed in Regulation (EEC) No 2408/92, including the 'seat-only charter' and 'one-way charter'. This means that these types of air services will be authorized notwithstanding that the Azores are temporarily excluded from the application of Regulation (EEC) No 2408/92,

— reaffirmed its determination and willingness to follow in 1995 a public tender procedure for the connections between the Portuguese mainland and the islands of Madeira and the Azores in accordance with Article 4 of Regulation (EEC) No 2408/92. Moreover, it is the intention of Portugal to inform the Commission during the first half of 1995 about the contents of the obligations of these public services, in order that they may be published in the *Official Journal of the European Communities*. In that respect the Commission recalls that Article 4 of that Regulation means that the contents of the public service obligations are to be separately published in the *Official Journal of the European Communities*. Following publication, should no European carrier declare its readiness to fulfil these public service obligations, the right to operate such services shall be offered by public tender either singly or for a group of such routes to any European air carrier entitled to operate such air services.

With regard to TAP's monopoly on ground-handling, the Commission, given the lack of liberalization measures at a Community level, is satisfied with the fact that every airline may self-handle at Portuguese airports.

IX

In the light of the above, the aid to be granted by the Portuguese Government to TAP in the form of increase in capital, borrowing guarantees, and exemption from taxation over the restructuring period may benefit from an exemption pursuant to Article 92 (3) (c) of the Treaty and Article 61 (3) (c) of the Agreement, provided that certain conditions are fulfilled,

HAS ADOPTED THIS DECISION :

Article 1

The aid in favour of TAP, to be granted during the period 1994 to 1997, in the form of a capital increase of Esc 180 billion, to be paid in four tranches, borrowing guarantees up to a maximum of Esc 169 billion, and tax exemption, aimed at its restructuring in accordance with the plan and the commitments given by the Portuguese Government, including its partial privatization are compatible with the common market and the EEA Agreement pursuant to Article 92 (3) (c) of the Treaty and Article 61 (3) (c) of the Agreement, provided that :

(a) the payment of the second, third and fourth tranches is subject to TAP's achieving the forecast operating results ;

(b) the tax exemption in favour of TAP is abolished at the end of the restructuring period (31 December 1997) and the borrowing guarantees comply with the condition laid down in the Commission's letter to Member States of 5 April 1989 ;

(c) TAP does not increase its supply beyond the figures provided to the Commission (see Chapter VIII, point 3), to be adjusted on an annual basis should the real growth of the relevant EEA market be lower than TAP's growth ;

(d) the Portuguese Government will submit annual reports on the restructuring of TAP at least four weeks before the date of the payments in 1995, 1996 and 1997. Should the Commission decide, after consultation with the Portuguese Government, to appoint an independent expert to examine the progress of the restructuring plan and compliance with the conditions attached to the approval of the aid, the Portuguese Government will postpone the date of the payment by another four weeks in order to allow the Commission to make comments if necessary;

(e) the Portuguese Government fulfils its commitment to apply Article 4 of Council Regulation (EEC) No 2408/92 to the Atlantic Islands of Madeira and the Azores as of 1 January 1996 at the latest, publishing public service obligations for the individual routes in question (see Chapter VIII, point 3);

(f) the Portuguese Government honours its commitments that the liberalization of non-scheduled transports between all Community airports and the Azores refers to all services, as expressed in Regulation (EEC) No 2408/92, including the 'seats-only' and 'one-way charter';

(g) the aid is used only for the restructuring purposes and not to acquire additional shareholdings in other carriers of the EEA;

(h) the Portuguese Government refrains, in accordance with Community law, from granting any further aid to TAP.

Article 2

This Decision is addressed to the Portuguese Republic.

Done at Brussels, 6 July 1994.

For the Commission

Marcelino OREJA

Member of the Commission